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TWO - Q3 2014 Two Harbors Investment Corp Earnings Call

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CORPORATE PARTICIPANTS

July Hugen *Two Harbors Investment Corporation - Director of IR*

Bill Roth *Two Harbors Investment Corporation - CIO*

Brad Farrell *Two Harbors Investment Corporation - CFO*

Tom Siering *Two Harbors Investment Corporation - President & CEO*

CONFERENCE CALL PARTICIPANTS

Douglas Harter *Credit Suisse - Analyst*

Trevor Cranston *JMP Securities - Analyst*

Rick Shane *JPMorgan - Analyst*

Mark DeVries *Barclays Capital - Analyst*

Joel Houck *Wells Fargo Securities, LLC - Analyst*

Mike Widner *Keefe, Bruyette & Woods - Analyst*

Lucy Webster *Compass Point Research & Training - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors Investment Corp third-quarter 2014 financial results.

(Operator Instructions)

As a reminder, this call is being recorded. I would now like to turn the conference over to your host for today, Ms. July Hugen, Director of Investor Relations. Ma'am, you may begin.

July Hugen - *Two Harbors Investment Corporation - Director of IR*

Thank you, Ben, and good morning, everyone. Welcome to our third-quarter 2014 financial results conference call. With me this morning are Tom Siering, President and Chief Executive Officer; Brad Farrell, Chief Financial Officer; and Bill Roth, Chief Investment Officer. After my introductory comments, Tom will provide a recap of our third-quarter 2014 results, Brad will highlight some key items from our financials, and Bill will review our portfolio performance.

The press release and financial tables associated with today's conference call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website and the SEC's website. This call is being broadcast live over the Internet and may be accessed on our website 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.

Reconciliation of non-GAAP financial measures to GAAP can also be found in the presentation. 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 forward-looking statements if later events prove them to be inaccurate. I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Good morning. Thank you, July, and thank you to our audience for joining us today. Please turn to slide 3. I will provide a brief overview of our financial results. We had a strong quarter, delivering a total return on book value of 3.8%, which brings us to 13.9% for the first nine months of the year. Considering our low leverage profile, we are pleased to report this performance.

For the quarter, we produced comprehensive income of $152.6 million, or $0.42 per weighted average diluted share, representing a total return on average equity of 14.9%. Core earnings were $0.23 per share and GAAP earnings were $0.53 per share, though we view total return as a more informative measure of our performance. These quarterly results were achieved despite some defensive positioning that Bill will discuss in a bit.

I would like to briefly discuss the mortgage loan conduit, MSR, and our RMBS holdings. We closed two securitizations during the third quarter, highlighting the momentum our conduit gained over the summer. Our pipeline is robust and we expect to be a regular issuer.

I'm pleased to announce that subsequent to quarter-end, we began working with our originator partners on high-LTV and non-prime products.There continues to be a huge national cohort of people able to responsibly purchase a home that simply haven't been able to get a mortgage heretofore. These products are intended to expand the availability of mortgage credit to such borrowers. This is an exciting development for our business and for the housing and mortgage markets.

MSR continues to be an excellent asset for our portfolio on a yield basis as a hedge to mitigate interest rate and spread risk. We have made and will continue to make a concerted effort to position our MSR platform for long-term growth and have made progress on further flow arrangements. Finally, our Agency and non-Agency's securities continued to perform well, contributing to our overall performance.

Please turn to slide 4. Now I would like to take a minute to discuss a variety of subjects that could impact our markets over the longer-term. One subject currently being discussed is the FHFA's proposed rulemaking regarding membership in the Federal Home Loan Banking system. Obviously, we are disappointed with the proposed rulemaking, but we have a strong relationship with Home Loan Des Moines and our mission aligns well with that of FHLB system.

Additionally, our secured financings are consistent with their safety and soundness mantra. The strength of our alliances is, in our opinion, underscored by the fact that the facility with the Home Loan was expanded to $2.5 billion during the quarter. We believe this highlights Home Loan's comfort with us as a counterparty and provides us with incremental long-term financing at favorable rates, which enables us to provide liquidity at better rates to borrowers.

Even if the rulemaking were implemented in its current form, final rules would not take effect for some time. We plan to submit a response during the comment period, which was recently extended to early 2015, possibly indicating that a large number of constituents plan to weigh in on this important matter affecting housing.

