# Two Harbors Investment Corp.
# Fourth Quarter 2020 Earnings Call Transcript

February 10, 2021

TWO HARBORS
Investment Corp.

**PREPARED REMARKS**

Operator: Welcome to the Two Harbors Investment Corp. Fourth Quarter 2020 Financial Results conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Paulina Sims. Please go ahead.

Paulina Sims: Good morning, everyone. I'm excited to join the Two Harbors team and look forward to working with all of you. I'd like to welcome you to our call to discuss Two Harbors' fourth 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 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 maybe 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. These statements are based on the current beliefs and expectations of management and the 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. With that, I will now turn the call over to Bill.

Bill Greenberg: Thank you, Paulina. Good morning everyone and welcome to our fourth quarter earnings call. Before I begin, I'd like to publicly welcome Paulina to our team on this, her first earnings call with Two Harbors. Paulina brings with her more than a decade of financial services and investor relations experience and we are very excited to have her here with us. This morning, I will go over our quarterly results at a high level and share some thoughts on our forward outlook. Mary will give more details on our financial results, and Matt will discuss our portfolio composition activity and risk profile.

Turning to slide three. We are very pleased with our fourth quarter performance and book value of $7.63, which represents a 5.8% quarterly return on book value. The results were driven primarily by continued outperformance of lower coupon TBAs, some improvement in specified pool payouts and some marginal tightening in MSR spreads. We have spent a significant amount of resources over the years, building out our MSR acquisition and oversight platform and we reaped some benefits this quarter, as we added over $40 billion of unpaid principal balance of MSR through both our flow sale channel and bulk purchases. Finally, as a reflection of all of these trends and with the confidence in our forward outlook, we also raised the common stock dividend this quarter by 21% to 17 cents per share.

We have also been very focused on our liability structure. Subsequent to quarter end, we issued $287 million of a new convertible note maturing in 2026, and these proceeds were primarily used to refinance the existing convertible note that is maturing in January 2022. We felt it was important to execute this exchange sooner rather than later, as it provides certainty for us in our capital structure for the intermediate future without having this maturity looming for the next year. Additionally, we wanted to have as many potential opportunities as possible to execute and this window was available and so we were pleased to access it.

With the certainty provided by the exchange and maturity extension of the convertible note, we also felt it was the right time to call our series D and E preferred stock. As a consequence of the events of the first quarter, our ratio of preferred stock to total equity had increased from 20% to about 32%. While we have stated that we felt this amount was manageable, we did recognize that this was not only high compared to our peers, but more importantly is not what we would write down on a blank piece of paper for our capital structure. During 2020, we built up a very sizable liquidity position to protect us against further market stress. As time has passed and as the markets have stabilized, we have come to recognize this amount of available liquidity as overly conservative. Furthermore, the primary measure by which we manage our portfolio is potential loss to stockholder equity and not nominal leverage, and we have stated many times that we are comfortable with our portfolio risk profile. Further deploying all of this excess liquidity into our target assets would increase our risks to uncomfortable levels. Those two ideas together led us to the conclusion that we had a certain amount of capital that was essentially fallow and that its best use was to call the series D and E preferred stock.

After the call is completed on March 15th, our new ratio of preferred stock to total equity will be about 26%, which we think is appropriate for our Agency plus MSR portfolio.

The convertible note exchange and the call of the preferred stock will result in a mix of common, preferred and unsecured debt that is the right size for our portfolio composition and risk appetite for the foreseeable future. It is also accretive to earnings as Mary will discuss in a few moments.

We continue to see good momentum in our MSR purchase program, which has helped to offset the impact of high prepayment speeds we have been seeing. Purchases in our MSR flow program grew by over 136% year over year, reflecting the strength of the platform and relationships we've built to source and manage the assets. On the RMBS side, there are still several tailwinds, the most important of which are very low funding rates and continued Fed involvement which, they have indicated, will persist for some time. However, spreads on RMBS are at very tight levels as Matt will discuss later and we think some caution is warranted. While unsure of the timing of any potential spread widening, we believe that an environment with uncertainty in the direction of RMBS spreads is one where our portfolio, with its lower exposure to those spreads because of the MSR offset, is especially attractive.

