Two Harbors Investment Corp.
Third Quarter 2020 Earnings Call Transcript

November 5, 2020

TWO HARBORS
Investment Corp.

PREPARED REMARKS

Operator: Good day and welcome to the Two Harbors Investment Corp. Third Quarter 2020 Financial Results Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Corey Stolhammer. Please go ahead, sir.

Corey Stolhammer: Good morning, everyone. Thank you for joining our call to discuss Two Harbors' third quarter 2020 financial results. With me on the call this morning are Bill Greenberg, our President and CEO; Mary Riskey, our Chief Financial Officer; and Matt Koeppen, our Chief Investment Officer.

The press release and financial tables associated with today's call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website or on the SEC's website at www.sec.gov.

In our earnings release and slides, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today's call. I would also like to mention that this call is being webcast and may be accessed in the Investor Relations section of our website.

I would like to remind you that remarks made by management during this conference call and the supporting slides may include forward-looking statements. Forward-looking statements are based on the current beliefs and expectations of management and actual results may be materially different because of a variety of risks and other factors. We caution investors not to rely unduly on forward-looking statements. Except as may be required by law, Two Harbors does not update forward-looking statements and expressly disclaims any obligation to do so.

I will now turn the call over to Bill.

Bill Greenberg: Thank you, Corey, and good morning, everyone.
I'd like to welcome you all to our third quarter 2020 earnings call. The structure of this call will be as follows. I will go over the quarterly results at a high level, then Mary Riskey, our Chief Financial Officer will give more details on our financial results and then Matt Koeppen, our Chief Investment Officer, will discuss our portfolio composition, activity, and risk profile. And then Matt will make some comments about our forward outlook. Finally, we will be happy to take any questions.

A summary of our results is shown on Page 3. Our book value at September 30th was $7.37 compared to $6.70 per share on June 30th. This represents a 12.1% return on book value for the quarter. Included in these results are reversal of the previously accrued termination fee of $0.51 per share, attributable to the non-renewal of the management agreements, which reflects the fact that there is no longer any payment due as a result of the for cause termination.

On a purely economic basis, excluding that reversal, our total return on book value would have been 4.5%. This favorable return is generally due to strong performance in lower coupon RMBS, tempered somewhat by the volatility-reducing presence of MSR in the portfolio.
This result validates our agency-plus-MSR strategy in which MSR is intended to mute the effects of mortgage spread widening and tightening in RMBS and produce more stable risk adjusted results over the long term in a variety of economic cycles.

Our core income for the quarter was $0.28 per share, which is far in excess of the declared dividend for the quarter of $0.14 per share. As we have discussed many times in the past, we believe that core earnings is not necessarily the best measure of the expected economic returns in the portfolio.

Although the dividend represents roughly an 8% return on book value for the quarter, we expect to modestly increase the dividend next quarter, which will be more in line with what the portfolio is expected to economically earn net of expenses. The core number of $0.28 depends, as it is designed to do, on historic yields and costs and in this environment, is higher than what we think current market returns are.

Our ability to source MSR at attractive levels has been very encouraging. Low mortgage rates have resulted in record amounts of originations in the market and we have been able to procure significant amounts of MSR from our flow seller relationships. During the quarter, we settled on approximately $14.5 billion UPB of MSR, which was our biggest quarter ever, with the fourth quarter is already shaping up to be even better. Post quarter end, we settled on an additional $14.5 billion UPB in three separate bulk transactions. Current flow volumes with recent bulk settlements exceed our projected runoff and our MSR portfolio has begun to grow again.

I am also pleased to tell you that we closed on a $200 million servicing advance facility with a large bank counterparty. Since the level of current forbearance in the portfolio has come in lower than we initially anticipated, we reduced the size of this facility in order to be more in line with our expected needs. Indeed, as at September 30, only 5.0% of our portfolio by loan count was in forbearance, of which 28% of borrowers had made their September payments, so that the delinquent forbearance loans were only 0.6% of our MSR portfolio.

Despite the fact that forbearances have been manageable, we feel that this facility expands our risk management tool kit and is a prudent addition to our funding mix. It also offers protection should forbearance numbers increase in the future.

On August 15th, we completed our transition to self-management after the termination of the management agreement on August 14th. This transition occurred without interruption and was virtually seamless. This is not to say that there was not a lot of work involved, because there certainly was. The Board hired 100% of the employees who had previously supported Two Harbors and all of our business operations had continued without interruption. We are excited about this new beginning for Two Harbors and we are looking forward to the positive impact it will have on the company and its stockholders. The litigation with Pine River continues and we expect it to continue for the foreseeable future. Unfortunately, I can't say much more than that at this time.