Let's discuss the macroeconomic environment. CoreLogic reported that home prices were up 6.4% on a rolling 12-month basis as of August 31. According to most research firms, home prices are expected to increase over the next few years, albeit likely at a lower rate than 2014. Unemployment figures improved throughout the quarter, dropping to 5.9% in September. Both metrics are tailwinds, helpful for credit performance and the potential for further non-Agency price appreciation.

While not a surprise, the Fed announced the final reduction in the asset purchases following its October 2014 meeting. Despite the end of QE, it appears the Fed will continue to make significant investments of MBS paydowns for the foreseeable future. Furthermore, it also made dovish commentary, which suggests that it will not raise interest rates until the economy can support it, the timing of which remains unclear. The interest rate curve flattened modestly in the third quarter, which as Bill will discuss, contributed to our return.

As most would agree, the health of the housing market heavily influences the psyche of our country. With the multitude of policy and regulatory changes under consideration in Washington, we have consciously increased our efforts to engage on these topics.

In September, we hired Beth Mlynarczyk as our Vice President of Policy and Strategy, who will help us be a thought leader in the industry as it relates to the housing finance policy. We believe mortgage REITs, like Two Harbors, as a permanent source of capital dedicated to the US housing market, will play an integral part in providing financing stability to the mortgage market over the long-term. With that, I will now turn the call over to Brad for a discussion of our financial results.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thank you, Tom, and good morning. I will start with our book value roll forward, which is illustrated on slide 5. Book value increased to $11.25 per share, as comprehensive income of $152.6 million, or $0.42 per weighted share, more than offset our dividend declaration of $95.2 million, or $0.26 per share.

Our rates strategy contributed 53% of comprehensive income, driven by both carry and market value appreciation on our Agency RMBS holdings. Our credit strategy accounted for 47% of comprehensive income, which includes realized gains on the sale of certain of our non-Agency RMBS.

Please turn to slide 6 for a summary of our financial results. Core earnings of $0.23 per weighted share represented an 8.1% annualized return on average equity. Core earnings was driven by low implied debt-to-equity, higher swap spread expense, and a lower other operator expense ratio.

Our implied debt-to-equity ratio, including our TBA position, was 2.7 times, a modest decrease from 3 times at June 30. Our swap spread expense was higher in the quarter due to repositioning of hedges to protect book value, which I will discuss more in a moment.

Our expense ratio declined 30 basis points, quarter-over-quarter, to 1.2% of average equit, due to lower compensation expense as a result of fair value accounting adjustments on our outstanding restricted stock and reduced legal and professional fees due to lower transactional volume. And as we have noted in the past, the other operating expense ratio will fluctuate in the mid 1% range depending on opportunities in the MSR and conduit businesses.

We occasionally get questions about the sustainability of our dividend with respect to core earnings and it is worth reiterating a point that we have highlighted in the past. Given the complexity of our assets, liabilities, and hedges, core earnings is not a primary driver of our dividend, as we make decisions based on providing total return for our stockholders, and protecting book value, which can often reduce core earnings for a period of time.

In fact, that happened this quarter as swap spread expenses moved higher because we replaced swaptions, which are not included in core earnings, due to their option structure with swaps, which are included in core earnings. While negative to core earnings, this repositioning helped our overall hedge result, which Bill will discuss. Before moving from this slide, it is also important to note that our taxable income for the full year is in line with our expectations when we set the third-quarter dividend.

Please look to slide 7 for an overview of our financing profile. The repo markets are functioning in a normal manner for us and we have not experienced any meaningful shifts in financing haircuts or rates. We maintain a diversified counterparty mix, including the addition of one new counterparty during the quarter.

As well as having 25 active counterparties, we maintain a lengthy maturity profile with an average of 100 days to maturity as of September 30, an increase from 68 days at June 30. Consistent with our past practice, we choose to roll some maturities out past year-end, to avoid potentially choppy trading around that time.

As Tom noted earlier, toward the end of the quarter, our FHLB facility was expanded to $2.5 billion. As of September 30, we had secured advances of approximately $1.5 billion, with a weighted average maturity of approximately 44 months. While our advances remain primarily collateralized by Agency securities, we continue to shift the collateral mix toward certain A-rated or better non-Agency RMBS and prime jumbo whole loans.

