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TWO - Q4 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 fourth-quarter 2013 financial results conference call. At this time all participants are in a listen only-mode. Later, we will conduct a question and answer session and instructions will follow at that time.

(Operator Instructions)

As a reminder today's conference is being recorded. I would now like to turn the conference over to Miss July Hugen, you may begin ma'am.

July Hugen - *Two Harbors Investment Corporation - IR*

Thank you, Kevin, and good morning. Welcome to our fourth-quarter 2013 financial results conference call.

With me this morning are Bill Roth, Chief Investment Officer; and Brad Farrell, Chief Financial Officer. Tom Siering, President Chief Executive Officer is unable to join us today due to a bad case of the flu, although he looks forward to speaking with all of you again soon. Bill will be giving a brief overview of the full year and fourth quarter, Brad provide information about our financial results, and Bill will close with a portfolio update.

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 and the SEC's website.

This call is being broadcast live over the Internet and may be accessed on our webpage in the Investor Relations section under the events and presentations link. We 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 future looking statements, forward-looking statements if later event proven to be inaccurate.

Before we discuss fourth-quarter and full-year results I wanted to mention that we will be hosting an analyst and Investor Day in New York on February 20. The event will feature special guest speaker, James Grant from Grant's Interest Rate Observer. We hope you can attend the event. There's limited space available so please contact me to RSVP if you have not already done so.

I would now turn the call over to Bill who will provide some highlights as summarized on slide 3.

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

Thank you, July. Good morning, everyone and thank you for joining us today. Before I delve into the quarter I would like to recap 2013, which was an excellent year for us despite a volatile environment with respect to both interest rates and mortgage spreads. I am pleased to report that we generated a return on book value of 10.4% for the year, delivering strong results in a challenging year for fixed income and the sector. We also made significant accomplishments on a variety of new investment initiatives during the year, which I will discuss more fully later.

Let me touch on our fourth-quarter and full-year financial results. Our book value was $10.56 per share December 31, representing a quarterly return on book value of 4.5% when combined with our fourth-quarter dividend of $0.26 per share. We recorded comprehensive income of $171.4 million or $0.47 per weighted average diluted share during the quarter, and for the full-year we generated $327.3 million in comprehensive income, representing a return on average equity of 8.5%.

For the quarter ended December 31 we reported GAAP and core earnings of $0.66 a share and $0.21 per share respectively. And importantly, all of these metrics are consistent with our expectations when we set the fourth-quarter dividend.

Let's touch on our stock repurchase program. For the year we repurchased approximately 2.5 million shares. Our total authorization is for 25 million shares, so we have capacity to continue to repurchase stock.

We did not repurchase any stock in the fourth quarter as we believe it was not advisable under securities laws due to the anticipated public announcement of various matters, including the Flagstar MSR transaction, and our subsidiaries FHLB membership that came later in the quarter. Going forward, we will continue to consider share repurchase opportunities available to us in an effort to optimize value for our stockholders.

In the fourth quarter, approximately 511,000 of our warrants were exercised before they expired on November 7. The warrants were delisted from the NYSE upon their expiration, leaving $3.6 million that were not exercised. No warrants remain outstanding.

Turning to slide 4. During 2013 and the fourth quarter we continue to make strides on several initiatives that have allowed us to develop a high-quality operational platform that spans multiple components of the mortgage market. We believe this infrastructure will allow us considerable investment flexibility.

I will comment more fully on MSR in the conduit later as part of my portfolio overview, and Brad will discuss the implications of our wholly-owned subsidiary been granted membership to the Federal Home Loan Bank of Des Moines. We are excited about this relationship as it will provide us access to long-dated financing and to a variety of products and services offered by the FHLB.

Please turn to slide 5. There are a variety of economic and policy-related factors important to our business, several of which are on this page. Of particular interest are interest rates, unemployment metrics, housing prices, and potential changes in policy.

We certainly continue to monitor the Fed's reduced monthly purchasing of agency MBS and US Treasuries, as this impacts both interest rates and mortgage spreads. We believe this is the first in multiple steps in the tapering process likely to unfold throughout 2014.

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

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thank you, Bill and good morning, everyone. Last evening we announced comprehensive of income of $171 million or $0.47 per weighted share, resulting in a 17.7% return on average equity, and an increase in our stockholders equity to $10.56 after adjusting for the quarterly dividend of $0.26 per share.

Let's turn to our book value roll forward on slide 6. Approximately two-thirds of this quarter's comprehensive income or economic return equivalent was driven by our credit strategy, as our nonagency RMBS portfolio recognized realized and unrealized valuation gains. The remainder of the economic return was largely driven by yield or carry on our rate strategy, which includes MSR. Mortgage servicing rates contributed to quarterly returns for the first time in our history, due to the recognition of net servicing income in the month of December as a result of the acquisition of the Flagstar MSR.