Please turn to Slide 4. Looking ahead, we are very optimistic about our strategy as an agency-plus-MSR REIT. Our business model of pairing MSR with the agency RMBS with the size and scale of MSR that we have is unique in the market. We continue to believe that this paired construction will deliver high adjusted returns with lower mortgage spread risk than other portfolios without MSR.

In the current environment, we expect to be able to grow our position in conventional MSR which will lower our mortgage spread risk even further. Today, yields have tightened, the presence of MSR has tempered returns, but in general, when the direction of MBS spreads are uncertain, our portfolio of construction should provide a less volatile profile over time.

I will now turn the call over to Mary to discuss the details of our financial results.

Mary Riskey: Thank you, Bill. Turning to Slide 5 to review our financial results for the third quarter. As Bill mentioned, our book value at September 30 was $7.37 compared to $6.70 per share on June 30th, resulting in a return of 12.1%. Excluding the result of the previously accrued management agreement termination fee, the quarterly return on book value would have been 4.5%. Book value growth was driven by positive performance from our RMBS portfolio and was offset by lower MSR pricing from past fees and mortgage spread compression. As you can see in the middle of the page, the reversal of the management agreement termination fee was $139.8 million or $0.51 per share. When the Board of Directors announced this plan to not renew the management contract with Pine River on April 13th, the nominal payment as well as this updated legal and advisory costs largely recorded in Q2.

As announced on July 21, the Board of Directors subsequently terminated the management agreement for cause, which carries with it no associated termination payment. Following GAAP principles, we reversed the termination fee in the third quarter.

Moving to Slide 6, let's discuss our core earnings results. Core earnings were $0.28 per share in the third quarter compared to just $0.05 in Q2. Our favorable core earnings were primarily driven by three factors. First, net interest income was higher moving from $45.2 million to $60.5 million due to favorable repo rolls on lower LIBOR, offset by rotation into lower coupon Agencies and fast prepayment speeds.

Second, restructuring our entire swap portfolio at current rates at the end of Q2 resulted in favorable swap interest spread, changing from an expense of $56.3 million to income of $0.8 million. Finally, expenses were lower in the quarter, declining from $46.8 million to $43.5 million due to termination of the management agreement on August 14th and our transition to self-management.

Turning to Slide 7, our portfolio yield in the quarter was 2.42% and our net yield increased 155 basis points to 1.78% from 0.23%. Portfolio yield decreased by 42 basis points from 2.84% to 2.42% due to sales of higher-yielding RMBS in June, higher agency amortization due to prepayments, and higher servicing expenses and lower servicing income due to MSR portfolio run off and forbearances.

However, our cost of funds more than offset the yield decreased, declining 197 basis points from 2.61% to 0.64%, driven primarily by favorable repo rolls and the restructuring of our swap book in June.

I'd like to reiterate something Bill mentioned and we discussed last quarter. In our portfolio construction, the presence of MSR provides most of the interest rate hedging needed to offset the duration of RMBS portfolio and our position in interest rate swaps is now very small and the contribution to net yield is negligible. However, since our RMBS positions still reflects the accounting yields from the higher rate environment in which they were purchased, both core earnings and portfolio yield are anticipated to exceed our expected returns in coming quarters. As we continue to rotate our asset portfolio, reducing some of our older holdings and moving into newer low coupon pools, we expect our asset yields to decline over time to market rates and the net portfolio yield should start to converge to market levels that are more consistent with our return expectations.

On Slide 8 we have summarized our financing profile as of September 30th. Our economic debt to equity at quarter end was 7.7 times compared to 7.4 times at June 30th and our quarterly average economic debt to equity was 7.6 times in Q3 up from 6.8 times in the second quarter. I would note here that had we not reversed the management fee termination payment in Q3, we would have ended the quarter with economic debt to equity of 8.1 times. Our liquidity position remains strong with unrestricted cash of $1.6 billion at September 30th.

At the end of the third quarter, we had 20 active agency repo counterparties with a weighted average maturity of 83 days. Across our MSR facilities, we had $274.8 million outstanding in bilateral structures and $400 million outstanding in term notes. As of September 30th, our total committed capacity across our MSR asset financing alternatives was $850 million, of which $175.2 million was unused. During the quarter, we closed to two MSR-related facilities, a $100 million MSR financing facility and a $200 million servicing advance only facility. These facilities provide us with additional liquidity in the event of increased forbearance or defaults and support future MSR portfolio growth. For more information on our financing profile, please see Appendix Slide 27.