At quarter-end, over 35% of our borrowings were for AAA RMBS and loans. As we have stressed before, the FHLB facility is just one of many tools we use to diversify and optimize our funding mix. For more information on our repurchase agreements and FHLB financing, please see the appendix on slide 23. Now let me turn the call over to Bill.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thank you, Brad, and good morning, everyone. This is a great quarter with respect to our portfolio performance, especially considering our conservative positioning. We are also proud to report several meaningful accomplishments within our mortgage loan conduit. Let's turn to slide 8.

Our rates strategy performed well this quarter, driven largely by our positioning in shorter duration assets and from a curve flattening bias in our rate hedges. We repositioned our hedges to protect against higher short-term rates in 2015 and 2016, which contributed nicely to our performance as the curve flattened during the quarter. Our credit strategy was driven by legacy non-Agency bond price appreciation, which contributed to our book value performance.

The yields realized in our rates strategy decreased 20 basis points, quarter-over-quarter, to 3.6%. Despite this, we are pleased with the stable long-term performance of our Agency RMBS assets, and the incremental yield provided by MSR. For example, in the third quarter, realized yields in our rate strategy were up 80 basis points year-over-year, due in part to our incremental investment in MSR.

Within our credit strategy, the yields on legacy and new issue non-agencies were generally consistent with the second quarter. Our net economic interest in securitization yield declined as we chose to retain some of the AAAs from our securitizations, specifically those from the Agate Bay 2014-1 deal, due to their healthy projected ROEs. Going forward, we expect the yield on our net economic interest and securitization trust to increase as the amount of retained subs and IOs grows as a percentage of our retained interest.

Our aggregate portfolio generated an annualized net interest spread of 3%, down about 40 basis points from the second quarter. This was principally driven by higher overall swap expense from two- and three-year swaps, which we will detail later as part of our hedging discussion.

Please turn to slide 9. Our portfolio as of September 30 was $14.3 billion, including $10.4 billion in rates and $3.9 billion in credits. Approximately 56% of our capital is allocated to our rate strategy, including 44% to agencies, and 12% to MSR. The remaining 44% of capital was allocated to our credit strategy, with 7% to our conduit business.

We made two adjustments on the asset side of our portfolio during the quarter. First, we sold approximately $1.25 billion of MHA and low FICO pools, as we believe that with the improvement in housing prices, these pools might lose their prepayment protection and show faster prepays going forward. We replaced them with lower loan balance pools, which we expect will demonstrate more stable prepays over time.

Second, we finished selling the remainder of the longer reset ARMs that we held. You may recall we were trimming this position in the second quarter as these assets returned to unattractive levels. We still own a few very seasoned ARMs that, from a risk and return profile, fit nicely in the portfolio.

In general, opportunities in the Agency space remain limited during the quarter. As such, we continue to have low leverage on our Agency RMBS portfolio. We are also keeping our basis risk exposure low by focusing on shorter duration Agency assets, and through our MSR holdings, both of which serve to protect against the impact of potentially wider spreads in the future.

Our credit portfolio remains weighted toward legacy non-Agency RMBS, particularly subprime. Last quarter, we released a webinar profiling a subprime bond we held in our portfolio, housing price [appreciation] over the past few years, and how the bond outperformed our original return assumptions.

Today, affordability is about 26% better than the historical means, which indicates that homes are still quite affordable. Therefore, we expect there could be continued home price appreciation performance over the next several years. With the average market price of our non-Agency bonds in the mid-$70s, we believe upside optionality remains as the economy and housing market continue to improve.

While we have significant legacy non-Agency holdings, we are also excited about the opportunity our conduit business presents, and have increased our capital allocation to this platform from very little exposure at December 31 to over 7% at September 30. From a market value standpoint, our total net economic interest and securitization trust increased by approximately $250 million, quarter-over-quarter, to $490 million, as we retain the aforementioned AAAs along with the subs and IOs.

Finally, our prime jumbo mortgage loans held for sale increased to $419 million this quarter, versus $377 million at June 30. As a result, we expect our capital allocation to assets generated by the conduit to increase over the next few years. More on our conduit progress in a bit.

Turning to slide 10, you will see that our leverage remains low, with our implied debt-to-equity ratio for RMBS, Agency derivatives and mortgage loans held for sale, net of TBAs, at 2.7 times. Our Agency prepayments remain low and stable, dropping a bit in the quarter.