In Tom's absence, I would like to step into his shows for a moment and commend Bill and his team for a strong result in a volatile year. The return outpaced the sector and it illustrated the importance of excellent portfolio management and risk management strategies. Well done, Bill and his team.

Now please turn to slide 7. Core earnings of $0.21 per weighted share represented a 7.9% annualized return on average equity. The $0.21 per share is consistent with our expectations for the quarter as we continue to defensively positioned our portfolio and manage an appropriate amount of excess liquidity in anticipation of the Flagstar MSR settlement.

Core earnings increased by $8.7 million on a quarter over quarter basis, primarily due to investments in MSR and an increase in deploy capital. Our implied debt-to-equity ratio, which includes our TBA position, was 3.1 times and 3.2 times at December 31 and September 30, respectively.

Although our capital is more fully deployed as compared to the prior-quarter end, a sizable portion of our capital is now deployed to MSR, which is unlevered. While we continue to believe a low leverage profile is prudent given the risk profile in the market, this profile also frees up capital for us to allocate to alternative, more attractive investment initiatives, including our MSR and conduit activities.

Our other operating expense ratio as a percent of average equity moved modestly higher on a quarter over quarter basis to 1.3%. The increase was largely due to incremental professional expenses and associated transaction cost on MSR activities, and the amortization of certain business combination costs. Looking ahead, certain operating expenses will ebb and flow in concert with the evolving contractual and infrastructure needs of our MSR and conduit initiatives.

I would now like to briefly touch upon multiple accounting topics. First, I would like to point out that our MSR assets increased from approximately $16 million as of September 30, to $514 million at year end. It is important to note we have chosen to account for this asset at fair value.

Although this decision will potentially generate further volatility in our GAAP income statement, it is consistent with our objective to have stockholders equity represent a fair value measurement. Beginning with our 2013 10-K, we will breakout MSR separately on the balance sheet, as well as provide additional detail around servicing income and the assets collateral attributes.

Second, we did not recognize any other than temporary impairments in the quarter, but we did release approximately $62 million of credit reserves on our nonagency RMBS. The release of credit reserves was driven by continued improvement in the performance of our nonagency holdings.

Our taxable income and dividend distributions are highlighted on slide 8 and 9. For the year, we declared dividends of $772.9 million, due to combination of forecast dividends and our special dividend of Silver Bay stock. As previously stated, separate from the Silver Bay dividend, it was 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 distributive $427.1 million, which equates to approximately 100.3% of our taxable income at December 31 when combined with a carryover from last year of $10.7 million.

On slide 8 I would like to point out one thing regarding the Silver Bay special dividend and it's 1099 treatments. In accordance with US tax law the Silver Bay shares cannot be treated separately from our cash distributions.

As shown on slide 9, we had taxable income of $425.6 million, which represents 55.1% of our total distributions of $772.9 million for the year.

As such 55.1% or approximately $1.17 per share of our total distributions for the year will be treated as dividend income, with the remaining $0.95 per share treated as a return of capital to Two Harbors stockholders. Please reference the Investor Relations section of our website for additional information regarding the dividend and tax treatment.

As indicated by these Slides, taxable income was the largest driver of our dividend distributions in 2013 due to our Silver Bay distribution intentions. However, as always, we weigh many factors in our dividend declarations. One of the most important factors is our comprehensive income. As we have previously noted, the ability to protect and grow book value is the most meaningful metric as it relates to our long-term ability to distribute dividends.

Please turn to slide 10. I would next like to spend some time discussing our recently announced membership with the FHLB of Des Moines, as well as an update on the repo markets.

After several months of discussions, our subsidiary was approved for membership in the FHLB in the fourth quarter. As a member of the FHLB, our subsidiary has access to a variety of products and services offered by the FHLB, including secured advances. As of December 31, 2013 we have not requested any secured advances and had $1 billion of available uncommitted credit for borrowings, which amount may be adjusted at the sole discretion of the FHLB.

Our ability to borrow from FHLB is specific to our continued credit worthiness, pledging a sufficient eligible collateral to secure advances, and compliance with certain agreements between us and the FHLB. Each advance will acquire approval by the FHLB.

Eligible collateral securing the advances may include conventional, one to four family residential loans, agency mortgage-backed securities, and nonagency mortgage-backed securities with an A rating and above. We value our new relationship with the FHLB and the additional source of financing as we work toward achieving our objective as a leading capital provider in the mortgage industry.

Turning to slide 11. Through year end the repo markets generally functioned in a normal manner, and we have not experienced any meaningful shifts in financing haircuts or repo rates. We continue to maintain a lengthy maturity profile, with an average of 72 days to maturity at December 31.