I will now turn the call over to Matt for markets overview and portfolio update.

Matt Koeppen: Thank you, Mary, and good morning, everyone.

Turning to Slide 9, let's review quarterly portfolio activity and composition. As previously noted, the third quarter economic return on book value was 4.5% excluding the reversal of the termination fee associated with non-renewal of the management agreement. This performance was driven by a general spread tightening in MBS across most TBA and specified pool coupons as the Federal Reserve continued its balance sheet expansion by purchasing more than $300 billion mortgages this quarter.

Mortgages have also benefited in the backdrop of relatively low implied and realized volatility during the quarter which minimized delta hedging costs and muted embedded option costs within the asset. With interest rates stable, the market price of servicing was steady and behaved largely as expected.

I would point out that third quarter returns are lower in our portfolio construction than in the mortgage portfolio without MSR. As an agency-plus-MSR REIT, this is by design. We've discussed in the past that MSR acts as a short position in the current coupon which outperformed this quarter and results in overall lower mortgage spread exposure.

We estimate that the presence of MSR reduced returns relative to a portfolio without MSR by around 3% to 4%. On the other hand, we anticipate that our portfolio returns would likely outperform in periods of mortgage spread widening for the same reason. We did increase our RMBS portfolio mostly through adding exposure to current coupon TBA as we find them relatively attractive. The continuation of the Fed's large-scale purchase activity should cause roll specialness to persist in the near future.

Our net TBA balance increased by about $3 billion and our specified pool position is lower by approximately $1 billion due largely to run-off. Additionally, as Bill mentioned, we've been able to source substantial volumes of new servicing through both flow and bulk channels and expect to be able to grow our MSR portfolio in coming quarters. One of the most interesting dynamics in today's market is the impact of roll specialness in the TBA market.

Please turn to slide 10. As a refresher, holding a position in a TBA mortgage contract generally replicates exposure of a mortgage pool with some differences possible due to implied prepayment speeds and implied funding rates. An actual mortgage pool will deliver CPR based on actual underlying borrower activity and will have a real funding rate achieved in the repo market. With TBA, these aren't directly observable. Rather, the impact of some implied prepayment rates and funding rates are embedded in the pricing of the contracts. You can think of the TBA roll as a collateralized borrowing, where the price differential between settlement months implies the interest rate on the loan. When TBA rolls are trading at so-called fair value, the roll income, which is simply the price difference between settlement months is roughly equal to the carry you would receive from holding the security and you would be economically indifferent to holding one versus the other. Sometimes it's possible for the implied funding rate to be different from the so-called fair value. When the implied funding embedded in roll price is lower than market funding costs, the roll would be considered special and there would be an incentive to hold TBA. If there were no frictions in the TBA and the underlying collateral markets with infinite and equally offsetting supply and demand, you would expect only small deviations in the economics in the two because of the delivery mechanism. In the real world, there can deviations and in fact, that is where we find ourselves today.

Large market participants, like the Federal Reserve who take delivery of significant amounts of collateral, can distort the normal supply and demand dynamics, causing rolls to trade special. In this instance, a lack of available collateral to deliver into front month contracts combined with continued origination sales in back-month contracts causes a larger price differential than what would be fair. The chart shows the effect in recent months of Fed purchases on two different months. In the case of the 2% coupon, debt purchases have been steadily increasing as current coupons are the focus of QE4. The result has been to drive the funding advantage to a 100 basis points or more in recent months.

On the other end of the spectrum, while the Fed initially included the 3% coupon in their purchases back in March and April, which caused roll specialness, rolls collapsed as they stopped buying the coupon and moved that purchase activity down to lower coupons. In fact, it even moved beyond fair value, implying a higher funding rate than available in the repo market.

Please turn to Slide 11, as we discuss our specified pool positioning and prepayments. You can see a lower left hand chart, the performance TBA coupons in gray and also specified pools in blue. Our higher coupon specified pools outperformed the TBA counterparts. While we don't own any specified pools in the 2% coupon, we do own TBA, which outperformed by more than a point and a half during the quarter supported by strong Fed demand and attractive roll dynamics.