Given the recent rally in rates, it is worth a reminder that over 96% of our Agency holdings are prepay protected. On the non-Agency side, however, prepays were higher in the quarter, which given the deep discounts of our holdings, is very beneficial.

Moving to the right-hand side of the slide, there are a few items I would like to discuss with respect to hedging that Brad touched on. During the quarter, we reduced our swaptions notional by approximately $4 billion, and extended the maturity from three to five years. To offset this, we increased our notional swap position by about $4 billion, with a focus on the front end of the curve.

This repositioning intends to protect against potentially higher rates in 2015 and 2016, if the Fed decides to raise interest rates next year. It also creates a flattening bias to our hedges, benefiting if short rates rise faster than long rates. This helped drive our performance in the third quarter.

Overall, we continue to be positioned conservatively, with low interest rate and basis risk and also low leverage. For more on our rates and credit holdings, please refer to the appendix, slides 18 through 22, and see slides 24 and 25, for more information on our hedging.

Turning to slide 11, our mortgage loan conduit was certainly a highlight of the third quarter. We completed two securitizations, Agate Bay 2014-1, a $268 million deal, and 2014-2, a $374 million deal. Additionally, our pipeline, which includes our prime jumbo loans and interest rate lock commitments, was approximately $750 million, at September 30. We expect this pipeline to lead to one securitization in the fourth quarter, and tee up another for early 2015.

We are excited about the maturation of our conduit program. We had 28 originators on our platform at quarter-end, with more expected to be approved by the end of the year. As mentioned earlier, our FHLB facility was expanded to $2.5 billion during the quarter, which helps us efficiently provide permanent capital to the US mortgage market. The long-term nature of this funding allows us to provide stable and consistently attractive pricing to our originator partners, both of which ultimately help homeowners finance the purchase of a home.

Please turn to slide 12. While our conduit efforts have thus far been focused on sourcing prime jumbo loans, we are pleased to announce that we launched high-LTV and non-prime programs post-quarter-end. Our high-LTV program is an extension of our current prime jumbo program, as it is focused on higher credit quality borrowers who need or desire to make smaller down payments in order to purchase a house. Our non-prime program provides products to meet the needs of borrowers with average credit quality who, so far, have been unable to get a loan due to the extremely tight credit standards that exist in the market today.

Given that we have just rolled out these products, it is important to note that it will likely take time to drive volumes in these programs. That said, it has been clear to us for some time that the market has a need for products like this, and we are excited to be able to extend our reach as a capital provider to these segments of the mortgage market.

Finally, let me touch briefly on MSR. We remain pleased with the ramp of our flow arrangement with PHH, under which we added approximately $700 million UPB during the quarter. We are working on and anticipate adding more MSR flow sellers during the remainder of the year and throughout 2015. A key benefit to our platform is the ability to cultivate a large network of sellers that we can use to access a variety of products, including MSR, prime jumbo, non-prime, and high-LTV.

In closing, we are excited about the potential for our business as our operational platform gains traction, and with the launch of new products aimed at providing solutions to the quandary facing the mortgage market today. We remain focused on the creation of total return for our stockholders and are vigilant with respect to the protection of book value. I will now turn the call back to Ben and we would be happy to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Douglas Harter of Credit Suisse. Your line is open. Please go ahead.

Douglas Harter - *Credit Suisse - Analyst*

Good morning. I was hoping you could talk about what has changed in the market to allow you to accelerate on the jumbo conduit side? Is it the maturation of your platform or have the economics changed?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Sure. Good morning, Doug. It is Tom. Mostly due to the fact that our originator partner network has just expanded so much. It has grown tremendously in 2014 and that is a testimony to the hard work of our team around that. With regard to market conditions, I will hand it to Bill.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Certainly, the FHLB line helped us provide very consistent pricing, and we have mentioned that in the past. Tom hit it on the head. As you grow the number of sellers, and if your pricing is competitive, and also, by the way, we feel that delivering very high service is important, because if the borrower can't close, because people aren't paying attention, that is very important. We have gained a reputation of delivering consistent pricing, high levels of service, and those are the contributing factors.