One additional point we would like to highlight with regard to the repo market is that it appears the Basel committee will loosen its leverage ratio definition, we believe this will ultimately quiet any fears of increased volatility in the securities financing market over the coming year or two. We will continue to monitor these regulatory activities closely.

Given the changes to our balance sheet over the last several quarters, we are always exploring opportunities to further diversify and improve our funding position. Our low-leverage, cash-funded collateral, and available capacity with counter-parties, provide us with both the flexibility to manage through market volatility, and the capability to continue to deploy capital to the most attractive investment opportunities.

Now I'd like to turn the call over to Bill for our portfolio of day.

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

Thanks, Brad. Please turn to slide 12. As I noted earlier, in the fourth quarter we generated a return on book value of 4.5%, bringing our full-year return on book value to 10.4%. Our philosophy of maintaining conservative positioning (inaudible) interest rate exposure and leverage, as well as our use of a variety of hedging strategies, served us well in 2013's challenging markets. These enabled us to have solid returns for the year, both on an absolute basis and relative to the performance in the sector.

This year we have meaningfully grown our investment in MSR, and continue to expand the foundation of our conduit business, both of which position our portfolio for continued performance in the future. I will touch more on these later.

Turning to quarterly results. Both our rates and credit strategies delivered strong returns in the fourth quarter. On the bottom left of slide 12, you can see that for both the quarter and the year, we outperformed the 50/50 benchmark indices with outperformance of 340 basis points in the quarter and over 600 basis points for the full year. This strong result was driven by our overall positioning and portfolio and risk management strategies.

Returns available in the agency space today continue to be tight. As such, we have remained focused on maintaining a low-leverage and risk profile and high liquidity to be able to fund additional investments in more attractive opportunities, including MSR where we can get better returns. We anticipate better opportunities in the agency space later this year as the Fed winds down their purchase program and spreads normalize.

On the top right of slide 12, you can see a dramatic improvement in rate strategy yields, which were driven by slower prepays on IO and inverse IO, and the contribution from MSR. Our credit strategy also had another good quarter; continued improvement in housing metrics and job growth lead to better performance on many of our holdings, and as a result, the portfolio experienced price appreciation during the quarter. Additionally due to this better performance, we released over $62 million in credit reserves.

Continuing the trend from prior quarters, we also sold some high-dollar price nonagency bonds that had realized the upside optionality we had hoped to achieve. Given the backdrop of expected higher home prices and a continuation of better borrower performance, we continue to maintain a substantial holding of lower-dollar price nonagency bonds, which had an average market price of $66 at December 31.

Please turn to slide 13. Our portfolio as of December 31 was $13.7 billion, including $10.2 billion in the rate strategy and $3.5 billion in the credit strategy. Our portfolio composition reflects a 57% capital allocation to rates, which is comprised of 44% to agencies and 13% to MSR. MSR have become a larger component of our rate strategy, and our aim is to continue increasing our capital allocation to MSR over time.

Turning to slide 14. Our implied debt-to-equity ratio for RMBS agency derivatives and mortgage loans held for sale net of TBA is 3.1 times, largely in line with 3.2 times at the end of the third quarter. This position is reflective of the generally tight agency spreads that were in place for much of 2013, and therefore why we have been carried low leverage on our agency portfolio.

Our nonagency CPR fell somewhat in the quarter to 3.8%, due largely to seasonal. As a reminder, we have modeled our nonagencies with fairly Draconian assumptions of 1 to 2 CPR for life. Higher prepays on this portfolio over time can greatly enhance our performance metrics. For more on our rates and credit holdings, please look at appendix slides 25 through 27.

Moving to the upper right-hand side of this slide, let's discuss interest rate exposure. For most of 2013 we had very limited exposure to both interest rate and mortgage basis risk, but this past spring we were pretty significantly net short interest rates. We covered this short after the big rate back up, and today continued to carry a low overall exposure to rates.

It is worth noting that this exposure includes duration measures for all of our holdings, including MSR, nonagency and loan positions, as well as all associated rate hedges. Also, given generally tight agency MBS spreads, the improving US economy and the Fed's tapering actions, we expect to maintain a low basis risk exposure for the near future. You can find additional details on our financing and hedging strategy in the appendix on slides 23 and 24.

Please turn to slide 15. In late December we announced a substantial bulk MSR deal with Flagstar Bank with an unpaid principal balance of $40.7 billion. This bulk deal consisted of Fannie and Ginnie production and with largely post-2010 production. Flagstar will provide the ongoing sub-servicing for the mortgages. This represents an exciting step towards building a meaningful MSR portfolio, and it aids greatly in our hedging of both interest rate and mortgage basis risk.