Today, with regards to specified pools, we remain positioned largely in loan balance and geography stories. In the lower right-hand chart we show a comparison of generic speeds to our specified portfolio speeds by coupon. The slower prepayment speeds of the specifieds compared to generic highlights the reason that specified pools command a significant price premium over TBA. We expect prepayment speeds to persist in the near term, but specified collateral should continue to be slower and more stable than generic speeds. This stability allows more readily and consistently extract the spread that those bonds offer.

Moving to Slide 12, you can see that our MSR portfolio was valued at $1.26

billion as of September 30th and consisted of $164 billion UPB with a gross coupon of 3.9%. That translates into a price of about $0.76 or right around 2.8 multiple on our existing portfolio. We settled on $14.5 billion UPB of new MSR through our flow program during the quarter, which represents record volume for us. Volumes have continued to increase in October as additional sellers have come online.

Activity in the bulk market continues to increase as well with price discovery taking place and we find valuations to be situational with some packages trading at pre-crisis yields while some trading at wider spreads. We had some success in the bulk market and post quarter end, settled on $14.5 billion UPB in three separate transactions. This is exciting and at a similar pace, we would be able to not only replace run-off, but actually grow the portfolio.

Pricing multiples in the flow market are right around the three times level and that has been stable over the quarter. While it's true that pre-crisis MSR multiples were around 4, we would not necessarily say that MSR is one multiple cheaper. If nothing changes in the world then we would expect the spread between primary and secondary mortgage rates to compress meaning that newly originated loans might actually be in the money and refinanceable. In that case, 3-mult is the appropriate price for MSR backed by in-the-money mortgages.

In the lower right-hand chart, we have another prepayment comparison. This one showing our servicing prepayment speeds in blue versus generic collateral in gray. The collateral backing our MSR is more diversified than our specified pool position and has greater variation in prepayment speeds. In general, when we purchase MSR, we're purchasing something that looks like the entire cohort rather than on the collateral that trades at the payup. Currently, a majority of the underlying loans in our servicing portfolio have some form of seasoning or prepayment protection, which is why speeds are somewhat slower than the implied TBA speeds.

Nevertheless, we do have expectations for should speeds remain high going forward. Primary mortgage rates have continued to grind lower with 30 year rates generally below 3% in national surveys, even with the spread between primary and secondary rates at very wide levels. The longer that interest rates stay at these levels, the greater our expectation that primary mortgage rates will decrease further. As a result, unless interest rates fell off and provide prepayment relief, these faster prepaid fees will certainly continue to impact returns.

On the next few slides we discuss our effective coupon positioning and risk profile. On slide 13, you can see we hold long pool and TBA positions in 2s through 5s while our MSR act as a short position in 1.5% and 2% coupons.

As of September 30th, our effective coupon positioning was short to 1.5 among 2s through 5s shown in the right on the top row. TBA 1.5s have begun to trade,

are regularly quoted and are seeing increased volumes at these rate levels. The diamond bullets indicate our end of Q2 positioning, which you can compare to September. The main change in our effective positioning was a decrease in 2.5s and increase in 2s, in fact moving from a short to a long position.
The lower left-hand chart shows our common book value exposure to 25 basis point spread widening or tightening and indicates that book value would decreased by 5.3% in an instantaneous 25 basis point spread widening. The magnitude of this exposure is higher than in recent periods due to both increase to the size and extending durations in current coupons. We consider this risk measure to be acceptable and we are very comfortable with level of exposure.

Moving to Slide 14, we are introducing a new measure in the right-hand chart. Given the commitment of the Federal Reserve to stimulate the economy and their stance that "they are not even thinking about thinking about raising rates", it's useful to think about interest rates moving in a non-parallel way in addition to a normal parallel shock. This chart shows a scenario that shifts the 2 year zero basis points, the five year about 9 basis points and the 10-year and out shifts 25 basis. The up 25 scenario, which is a bear steepening move, shows the book value increase of 0.1% which we consider to be essentially flat. The parallel up 25 scenario shown on the chart on the left also shows a low exposure of down 0.8%. Both are low and in line with our historical positioning.

Another aspect to point out in both scenarios is that the MSR provides significant interest rate hedging benefits, which you can see by comparing the grey bars to the blue bars. We intend to continue showing our non-parallel interest rate shocks going forward.