Douglas Harter - *Credit Suisse - Analyst*

Great. And then on the new initiatives within the conduit business, do you have financing in place for that or, as it small, will it be unlevered? How are you thinking about the financing side there?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Doug, it's Bill. Let me at least talk about the products first, then I will turn it over to Brad. We just rolled these out, literally, in the last few weeks. By the time we get into educating our originator partners and also in the situation where we start to see volumes, given our balance sheet and our cash balances, certainly, we have plenty of capacity to absorb loans without any reliance on outside financing. But let me have Brad tackle the financing side.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thanks. I don't have much to add. Most of what we are looking at is still very high-quality credit, very focused on ability to repay. A lot of those product quality or attributes do fit into FHLB refinancing. As well as, we have talked to many players, in the street, on warehouse lines. So in the short-term, as Bill noted, it is going to take a while to grow it. We have the capital to support it, but we have already looked at a couple of options on the financing side and feel very comfortable with where that is headed.

Douglas Harter - *Credit Suisse - Analyst*

Great. Thank you, guys.

Operator

Our next question comes from the line of Trevor Cranston of JMP Securities. Your line is open. Please go ahead.

Trevor Cranston - *JMP Securities - Analyst*

Hi, thanks. A couple of follow-ups on the developments in the conduit. It looks like you guys are still retaining a decent chunk of the AAAs you are creating. Could you just talk a little bit about where are you seeing AAA levels today and what is driving the decision to retain versus sell currently?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Hey, Trevor, it is Bill, good morning.

Trevor Cranston - *JMP Securities - Analyst*

Hey, Bill.

Bill Roth - *Two Harbors Investment Corporation - CIO*

If you look at the number of the deals that we have done, we certainly sold most, but not all the AAAs. In the 2014-1 deal, we just had a situation where we had -- we thought it was appropriate to retain some of them, which we did. Our decision to retain or not retain is basically going to be driven by where they clear the market and if it makes sense for us to hold them.

At the time we saw low double-digit ROEs on certain parts of the capital structure, although obviously we didn't retain them all, so we sold a bunch of them. It is hard to quantify how much we will or won't retain, but it will just come down to whether we think it is going to present a good expected ROE or not. I would say, over time, you should expect that we are going to sell most, if not all, of our AAAs, depending on the market.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Trevor, just to add to that a little bit, due to the Home Loan facility, it gives us the ability to wait for what we consider to be a sunnier day in the AAA space so we can do things that are really economic and really optimize what we have on the facility at any given time, dependant upon market conditions.

Trevor Cranston - *JMP Securities - Analyst*

Yes. That makes sense. And then on the new initiative, can you maybe expand a little bit on the product you're offering in the non-prime space, if it is maybe an expansion in DTI or if it is different documentation, just what the targeted borrower there is?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Yes, that is a great question. Basically, if you look at the landscape today, there's many borrowers who go through this automated underwriting system and that is fine, but there is lots and lots of borrowers who don't fit in that box. They either need extra care, whether their FICO is in the 600s or they had a credit problem at some point, or if it is a DTI issue, effectively they require higher touch than what an automated system would require, which is really where we intend to add value, because heretofore, many of these borrowers just wouldn't be able to get a loan.

That being said, we are very focused on them being borrowers that have the ability to pay, and good borrowers that can make the payments and afford the house. So that is where we think our value add is. It is hard to be specific as to whether it is a DTI or a FICO or some combination, but that's what the program is designed to do.

Trevor Cranston - *JMP Securities - Analyst*

Got it. That makes a lot of sense. Okay. Thanks, guys.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thanks, Trevor.

Operator

Thank you. Our next question comes from the line of Rick Shane of JPMorgan. Your line is open. Please go ahead.

Rick Shane - *JPMorgan - Analyst*

Hey, guys. Thanks for taking my questions this morning. Most of them have been asked and answered, but just wanted, on the non-prime program, what will the long-term funding strategy be there? Is your expectation it will be holding that on balance sheet?

Bill Roth - *Two Harbors Investment Corporation - CIO*

So yes, hey, Rick, this is Bill, good morning. And for you, it is a really early morning. Yes, in the short run, we have already talked about that. Long-run, our expectation, and certainly hope would be, as this market opens up and becomes fairly meaningful, that a securitization market would develop for that. We are obviously in the prime jumbo securitization space, and that is going to continue to grow from our standpoint. Certainly, we hope that market opens up the way that most market participants hope. Once that market gains footing, you will start to see a market develop for other products. So I would say longer term, it is probably measured in years, not months, I would expect to see a securitization market develop.