We also previously disclosed that we have a two-year flow arrangement in place with PHH, where we will purchase 50% or more of PHH's MSR on new origination production, subject to pricing terms and agency approvals, with PHH providing the sub-servicing. We believe this will provide a steady stream of MSR investment for us from a high-quality originator.

The continued growth of our MSR portfolio is important to our long-term portfolio positioning. MSR are not only attractive from the perspective of offering a yield higher than currently available on agencies or nonagencies, but they also offer the opportunity to reduce our hedge cost as they are a negative duration asset. The yield, combined with the reduced cost of swaps and swaptions, could add 150 bit to 250 basis points to the agency strategy.

We continue to make significant strides towards building the infrastructure necessary to support our operational platform so that we can grow this initiative even further over the next few years. We have added staff to support both MSR and the conduit, including building our technology infrastructure, servicing oversight, and underwriting capabilities, which we will continue to develop based on the market opportunities. Importantly, the infrastructure necessary for MSR nicely complements the conduit and vice versa offering operating efficiencies.

As we turn to slide 16, let's talk about the conduit. In 2013 we completed two prime jumbo securitizations, totaling over $800 million. In the first quarter we participated in the securitization with Credit Suisse, and in the third quarter we closed Agate Bay 2013-1, a $434 million securitization, which was the first using our own depositor. Both of these deals enabled us to invest in attractive credit and IO bonds.

More importantly, having a top-tier conduit platform going forward allows us to opportunistically create attractive credit assets for our portfolio, and also creates the ability for us to source MSR and other loan products in the future. Continuing to expand our network of high-quality originators remains a key focus for 2014.

2013 was an exciting year for Two Harbors. First, we are proud of our ability to have successfully navigated the dramatic moving interest rates and volatile spread environment. At the same time, we executed several MSR deals, completed two prime jumbo securitizations, including the first using our own depositor, and began developing an expensive pipeline of originator partners, while building the infrastructure necessary to support these initiatives.

In the process, we have created a nimble, industry-leading operational platform that positions us to take advantage of a variety of opportunities in the housing finance space in the coming years, and to increase the value of the Two Harbors franchise. Having the ability to directly source assets for our portfolio, combined with our investment team's ability to capitalize on opportunities in the securities market, we believe uniquely positions us to best deliver for stockholders.

I would now like to turn the call back to Kevin.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Douglas Harter, Credit Suisse. Douglas, your line is open.

Douglas Harter - *Credit Suisse - Analyst*

Sorry about that. Good morning, Bill. You guys have remained sort of with low leverage and more defensively positioned, I guess can you look out as we go through 2014 kind of what would be the opportunities that you're looking for to move to sort of a more normalized level of leverage?

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

Doug, good morning, thanks for joining us. First of all, the best thing we can do with $1 today, as we've said numerous times over the past several months, is to invest in MSR. That's -- I don't think what you're referring, I think you're more alluding to the agency side. And if you look at agency spreads going back 10 years or longer sort of get through all sorts of different environments, you'll see generally and depending what data you look at, we're anywhere between 15 and 30 basis points tighter been sort of average.

And so it's our belief that the agency -- for spreads to normalize, we would expect to see a widening from where they are today. We are seeing a limited amount of opportunities in certain parts of the agency space that are sort of low-double digit, but without taking any duration risk, it's very hard to justify putting a bunch -- increasing our leverage until we see wider spreads. So if wider spreads come about later in the year as the Fed reduces their program, that'll be a good opportunity for us to increase our leverage.

Douglas Harter - *Credit Suisse - Analyst*

And I guess how do you view the opportunity to do other large bulk MSR acquisitions, whereby you could essentially pick up your leverage on book to fund that?

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

So we're in constant dialogue with a number of potential partners in that, as well as the servicing brokers who show packages to us multiple times a week. So it certainly depends on our ability to source and close deals, as you know these things can take a number of months. But I mean we are, I think we've established that we're a credible partner, we have two excellent relationships with PHH and Flagstar, and we're certainly working on continue to expand that. But I don't have anything specific to say further about specific transactions on today's call.

Douglas Harter - *Credit Suisse - Analyst*

All right, thanks, Bill.

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

Thank you.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Bill, could you just give us your kind of high-level thoughts on what the ROEs are generally available to right now in your defensive investment opportunities?

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

Sure, Mark. Good morning, thanks for joining us. Yes. And so on the agency space, as I mentioned just a minute ago, we're seeing a very limited amount of opportunity for low-double digit returns. And you know you have to remember that we look at these things carrying leverage in the 6 to 7 times with fully hedging out the duration risk. So clearly if you use more leverage or you take duration risk, those numbers can obviously be higher.