Bill Greenberg: Thanks for that discussion, Matt. Finally, I'd like to take a look at our outlook for Two Harbors and our return expectations on Slide 15. After the significant spread tightening we have seen in the last two quarters, we see gross returns for specified RMBS paired with swaps are less attractive than they were and we see them to be in the range of mid to high single digits depending on coupon and story. Current coupon TBA returns are enhanced by roll specialness which is likely to continue for the near future. This can increase near term returns to the mid-teens area, depending on assumptions about how long specialness lasts. New investments and flow MSR paired with RMBS today can also drive returns in the low mid teens. And if you assume roll specialness on the RMBS component, it can be even higher. Investments in the flow channel are generally more attractive than bulk which can still at times be 200 to 400 basis points tighter. However, it is very deal-specific and some recent bulk transactions have occurred at attractive levels too.

As Mary discussed, our liquidity profile remains not only stable but strong. As we look forward, our expectations are to increase the size of the servicing portfolio and manage the RMBS portfolio accordingly, which would likely include the use of TBAs to enhance portfolio returns with attractive implied funding.

New investments in specified pools are less compelling today with spreads nearer to the tight end of recent ranges. But from a risk perspective, we are comfortable increasing our leverage to the 8 to 9 times area. In today's environment, with current spread levels, we would broadly expect to maintain overall risk and leverage that's consistent with current levels.

Thank you very much for joining us today and we will now be happy to take any questions you might have.

QUESTION & ANSWER

Operator: And your first question is from Doug Harter. Please go ahead.

Doug Harter: Just one - just wanted to clarify kind of the last comment you made about leverage. I think you said you're comfortable with higher leverage. I guess, do you expect to kind of increase to those levels in the near-term assuming kind of returns kind of stay with where you just kind of highlighted?

Matt Koeppen: I'll start with that one. I can see us - I could see us increasing slightly. I think we're perfectly comfortable as we've guided before with nominal leverage numbers in the 8 to 9 times. I would note, Mary pointed out that, had we not had the change due to the management fee, we would have been - our nominal levered numbers would have been about 8.3 times.

So I think we are operating sort of in a comfortable zone and we can see ourselves continuing here. I would - the last thing I would say is, I would point out that nominal leverage isn't the whole story with our portfolio construction. As we said before, the paired construction gives you lower mortgage spread risk despite what could potentially be higher nominal leverage numbers.

Bill Greenberg: Yeah, I would just add a couple of things. Good morning, Doug. Thanks for the question. On the sort of what we said on the last slide is that there has been some pretty significant spread tightening here in mortgages. The relative attractiveness of specified pools isn't what it was even a quarter ago.

And as we came out of the spring, we sort of said we were going to add risk and leverage slowly and prudently over time. This potentially - we thought there was potentially some uncertainty and some spread volatility that may be attributable to the election, which is again thankfully so far proceeding orderly. And so I would say, should market conditions warrant, we're totally comfortable increasing our leverage further into those levels. But given where things are right now, where market conditions are now, we expect things to be in the area that they are in currently.

Doug Harter: And then just if we could touch on the last slide, if you could help explain kind of why maybe - if you're pairing TBAs with either MSRs or swaps, you're kind of getting the - a similar kind of return outlook, why - kind of why the TBA is - there isn't kind of an advantage to pairing them with MSR versus swaps?

Bill Greenberg: Yes. Well, one way to think about it is purely from just from a mathematical standpoint, but if you have two things and one is yielding, right, where if you look at TBAs versus swaps as being call it low mid teens. And in order for the combination of something else to be higher than that, the other thing has to be higher than that also right.

And so what this is saying is that, that because the MSR by itself is sort of in that zone, it doesn't add anything because they are already starting from a pretty high number. So when you are averaging numbers, so to speak, right, the average ends up being the combination of two things. And so in order for it to be higher, the other thing would have to be higher itself.

Operator: The next question is from Bose George.

Bose George: Actually, can you give an update on book value quarter-to-date?

Matt Koeppen: Yes, so far we are pretty flat here in the fourth quarter. We've seen interest rates again pretty stable and steady during October. Performance in across coupons in MBS is a little mixed with current coupons have touched tighter - some coupons like the 2.5 and the 3 were a little bit wider. We've seen prices in servicing market have also been pretty steady. So overall, that nets to something pretty close to unchanged through October.

Bose George: And then if you - you talked about the economic return earlier in the call, but it's being a little higher than where the dividend is now and it's - but it's still obviously quite a bit lower than when you think about MSR paired with agency MBS or what you are generating now with the portfolio with the TBA specialness. But when you think about the longer-term return, is it because you want to exclude sort of the unusual income from the TBAs? Just help us kind of I think about where that longer-term return is and what's driving that.