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Rick Shane - *JPMorgan - Analyst*

It is interesting. There felt like there was a time where that would never happen again, but it does seem like we are moving in that direction, and that eventually it will occur. Also, just wanted to talk about the movements in the hedging portfolio. You talked a little bit about the shift from swaptions to swaps and shortening the tenor a little bit and that makes sense, but I would love just to explore the implications, not the accounting implications, but the strategy behind reducing the swaption exposure?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Hey, Rick, it's Tom. How are you? Good morning. This quarter was really an interesting quarter, because there was a lot of interest rate volatility. And as you know, Bill and the team run the portfolio, and I'm like the back-up quarterback who stands on the sideline with a clipboard and a baseball cap on backwards. But in other words, I'm in the flow of information, but Bill and the team run it.

There was a quarter where there was a lot of interest rate volatility and negative gamma can really be a factor. In other words, as rates move around, your interest rate exposure increases or decreases, unfortunately. The quarter was a testimony -- one of the reasons we had such a solid quarter relative to the space was just a testimony to the sophistication of our hedging strategies, particularly in regard to interest rates. Bill, do you want to add something there?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Yes, I just wanted to know what play the back-up quarterback is going to send in next time (laughter). The bottom line is that the Fed made it fairly clear, although we don't know how to play out, that they are on a certain path. If you look at the front end swap rates, they were pricing in either a slower path or a lower path. We felt that, look, as a REIT, the short end of the curve and the funding are really important.

While we hedge all points of the curve, it was our belief that the curve would flatten going into this cycle. If you look at past cycles, you can basically see that any time you get into a rising rate environment, the curve either flattens, or in some cases, inverts, and so our goal is, frankly, to make money for shareholders, and part of that was to express an opinion by way of moving some of our hedges shorter in swap space. Keep in mind, we didn't give up protection on the long end, because we extended the maturity of our swaptions from three years to five years to get us some extra protection, but in short, it was effectively just to take a view on the protection that we would get from that position.

Rick Shane - *JPMorgan - Analyst*

Got it. I will tell you, I find that the chart on slide 10 fascinating in terms of how dynamic your hedging strategy has really been over the last couple of years, and even going further back, in terms of the views you guys have expressed, frankly, on the right side of your balance sheet.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Thanks for those kind words. As I said, the team takes certainly a sophisticated approach. This was a touch quarter in hedging interest rate exposure. There was a lot of volatility even intra-day and so I'm really proud of the job that they did.

Rick Shane - *JPMorgan - Analyst*

It is not easy. And just so you know, the reason I wear a baseball cap is, having lost a lot of hair covering the mortgage REITs over the years, covers that up for me (laughter).

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Okay, fair enough. As you know, Bill and I can't do bragging in that department (laughter).

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thanks, Rick. We appreciate it.

Rick Shane - *JPMorgan - Analyst*

Have a good day.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Yes, you too.

Operator

Thank you. Our next question comes from the line of Mark DeVries of Barclays. Your line is open. Please go ahead.

Mark DeVries - *Barclays Capital - Analyst*

Yes, thanks. I apologize if you guys covered this already. I'm trying to multi-task this morning. But did you indicate on the non-Agency, the high-LTV and non-prime originations you are looking to do, whether those would also be non-QM loans or are they going to technically fit within the QM bucket?

Bill Roth - *Two Harbors Investment Corporation - CIO*

The answer is that we did get a number of questions on that, but we did not actually get that one specifically. Many non-prime loans could be either QM or non-QM, depending on the situation. Our program is set up to accommodate either. At the end of the day, though, we obviously want to make loans where the borrowers can afford the house and can make the payment, so that is the first and foremost, because if that is accomplished, then we are going to have happy borrowers and good loans. But the program is set up to accommodate both.

Mark DeVries - *Barclays Capital - Analyst*

Okay. So you guys have gotten comfortable at this point with the notion of originating non-QM loans. Are they going to -- I assume -- are they going to, if they're non-QM, skew towards the higher FICO range?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Well, it is hard to tell, because every loan stands on its own, right? If you have a 600 FICO loan that the reason the FICO is there is for whatever, but the rest of the -- the guy can afford the house and make the payment, that's fine. If you have a 700 FICO where the guy cannot make the payment, we are not going to make the loan.