Turning now to some comments about the full year performance. Results for 2020 as a whole were disappointing to be sure, as book value declined to $7.63 from $14.54, a result of the market volatility and dislocation induced by the pandemic. The decisive and proactive actions we took in the first quarter to sell our non-Agency portfolio de-risked the balance sheet and generated a strong liquidity position. We took control of our own destiny and we met every single margin call during the period.

Apart from portfolio returns, 2020 has been a transformational year for Two Harbors as we transitioned to self-management. Our stakeholders continue to benefit from the collective investment, risk management, governance and operations expertise from those who have been supporting the company for many years. At the same time, we have the opportunity to deliver additional value through significant annual cost savings and enhanced returns on any future capital growth. Importantly, the internalized management structure enhances transparency and further aligns our goals with that of our stakeholders. In many ways, we think of our newly internalized company as Two Harbors 2.0 and we are really excited for 2021 and the years ahead. I'll now turn the call over to Mary to discuss the details of our financial results.

Mary Riskey: Thank you Bill and good morning, everyone.

Please turn to slide four to review our financial results. We generated comprehensive income of $113.5 million or 41 cents per common share representing an annualized return on average common equity of 22.1%. As Bill mentioned, our book value rose to $7.63 from $7.37 per share on September 30th resulting in a total economic return of 5.8%. Book value growth was driven by favorable MSR pricing due to marginal tightening and MSR spreads, TBA dollar roll specialness and lower expenses due to transition to self-management.

Moving on to slide five, Core Earnings increased to 30 cents per share from 28 cents in Q3. Interest income decreased this quarter from $89.7 million to $72.5 million due to lower average balances and coupons as well as higher Agency amortization due to prepayments. This decrease was partially offset by lower interest expense of $22.6 million reflecting lower borrowing rates and average balances. Gain on other derivatives increased from $32.9 million to $43.5 million due to higher TBA dollar roll income on higher average balances and continued roll specialness. Roll specialness contributed 6 cents to Core Earnings versus 4 cents in Q3. Expenses declined by $6.2 million primarily due to transition to self-management and lower servicing costs.

Turning to slide six, our portfolio yield in the quarter was 2.26% and our net spread decreased two basis points to 1.76%. Portfolio yield decreased by 16 basis points from 2.42% to 2.26%, primarily due to higher Agency RMBS prepayments. Our cost of funds decreased 14 basis points from 0.64% to 0.50%, driven primarily by favorable repo rolls. This quarter, we are providing additional disclosure to reflect the impact of net TBA dollar roll income in our portfolio yields. Inclusive of this impact, the annualized net spread for the aggregate portfolio was 1.96% with the benefit of 36 basis points in cost of funds.

I'd like to reiterate that since our RMBS position continues to reflect some accounting yields from the higher rate environment in which they were purchased, both Core Earnings and portfolio yields are anticipated to exceed our expected economic returns in the coming quarters. We expect our asset yields to decline over time to market rates and the net portfolio spread should converge to market levels that are more consistent with our return expectations.

Slide seven highlights our strong liquidity and capital position. We have ample liquidity with $1.4 billion in unrestricted cash as well as $215 million in unused committed capacity on our MSR asset financing facilities. Late in the third quarter, we also added a $200 million servicing advanced facility to provide committed capacity in the event of increased forbearances or defaults. As a reminder, forbearance rates have been - to date - benign and lower than expected.

Turning to leverage, our economic debt-to-equity at quarter end declined to 6.8 times from 7.7 times at September 30th, as we decreased risk late in the quarter and our quarterly average economic debt-to-equity was 7.5 times in Q4, compared to 7.6 times in the third quarter.

On slide eight, we have outlined the pro forma impact of the liability and capital actions we have taken post quarter end. As Bill mentioned, the issuance of new convertible debt in February provided certainty around the maturity and refinancing of our existing convertible debt, which matures in January of next year. With that certainty in hand and our plans to optimize the financing of our MSR asset over the coming year, we elected to redeem $275 million of preferred stock effectively reducing our cost of capital as well as our preferred ratio to 26%. Taken together, these actions are expected to deliver an annual net benefit to earnings of approximately 4 cents per share beginning in 2022 - from the reduction in preferred dividends, offset by costs associated with the convertible debt and incremental MSR financing.
As a final note, we have included information on REIT taxable income and the tax characterization of our dividend distributions on appendix slide 27. For additional information regarding the distributions and the tax treatment, please reference the dividend information found in the investor relations section of our website.