Bill Greenberg: Yes, I'll start with that, Bose and good morning and thanks for joining. As the charts on Page 15 indicating us, some of those things and why we have fairly wide ranges shown there is especially on the TBA side in large part due to how long you think roll specialness on TBAs will last, right, and we happen to think it will persist in the near to intermediate term, at least. Obviously it depends a little bit on the Fed buying. Those numbers often will reflect where we think on the MSR side, right, new purchases are more attractive than existing holdings, right, especially in the flow markets, we're able to buy things several hundred basis points cheaper than bulk or where current portfolio is priced. And so putting all that together, we think that the prospective returns in the portfolio going forward are what we said, in the low mid teens.

We did indicate that we expect to modestly increase our dividends next quarter. We normally don't give dividend guidance in general, but given the unusual circumstances of 2020, we felt it was appropriate to give a little bit more visibility. And so that's what we expect there, which should bring the dividend more in line with what we think the portfolio is economically expected to earn.

Bose George: So thinking by the economic return, it is kind of a more of a double-digit number in that range. Is that a fair statement?

Bill Greenberg: Yes.

Bose George: Okay.

Bill Greenberg: I think once you put all that stuff together, it's probably low doubles. Yeah.

Operator: And your next question is from Stephen Laws.

Stephen Laws: I guess first I want to start with the question about the adverse market fee that goes into effect with refinances as on December 1st. Can you talk about, I guess, bigger picture how you think that's going to be handled by the market and how much of that fee is passed on to borrowers through higher refinance mortgage rates and along - from there the impact on your portfolio if it dramatically slows refi, this income statement benefit from lower amortization expenses and a positive mark on servicing valuations, does it impact the balance sheet from book value or a pace of MSR growth? Maybe take a couple of minutes and talk about how you expect that change on December 1st impact the market in your portfolio.

Bill Greenberg: Sure. Good morning and thanks for the question. It's a good one. I have a couple of thoughts about it. So first obviously an upfront fee amortizes over the average life of the asset, really only translates into maybe a 10 to 12 basis point elbow shift, if you will, in the refinancing curve. And so if you felt that that was entirely going to be passed through by the retail to consumers, that's what it would be and it would nominally reduce refinancing speeds by some amount. Now, it's true that primary, secondary spread is very wide. Originators could absorb all of that themselves if they wanted to and only have their profitability go down a little bit.

I guess different participants will do different things, right. If you ask me, I'd probably say it's going to be split 50-50. And so it will be something smaller than the 10 to 12 basis points or maybe 5 to 6 to 7.

Look, speeds have been really fast here and the adverse market delivery fee was meant to go into effect earlier, it's been postponed till the end of the year. That certainly had the effect of pulling through some refinancings sooner in the market rather than later. Maybe that's one reason why speeds have been more elevated than maybe some people thought here.

And so looking forward, I think it's certainly a complicated picture from everything I just said. I think it certainly has the effects directionally of slowing speeds in some way rather it’s a small effect or medium effect, it remains to be seen I think. That should generally help our servicing portfolio more than our specified pool position.

Our pool position is very well call protected very high-quality stuff mostly the loan balance and geography. It will have a marginal impact there. It will have a bigger effect on servicing and should improve valuations there, when we've been bidding on servicing we not included that particularly in our valuations in our flow grids or number of prices so potentially there is some tailwind there.

Stephen Laws: Great, thank you for the color on that topic, can you touch base on outlook for the operating expense line or non-interest expense. Now that you're internally managed maybe next year I think you guys have provided a little bit of color previously, but now that you've moved to an internal structure. Can you, update us on kind of your outlook for G&A and comp and benefits for say full year 2021?

Mary Riskey: Sure. Good morning, Steve, it's Mary.

Stephen Laws: Good morning, Mary.

Mary Riskey: So we would expect our operating expense ratio, excluding LTIP amortization and non-recurring expenses to be in the low 2% range. I would note that - included in our operating expenses are certain transaction expenses associated with MSR. So the expense ratio will move around a bit depending on our acquisition activity and the size of our MSR portfolio. What we generally believe it will be in the low 2%.

Stephen Laws: Great thanks, Mary. And lastly, can you talk about how you view potential stock repurchase that I guess where we're today about 25% discount to the new book value number relative to the low to mid-teen ROE talked about as far as new investments there. Do you think you guys should look at doing both through - is there one seems to outweigh the other. Can you talk a little bit about your considerations there as you reinvest capital either in new investments or after your own stock?