So, it is really too early to tell -- to draw a box around what we are going to do or what we are not going to do. What we want to do is have an expansive set of guidelines to meet this set of borrowers and provide capital to the market at rates and returns that we think are good for our shareholders.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

I would just add, Mark, it is Tom, that obviously, this is right in our wheelhouse because credit analysis is at the very center of our legacy non-Agency business, so understanding credit behavior is something that we have done for an awful long time. These new programs are very consistent with our capabilities and our history.

Mark DeVries - *Barclays Capital - Analyst*

Okay. I would also be interested to get your thoughts on how robust and how big you think that opportunity can be, particularly given that we are obviously in the very early days of this, and I would assume your assessment would represent a pretty wide range. It would be interesting to get some thoughts on what kind of conditions you will need to see to be towards the higher end of whatever opportunities that you see?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Well, it is a huge cohort, and the question will be how big can it be, and the answer is a complex one and not easily answered. As Bill said, it will be centered somewhat on whether a securitization market redevelops for these loans. Obviously, financing drives volumes in any space. One of the arguments we make around our ongoing membership to the Home Loan Bank is that the prime jumbo market must come back and securitization in that market must come back before any non-prime securitization can be revitalized.

That being said, some of these loans, likely would not be on the home loan facility at all, but the point being, the prime jumbo space has got to come back for the non-prime to come back. If it is developed, that will drive the volume of it, ultimately. But as I said in my opening remarks, there is a huge national cohort that can afford a home that just can't get a mortgage because they were a little banged up in the crisis or they don't have a down payment, or a combination of factors.

Mark DeVries - *Barclays Capital - Analyst*

Okay. And did you discuss how meaningful this might be for you over 2015, 2016?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

We did not. And it is hard to say.

Bill Roth - *Two Harbors Investment Corporation - CIO*

We just rolled these out. And so we fully expect it is going to take a decent amount of time to get any reasonable volume. We will obviously keep you guys updated as that comes through, but we are not expecting big volumes right out of the chute, just because we just rolled it out the last few weeks.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great, thank you.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Thanks a lot, Mark.

Operator

Thank you. Our next question comes from the line of Joel Houck of Wells Fargo. Your line is open. Please go ahead.

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

Good morning. I just want to ask you about the -- there has been a lot of institutional capital coming into the single-family rental market over the last several years. Most people think that has obviously helped the bid in terms of home prices figuring in certain geographies. Now those stacks are below book value, a lot of people are questioning the long-term profitability of that model.

My question is, because you guys have a lot of subprime bonds, if in fact that bid weakens, are you concerned at all, or is there risk that HPA could actually decline in certain areas, and if that is the case, what is your tolerance level for book value volatility? Somebody pointed out, you have done a great job hedging, it is mostly on the interest rate side, but the credit rate has been one way the last couple of years. Just curious as to your thoughts on that issue?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Well, without getting into the single-family rental sector, affordability is the super metric of price performance within the housing market. If homes are affordable, there will be a bid for them. If they're not, there won't be. Homes are extremely affordable today and we think that, that is a tailwind for the credit book. So the ability of the single-family rental sector to raise money, I really can't comment upon, but the things that we focus on are the overall health of the housing market and the affordability factors, and they are quite present in the market today.

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

So not terribly concerned about if we get a [float on a] housing market, that the -- perhaps the bid/ask or volatility of sub-prime bonds, you are comfortable with the current exposure?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Joel, if you think about it, the way we position that is we have these deep discount bonds, that every day that goes by, you have excess spread and enhancement that helps cover losses. We are not reliant on 10% a year HPA to get a return. We model these things with very low expected pre-pays, which to date, our realization has been much higher than our modeling, and modest HPA.

Now, look, if you think the housing market is going to go down 20% or 30% from today, then it would be very fair to assume that these things are going down in price, right? But that is not our expectation. We are very comfortable with the risk, given the price of the bonds that we have and the protection we have between the enhancement that's built into the structure, in terms of hard enhancement, excess spread and the fact that we have a deep discount.

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

Okay. Great. Thanks, Bill.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thanks, Joel. Have a great day.