But away from that, I would say most agency opportunities are below 10%. An the nonagency side, prices have held really quite nicely despite some of the emerging markets of people we've had, I mean US housing has got good tailwinds, et cetera. So yields on non-agencies are sort of in the 5% plus or minus, so that gets you on an ROE basis into the high-single digits. And I mentioned earlier MSR, we said in the past that MSR yields on new production, prime, are sort of high single -- these are expected yields, obviously it depends on what the prepayments are. But expected yields are high-single digits to low-double digits, and that's unlevered.

So the reason we're focusing on that is because if you combine that with being able to buy agency pools, that combination gets you, on an ROE basis, well into the double digits, in terms of combining the MSR with pools. So that's what our number one focus is.

Mark DeVries - *Barclays Capital - Analyst*

Got it, that's helpful. And Brad I think you in your prepared comments you referenced in front of the Flagstar acquisition you were running with excess liquidity, is there anyway you can scale for us kind of what the drag on core earnings was from that?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thanks, Mark. No, I don't have any comments on that. I think if you think about the size of that capital investment, if you look at our balance sheet at year end; I think you can probably back into a reasonable estimate. But again, I think I would echo my comments as, we were strategically positioning our capital to make that large capital investment. So if you apply that thought, take a look at some of our turnover in our RMBS portfolio, I think that's the best reference I can give you.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. And then just one last question. Can you talk a little bit about the relative cost of FHLB advances to you versus a comparable strategy using repo and swaps versus some other tenor? And also just how big can you scale that over time? Available to borrow there?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thanks, Mark. I'll try to address that and maybe I'll make some larger comments on the FHLB relationship. Really a big thing about this is really our intent around the FHLB. I think we've historically commented that diversification our counter-parties is extremely important to us, and so we see the FHLB as an extension of this, not only to reduce our liquidity risk, but also to kind of optimize our advance rates and funding.

So with that, we really are focused on the FHLB as not as a replacement for the repo market. Really it's an opportunity that we think aligns well with our [reminidoubt]. Our conduit objective is to provide capital to the residential mortgage market. And that's where it's probably the best synergy. So a lot of these are published on the FHLB site as far as advance rates and funding costs.

But the biggest benefits of the FHLB is one, the extension of maturities, so they offer products that extend into five years, and in some cases further than that across a variety of asset classes that we hold. Lending rates are generally LIBOR to LIBOR-plus 30, but that obviously varies based on obviously the asset classes just to a certain extent, again the FHLB does publish this on their websites.

The other appeal to us is they do offer fixed and floating rates at the various terms. So again that fits really well in how we think about conduit production and prime jumbo, as well as any other type of mortgage loan production that we look at. The ROEs start making a lot of sense if we can finance that product at those rates. And again I would just stress that we don't -- with $1 billion of uncommitted capacity, we see this as a complement to our overall funding strategy and not a strategic replacement for the repo markets. The repo market will be and are critical to kind of how we fund our agency RMBS and our overall balance sheet.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Great, thanks.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thanks, Mark.

Operator

Bose George, KBW.

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

Good morning. Actually first just on the MSR, the Flagstar MSR, how much of that came through in 4Q earnings? Just wanted to make sure the run rate for that going forward?

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

Oh, yes. Hello. Well obviously thanks, Bose and good morning. That transaction settled in December and I'll let Brad talk about sort of the timing and implications of that.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thanks. So first, one clarifying point, we noted that it settled in December, we actually took the economics and the income streams effective in the beginning of December, so one month of income came through in the month of December, so that's the first important point to make.

Secondly, we've disclosed and I believe it's on slide 12, we've kind of expanded our illustration of yields. So if you look at the right side of slide 12, we show at the bottom part our legacy illustration of our RMBS-only yields, and then above, you'll see the aggregate across the entire portfolio, including MSR, mortgage loans, as well as finance holdings and our securitizations.

And so you can kind of look at the delta there and kind of get a sense of the basis point increase this quarter, and generally subject to prepayments, that's going to be the exponential increase we potentially will see going forward.

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

Great. That's helpful, thanks. Just in terms of the accounting for that MSR, do you guys get the whole servicing fee and then the sub-servicing expenses go out as an expense back to Flagstar?

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

Yes. From a cash basis, it's more of a net settlement, but from our income statement, it's shown on a gross basis. So you think about our income statement, I look at it as three buckets, you have your gross servicing income, you have your sub-servicing expenses, which obviously flows through the expense captions, and then you have our evaluation, and the evaluation of consist of both the runoff, or quote unquote amortization, as well as the market shifts in the value of that MSR.

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

Okay, great. And then actually one follow-up on the FHLB discussion. If you're assuming you have the right collateral, what are the other constraints on funding through there? If there is the need [to new been] a meaningfully increase what you fund through FHLB?