Bill Greenberg: Sure, and I appreciate the question. I think we talked about this last quarter. Perhaps the lens through which we look at this question is really about obviously uses of capital, right. And if I think about 25% below book here compared to again, just the round numbers 12% returns on investable assets that's a two year breakeven right. That investors will earn the same amount of money in two years as they would by realizing that benefit today and as two years, a short time or long time is that worth it or not worth it.
Obviously depends on the relative spreads in the market and the investment opportunities and the relative discount to book. At those prices, it seems to me two years is a pretty low number, obviously we haven't made any decisions yet about those things. We did not buy any stock back in the third quarter, mostly for that reason that we felt that - it was a low number right. And so, we'll continue to monitor that as the world unfolds and develops, but that's the lens through which we're looking at this

Operator: And we'll take the next question from Trevor Cranston.

Trevor Cranston: Most of my questions have been asked. But I was curious you mentioned being able to - and growing the MSR portfolio again in 4Q. As you look at your portfolio today can you talk about sort of how much you would like to be able to grow the MSR book over time assuming that you're able to find product to buy related to relative to the size and the composition of the current agency book? Thanks.

Matt Koeppen: Yes good morning Trevor, excuse me, I'll start with that one. I don't think we have a particular target in mind. We certainly have room to grow the servicing asset. We do find it attractive it's one of the most attractive things that we see today. I think it would be, I think there is certainly. I think we have a lot of room to add we're sort of not close to levels where I think we would say that we have too much.

And we have like we said, we have been seeing volumes pick up, it's been pretty exciting actually. So the bulk markets - have become much more active. flow volumes like we said, have been higher. I think we've seen volumes increasing even further in the fourth quarter so far. So that's been really good. I can see just where we are in the cycle. I can see there being a period here where maybe the bulk market is a little less active, just because we're getting into year-end, but they - whatever it's a fast refi environment and people are certainly making new loans. They're making servicing and do we think that will make its way into the market eventually. So I do feel like we're in a place where we can grow the portfolio in coming quarters.

Bill Greenberg: I'll just add a couple of things to that Matt, if I could, really if I look at the combination of stories which are being told on Page 15 of the presentation and on Page 13 of the presentation right. So, as Matt said pairing agencies plus MSR is one of the most attractive things we can do. We think that the advantage of our portfolio is really is to lower mortgage spread risk and adding more MSR certainly lowers that risk as you see on Slide 13 there.

And many of those numbers - we're contributing 2.5% in lower mortgage spread risk from an existing of MSR that could be bigger right to make the total net smaller, which we think is really the main advantage of our portfolio. So yes, we want to grow the MSR portfolio and we think the market is allowing us an opportunity to do so in the near term here.

Trevor Cranston: Right, okay that's helpful. And then just one question on the cost of funds side. Do you guys have any meaningful amount of repo outstanding that hasn't yet rolled down to current market rates. And if so, could you maybe share when you expect that to roll?

Mary Riskey: This is Mary, I can start with that. The bulk of the repo had rolled to market rates. In Q3, I think we had a little bit lot to do in the fourth quarter. But for the most part the repo balances are at current market rates.

Operator: We'll take the next question from Rick Shane.

Rick Shane: Mary I wanted to talk about Slide 6 for one second, I think which was you show on there the gain on other derivatives being $32.9 million for the third quarter on a core basis? And when we look at the P&L, I'm going to go back to it. The gain on a GAAP basis was $65.6 million and then you make the adjustment in the core to get to that net number. I am curious what is driving those marks and how we think about what should be in core and what should be backed out of core?

Mary Riskey: Sure, so the gain in other derivatives line for core earnings is exclusively TBA dollar roll income.

Rick Shane: And what are the other income what are the other derivatives that are going through they are on a GAAP basis?

Mary Riskey: Well, any realized and unrealized on the TBAs would be on the GAAP income statement versus in core plus primarily it's TBA and maybe a few options. But I think the difference between what you see in core and what you see on the GAAP income statement is realized and unrealized.

Rick Shane: So we should think of what shows up as core on a net basis is actually the roll income and everything else is just marks on both sides?

Mary Riskey: That's correct.

Operator: And your next question is from Kenneth Lee.

Kenneth Lee: You mentioned that when you look at some of the MSR valuations a few were relatively situational. I guess, just stepping back more broadly, wondering if you could just share with us your thoughts on how would you characterize the overall MSR markets in terms of just activity and trading and whether things have truly recovered at this point? Thanks.