Operator

(Operator Instructions)

Our next question comes from the line of Mike Widner of KBW. Your line is open. Please go ahead.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Good morning, guys. Most of mine have been asked. So forgive me for a couple of detailed technical ones.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Sure, go ahead.

Operator

I'm sorry. We've are lost his line.

(Operator Instructions)

While we're waiting him to requeue, our next question comes from Lucy Webster of Compass Point. Your line is open. Please go ahead.

Lucy Webster - *Compass Point Research & Training - Analyst*

Hi, good morning. Just a quick one from me, too, as most of my questions were answered. I was just wondering, with the mix shift that we saw in the Agency RMBS portfolio this quarter, are you comfortable with your -- the HARP loans that you hold at this point, or do you think that we could see some of your holdings there roll off as well into more low loan balance prepayment protected securities?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Hey, it is Bill. Thanks for the question. Yes, if you look at our holdings, we have had historically, and continue to have very low exposure to faster prepays due to HARP. If you -- I'm just looking here in the -- if you look at the appendix, 28% are low loan balance pools of some sort, plus 17%, which are the very low, so that is almost one-half of our holdings. This is on page 18, just so you know. Then we've got 18% HECMs and then a variety of others. So we are not really positioned in pools or other assets that really have a great exposure to HARP.

Lucy Webster - *Compass Point Research & Training - Analyst*

Okay. Thanks for taking my question.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thanks for joining us.

Operator

Thank you. Our next question is again from Mike Widner of KBW. Your line is open. Please go ahead.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Thanks. Hopefully it will stay open this time. I was just asking, on page 24, you show $21 billion net, but with the payers against the receivers, of swaps. Then I just want to make sure I understand how to reconcile that with what you show as the implied allocations or swap expenses on the rates and credit strategy, slides 18 and 21. So the simple question is, are all of those swaps included there, when you show the swap costs of 0.8%, 0.9%, or is there some other allegation going somewhere else, or just trying to make all of the math square up?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thank you for that question. So just make sure I understood it, so you are asking if the swap positions disclosed on page 24, are those fully accounted for in the yield disclosures on page 18 and 21? Was that the question?

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Yes, that is essentially the question, yes. I am trying to work into the math because I don't -- unless you guys give an explicit allocation somewhere, I am just trying to make sure I understand it, so we can model it all appropriately and make sure we're catching everything?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

So the answer is yes. All swap costs, i.e., the spread on the fixed and float, are added to our cost of funding in the form of swap costs. The breakdown of whether those hedges are covering our Agency rate exposure or our non-Agency rate exposure, we don't have any additional breakdown of our swap positions in that form. But at least to your question, yes, all swap costs are embedded in that disclosure.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Appreciate that. And then, just, you may have mentioned this or not, but again, on 24, are any of those swaps forward starting or are they all current pay?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

They are all current pay.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Okay. Great. And one other one, for the FHLB advances, you've got basically an extra $1 billion of capacity, and if I take the $2.5 billion, you've got minus $1.5 billion that is drawn. How should we think about that extra $1 billion? Should we assume it is warehouse conduit? Or is there some other place we might think of as you using that financing to reduce net funding costs or something?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Hey, it is Bill. Consistent with what we have said in the past, we look at the FHLB not as a replacement for repo, but really to help us as we are able to build the conduit and provide consistent pricing to our originator partners for loans. So if you look at it today, roughly one-third or a little bit more is currently backed -- of our borrowings, are backed either by loans or assets generated by the conduit. The way we would think about the increase is just basically to continue to enable us to grow the conduit business and provide attractive rates to homeowners.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Yes. Certainly makes sense. And on that front, looking forward to seeing your comments back to the FHLB, or sorry, the FHFA?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Sure. We appreciate that. Obviously, one of the things that we feel very strongly about is that our prime jumbo securitization business is very consistent with the mission of the Home Loan. That is why we think that we are very suited to be members of it going forward.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Well, I will let Mel Watt that I agree with that assessment as well.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Well, then we look forward to seeing your response as well (laughter).

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

I already put a couple out, but probably have some more comments as well. So anyway, thanks. Appreciate it. And nice quarter, guys.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thank you.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Thank you.

Operator

Thank you. With no further questions in queue, I would like to turn the conference back over to Mr. Siering for any closing remarks.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Thank you, Ben. We had a lot of great questions today. We look forward to speaking to you soon. And have a great day. Take care.

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.