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

No, I can't really comment on that other than the FHLB as I stressed has the sole discretion on the capacity they give to us, and they can decrease that capacity or increase that capacity at their own discretion. It's an early relationship, we believe we're the first REIT that's achieved through its captive vehicle -- achieved access to that FHLB. Again, I stress that it is the captive vehicle that is the member of FHLB.

But I think we're excited about it, we think it fits really, really nicely with some of our prime jumbo asset classes, we think there's some opportunities to use in the near term. But we're more focused on using the capacity we have today, and over time we'll continue to establish that relationship and see if we can extend that capacity.

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

Okay, great. Thanks.

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

Thanks, Bose.

Operator

Trevor Cranston, JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Congratulations on a good quarter. To follow-up on the question about the income from the MSR portfolio in the fourth quarter, is there anything that's not captured in the income you recognized this quarter? Just kind of wondering, because I guess if you were to annualized the income from December, it seems like an extremely high yield on the $500 million purchase price.

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

Hello, Trevor, good morning.

Trevor Cranston - *JMP Securities - Analyst*

Hello, Bill.

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

Thanks for joining us. So I think the best way to think about the MSR, and I kind of alluded to this earlier, we mentioned that the expected yields, and I have to emphasize again expected, because it's based on our assumption on prepaids that could change obviously if the market moves. But we had mentioned sort of high-single digital to low-double digits.

And then if you think about pairing those with pools or alternatively taking swaps off, we mentioned it could be another 150 to 200 basis points. So that gets you sort of into the ROEs of certainly low-double digits if not higher. And so I think if you want to think about the value of the MSR, you can think about an ROE that's consistent with that, and compare that to ROEs that I think Mark had asked about, which generally are below 10%. So there's a huge benefit there.

Now obviously there's an expense quotient that comes into play, because we can't do that without the infrastructure we've built, but that's way offset by the increase in ROE. So I think the way we think about it is capital allocated to what that does to ROEs net of the expense and compare it to the other opportunities. The other thing I think is important to note is that the quality of that ROE is much higher, if you're just long agencies and hedging them with swaps, you have a substantial amount of basis risk. And we've seen what the results of that could look like. If you're hedging with MSR or other IO products you have a much, much higher quality hedge, because your hedging basis risk in addition to interest rate risk.

Trevor Cranston - *JMP Securities - Analyst*

Okay, that make sense and --

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

Brad you want to add to that? Because obviously that slide 12 is a bit of a new disclosure, I just want to make sure Bill, that you're not -- you're kind of so. On the bottom right we show the agency RMBS yield of 3.1%, which is consistent with our historical presentation, and above you'll see we're at 3.2%, including MSR.

Now obviously throw in some rounding and maybe look on the conservative side of the delta, I think you'll get back to the yields that Bill just mentioned. So again, that was a gross yields without sub-servicing expenses. So I think if you worked through those, I think it'll make much more sense to you.

Trevor Cranston - *JMP Securities - Analyst*

Okay. I was just looking at the income numbers on slide 15 when I was annualizing those, but that make sense.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Trevor, one more thing. I just want to caution you and others, we settled this thing in December, we had economics for one month, and trying to extrapolate one month returns for a year or forever is an extremely challenging notion. So I think we'll have a lot more clarity as 2014 plays out when we have this asset on our books for a longer period of time. So I just want everyone listening on the call to understand that one month is not indicative of what might happen over a long period of time.

Trevor Cranston - *JMP Securities - Analyst*

Yes, fair enough. And I guess to follow-up on the thought about, how the ROE has improved by also owning agency pools. I guess I was a little surprised to see you with the addition of the MSRs this quarter, I didn't see it first glance, any real meaningful changes to the hedge book? Can you comment on if there were any changes maybe in some basis risk hedges or something like that, that I might be missing?

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

Yes. Sure, thanks, that's a great question. I think it's challenging, there's a lot of things that go on in the book over the course of a quarter, whether it's change in TBA positions and associated hedges, swap hedges, or changes in pool positions, whether going from say different coupon.

So I think if you just look at the notional and say jeez, well the notional was about the same, why was that; that sort of is masked by other things that are going on in the portfolio. I think the best way to think about it is and these are high level numbers, so just take it for what it's worth, $500 million of MSR roughly is $750,000 of negative duration. Okay?

Trevor Cranston - *JMP Securities - Analyst*

Okay.

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

And that will move around depending on what coupon you have, et cetera. I'm talking about the kind of MSR that we bought. So if you said well what is that the equivalent to, that's the equivalent to about $1.5 billion of five-year swaps.

Trevor Cranston - *JMP Securities - Analyst*

Got it.

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

Okay. So irrespective of what we -- what our notional positions, did whether it's swaps or swaptions, effectively you can think about by including MSR, we were able to reduce five-year swaps by about $1.5 billion. Now it may not show up because of like I said, other things that were going on, but that's the impact.