Bill Greenberg: Yes, I'll start with that, Ken good morning and thanks for the question. I'd say it's continuing to improve from its earlier trauma. We have seen a fair amount of bulk packages out there. As Matt said in his comments, there is some amount of price discovery happening. There is more - as we've indicated, we are acquiring more flow volume here and I think prices are starting to return to more normal levels.

You still have this dynamic where the gain on sale is very high. And so would there are still many servicers that aren't particularly interested in selling servicing into that market, maybe they think rates are going to rise in the future with more stimulus or maybe they think that that's mults at 3 are supposed to go to 4 or for whatever reason, they don't need to sell. And so I'd say the volumes of expected MSR sales is still lower than I would say than the natural level is supposed to be but the pricing is returning to more normal. And there is I would call it a - an increasing degree of visibility into the market. I think people understand where market prices are bid offer spreads are lower than they were again, several months ago and so I would reiterate what I said, I think it's beginning to heal.

In addition, I think I said this, in fact if I didn’t I'll say now on the flow market, while there are - well just still too many participants are still retaining we are seeing more sellers be interested in selling flow MSR to us going forward. Again, maybe for the same reasons that hedging concerns might be coming up or maybe there's some cash needs to support. So the market overall starting to improve and to heal, but already, it's in a pretty good place right now.

Kenneth Lee: One follow-up if I may. When you just combine together all the dynamics of the Agency Markets, the Roll Specialness, as well as the funding cost. Wondering whether if you could just give us a sense of where net interest spreads could potentially expand over the near term? Thanks.

Mary Riskey: Sure, I can take that question. So if you look on Page 7, we have shown you our as of yield as of September 30th, which is a near-term outlook. I think over time we would expect those yields to decline as we rotate our asset portfolio into lower coupons. We would expect that to be in the 1 to 1.25 range for net yield. That's going to occur over time.

Kenneth Lee: Got you. Very helpful, thank you very much

Mary Riskey: And I would - I should add that our yield on Page 7 does not include TBA dollar roll income.

Operator: The next question is from Mark DeVries.

Mark DeVries: Just wanted to clarify some of the comments around the dividend. I think you indicated , Bill, - intermediate return expectations are kind we'll call it mid teens, which presumably is benefiting from a high returns on TBAs, a little bit, it looks like just on pools it's kind of the low-double digits. Should we expect the dividend to kind of move more towards in those intermediate returns or more towards the kind of the long-term sustainable once specialness disappears.

Bill Greenberg: I'd say the answer is probably somewhere in the middle, right? When we look at the graph on Page 15, we look at the returns attributable to pools, I'd say some of the low coupon pools - lower coupon pools, we don't have any in 2s as we said, probably towards the tighter end of that range and the higher coupon specified pools that we have are more towards the higher end of that range. As I said, certainly new MSR purchases combined with TBA are sort of in the low mid teens. Putting it all that together, we think it's in the low double digits. All right. Altogether, as we said, we expect to increase our dividend modestly in the next quarter and then we - and we said a dividend policy as you know as we said, with more than one quarter in mind with some look to sustainability and those sorts of issues, as well as issues like taxable income, so forth and so we'll have to see how things unfold. We're going to look at all of those factors. As we said, we expect increase modestly keeping all those things accountable, more than actually I see where things unfold from there.

Mark DeVries: And just wanted to get your view of how long you think specified persists. Is it as long as the Fed is an active buyer and if so, how long do you think that will be?

Bill Greenberg: I think that's exactly right. I think the graphs on page whatever - Page 10 show that, all right. And so, and so that's what we expect. I don't know, you know, one man's opinion, Matt can give you his opinion. Look, I think low rates and the refi volumes that we have here in terms of origination volumes and the coupon distribution in the world probably indicates that fast speeds will persist, assuming rates don't rise for another year or so. Right? The Fed involvement is probably going to be dependent on what their view of the economy is, right? I don't know what, how the presidential election is going to come out, but if we're looking at potentially a divided government with the ability to, for lack of stimulus of this kind of thing, maybe the Fed will need to keep their foot on the gas a little bit longer than they would have if it came out a different way. So I think this is going to be here for a little while.

Operator: All right. And it appears there are no further questions at this time. Bill Greenberg, I'd like to turn the conference back to you for any additional or closing remarks.

Bill Greenberg: I'd like to thank everyone for joining us today for our third quarter earnings call, and thank you very much for your interest in Two Harbors. We'll see you next time.

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