Trevor Cranston - *JMP Securities - Analyst*

Okay, perfect. That's very helpful. Thank you.

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

Thanks for joining us, Trevor.

Operator

Rick Shane, JPMorgan.

Rick Shane - *JPMorgan - Analyst*

Hi guys, thanks for taking my question today. Just want to make sure that we're thinking about the servicing business in the correct way, which is that the potential here I understand it from an economic perspective and from a hedge perspective, but from an operating leverage perspective, the opportunity here is more on the financial leverage side, it's not really an operating leverage businesses, it's not going to scale for you per se, is that correct?

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

Yes, hi, good morning Rick. Thanks for joining us. Yes, it's the financial asset. We're not a servicer, so you shouldn't think about us as a typical servicer. Whereby, if we keep adding, we're getting operating leverage, so you are correct in that. All of our servicing is outsourced to high-quality sub servicers, as we mentioned PHH and Flagstar as a few of them. So you're correct in that.

Rick Shane - *JPMorgan - Analyst*

Got it, okay. We understood the dynamics, we understood the construct of the business, I just wanted to make sure we weren't missing something in terms of the dynamics, that's the way we were thinking about it. So appreciate the answer guys, thank you.

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

The only thing I would mention obviously is in the infrastructure that we need to support that in the conduit business, clearly there is some leverage you gain from that. You need underwriters, you need servicing oversight people, et cetera. And so if we added $25 million of MSR, we wouldn't necessarily need to add any more people. Obviously if we added another 500, you are going to require more. But there is some benefit there, but not to the extent that you would see with an operating Company.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

It's not a high scale platform.

Rick Shane - *JPMorgan - Analyst*

Got it, great. Thank you, guys.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thanks Rick.

Operator

Dan Altscher, FBR.

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

Morning. Best wishes to Tom as he gets over the flu. Bill, just a quick clarification on your comment with Trevor, did you say $750,000 negative duration, did you mean $7.5 billion of negative duration?

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

Sorry I was on mute there, I apologize. It's -- the $500 million is -- no it's about $750,000.

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

Okay. Just to also go through on your comments before of not buying back any stock in the quarter because of a variety of information that was coming out between FHLB and Flagstar, how does that maybe sit now as a potential use of cash, because I haven't really heard that mentioned at this point?

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

Yes, sure that's a great question. And yes -- we consist -- we did buy back stock in 2013. Clearly the opportunity to buy back stock, when the opportunity presents itself, that is clearly something that we're very focused on, because it obviously drives the book value higher if we buy it at a discount.

And so that's something we're always taking under consideration based on where book value is and where shares are trading at the time. So we still have over 20 million shares available to purchase, and if the opportunities presented itself, we're not afraid to use it.

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

Okay. And just a quick one also on FHLB. Understood it's not a replacement for repo, it's more of a complement, but I assume since it's going to be at the insurance company, which is a captive, it also falls into I guess a TRS. And so are there limitations there as to how big this facility can eventually get related to TRS restrictions overall for the REIT?

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

Without getting into the minutia of the structure, the captive actually is a good REIT vehicle. But regardless of that, there is no foreseeable restrictions, the restrictions are going to be limited to our relationship with FHLB, and are eligible collateral that fits nicely with our remit to providers to central mortgage support as well as their remit.

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

Okay that's interesting. And MSRs are not eligible for advances under FHLB, correct?

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

No, they are not.

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

Okay, great. Thanks so much.

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

Thanks, Dan.

Operator

Joel Houck, Wells Fargo.

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

Thanks and good morning. Wondering how should we think about the size of the MSR, I think you mentioned 13% capital allocated. And have you guys looked to maybe comment on the impact, what the impact would have been had that -- as you had that position in place at the beginning of 2013? Just to get a sense for how the relative value I guess from that hedging strategy versus the standard 100% swap strategy?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Hello Joel, good morning. Let me -- sounds like there are a couple questions there in one. So we have said in the past in a variety of forms that if you look at the size of our book that we could easily have $1 billion of market value of MSR to hedge our holdings actually probably more than that, but certainly in terms of our comfort getting to that number is very high. So obviously if we get to that number, we're constantly revisiting how much capital, and it will depend on availability, it will depend on the price, et cetera. But there's a long way to go from where we are to getting there, so we're comfortable on that for sure.

In terms of -- and just to give you further color on that, because we're focused on new origination, one of the questions that have come up is what is sort of the supply, and that's kind of different for legacy servicing. There is over $1 trillion of new production, so it's just really a question of who is making it and who we can partner up with in terms of what we'll be able to obtain of that.

And then in terms of looking backwards, the answer is honestly we haven't looked back to see what the impact would be had we had it at January 1, and carried it throughout the year. Clearly the price at the end of last year when the tenure was well below 2%, the price of MSR, the same coupon was lower than it is today.

But we're more focused on what's available today, owning it, hedging it appropriately, and earning the returns going forward. So I unfortunately can't tell you what things would have looked like, although that would be I guess an interesting exercise to go through.

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

I was curious more than anything else. I guess and the last one, and forgive me if you disclosed during the call, did you talk about the economics between -- on the jumbo securitization, how much money you made?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

We did not.

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

Will that be in the K?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

I'm sorry, so the securitization that we did in August, the 3Q securitization?

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

Yes, it was just the total economics of the securitizations you did in all of 2013?

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

Joel this is Bill, we don't do gain on sale. These are assets that we create that go into the book and generate a yield that we earn over the years, so that the yields that we earn on assets, the credit bonds, the IOs, et cetera, that we retain will be part of the portfolio and help that portfolio's yield over the years that these assets are on the books.

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

Okay, so I guess maybe a better way to ask is there expected IRR or kind of a range of IRR that you think you get from these transactions?

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

Well --

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

Based on your --

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

Yes, we didn't actually talk about specific IRRs related to the transaction that we did, we have been asked many times and I'm happy to talk about it today what we think the IRRs are on securitization at any given point in time. So in today's world the expected IRR using a little bit of leverage on the credit bonds is in the low-double digits, but I will tell you that it's a little dangerous to sort of put that in ink, because if the loan price changes or the AAA price changes because of the inherent high degree of leverage involved, the AAAs are about 93% of the capital structure, so if you came to that price by 0.5 or 1 point, the ROEs can dramatically move higher or lower.

It's our expectation that ROEs over a longer period of time will be anywhere in high-single digits to as high as 20% or more, because that's soft of the range that we've seen historically. Frankly, our interest in having a conduit, securitization of new prime jumbo has been fairly low relative to overall mortgage supply.

I think in 2013 there was about $12 billion or $13 billion done estimates from this year ranged from similar to modestly higher. We view this sort of as meaning more of a longer-term opportunity as the GSEs gets reduced. And as rate changes and cycles change, you need to be there today to be able to capture huge volumes when the market opens up, so that is sort of what we're positioning for. So I guess we're more focused on that. Brad do you want to add anything to that?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Yes. And perhaps we talked about FHLB maybe before you joined or maybe -- I mean obviously the AAA pricing as Bill mentioned, has volatility and points and may not be where we like it. One of the benefits of the FHLB is that the prime jumbo collateral does finance, generally within their collateral requirements. So that's another option for us to finance that product on our balance sheet for a period of time until or when the AAA pricing is appealing. So I think that's an important point to make in how we look at that conduit activity.

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

All right, thanks, guys.

Operator

Eric Beardsley, Goldman Sachs.

Eric Beardsley - *Goldman Sachs - Analyst*

Just curious if you can comment on what you see the most attractive channel for acquiring MSRs, whether it be through a relationship like PHH or through the bulk acquisition? And then secondly if you contemplated any other channels to acquire MSRs like becoming correspondent lender --

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

Hello Eric, thanks for joining us, that's a great question. Yes, I think we're -- we're certainly focused primarily on the first two that you mentioned. We've got obviously some solid relationships with two very high-quality large originators, and that's obviously, those guys are good counter-parties for us.

There are other midsize and smaller originators that we're in discussions with as well. In terms of bulk or flow, I think if the partner's right and the package is appealing, and the price is right, I think we're, I don't want to say we're indifferent, but both of those are viable sources for us to obtain MSR.

In terms of correspondent, we haven't really spent much time thinking about that, we've been really focused on developing partnerships with the higher-quality companies where we think they'll be decent volumes. So I'd say you should think about it more in the first to than the latter.

Eric Beardsley - *Goldman Sachs - Analyst*

Okay. Could you use your conduit for that if you want to be a correspondent down the line?

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

Well, the conduit basically the way you want to think about it is we have originator partners, but these are originators and we could get jumbo loans from them, we could get MSR. But it would be more direct one-to-one with an originator, not sort of correspondent based.

Eric Beardsley - *Goldman Sachs - Analyst*

Got it. Great, thank you.

Operator

And I'm not showing any further questions at this time, I would like to turn the call back over to July for closing remarks.

July Hugen - *Two Harbors Investment Corporation - IR*

Thank you for joining our conference call today, we greatly appreciate your interest in Two Harbors. We are attending two conferences early in the year, including the 15th annual Credit Suisse Financial Services Forum in Boca Raton on February 11, and the Goldman Sachs Equity Investor Housing Conference in New York on February 25. We welcome the chance to speak with you at either event. Until we speak next, be well.

Operator

Ladies and gentleman this does conclude today's presentation, you may now disconnect and have a wonderful day.