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

Matt Koeppen: Thank you, Mary, and thank you all for joining today. Turning to slide nine, let's review our quarterly portfolio activity and composition. As previously noted, the fourth quarter economic performance was primarily driven by a general spread tightening in MBS as the Federal Reserve continued its balance sheet expansion, having purchased almost 1.5 trillion MBS during QE four so far. Not surprisingly, the strongest move was seen in the current coupon mortgages that have been the Fed's focus, with a more modest but positive performance and higher coupons. With interest rates modestly steepening, but generally stable, we also saw some modest improvement in MSR spreads.

As Mary noted, we did decrease risk somewhat during the quarter reflected by lower economic debt-to-equity of 6.8 times. This is in part from sales and pay downs in our specified pool portfolio, where valuations in some stories and coupons had become less attractive. In addition, after having increased our position size in TBA 2s to $7 billion, significant spread tightening and resulting valuations in the quarter led us to reduce that exposure. On net, we took our overall notional TBA exposure down by $1 billion to end the quarter at $5.2 billion. Another factor behind the decision to reduce our exposure was that the Fed began to focus its purchase activity in forward months, which aligns more closely with the origination sales and has the effect of decreasing roll specialness. The result has been that roll specialness in the 2% coupon has decreased significantly between mid December and the end of January.

We continue to have good success in sourcing substantial volumes of new servicing through our flow channel at attractive levels and have largely been able to maintain the size of our portfolio in this fast prepay environment. Additionally, we opportunistically added almost $200 million market value of interest-only securities, or IO, during the quarter. The market is seeing very strong demand from banks for structured mortgage-backed securities near par dollar price, which can only be created today by stripping IO off of premium securities. That demand has led to spreads on the stripped down security that are tighter than that on the underlying securities. We consider those spreads quite aggressive with some structures actually having negative option adjusted spreads, which means that the resultant IO that we retain is very attractive. Additionally, these positions provide portfolio benefits that are similar to MSR when paired with RMBS in reducing mortgage spread exposure even further.

Please turn to slide 10 as we discuss our specified pool positioning and prepayments. In the lower left hand chart, you can see that specified pool performance was mixed with the 3%, 3.5% and 4% coupon specifieds outperforming TBA, but flat or underperforming in both lower and higher coupons. While we don't own any specified pools in the 2% coupon, as I mentioned earlier, we do own TBA, which outperformed by more than a point 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 specified compared to generic highlights the reason that specified pools command a significant price premium over TBA.

Moving to slide 11, you can see that our MSR portfolio was valued at $1.6 billion as of December 31st based on $186 billion of UPB and with the gross coupon of the 3.7%. That translates into a price of about 86 cents or right around a 3.2 multiple on our existing portfolio. The balances from the end of 2019 are also shown here and I would highlight two things. First, our UPB is up modestly in a fast pre-pay environment, which is a testament to our ability to source new MSR investment. Second, the weighted average coupon fell from 4.1% to 3.7% consistent again with what you would expect in a refi environment. As we reinvest into new production collateral, it will benefit our portfolio prepayment speeds should rates stabilize.

We settled $23 billion UPB of new MSR through our flow program during the quarter, which represents record volume for us as we experienced our biggest three months ever. Activity in the bulk market continues to increase as well and we continue to find valuations situational with some packages trading at pre-crisis yields while some are clearing at wider spreads. We had some success in the bulk market and settled on $20.4 billion UPB in four separate transactions. Flow pricing during the quarter was fairly constant at a three multiple.

In the lower right-hand chart, we compare our servicing prepayment speeds in blue versus generic collateral in gray. Currently, the majority of the underlying loans in our servicing portfolio have some form of seasoning or prepayment protection, which is why our speeds are somewhat slower than the implied TBA speeds.

Nevertheless, we do have expectations for speeds to 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 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 sell off and provide prepayment relief, these faster prepayment speeds will certainly continue to impact returns.

Over the next two slides, we display our effective coupon positioning and risk profile. In the chart on the top of slide 12, we show the combined exposures of Agency P&I bonds and MSR at year end compared to our positioning at the end of Q3, as indicated by the diamond bullets. The main change in our effective positioning was a decrease in the 2.5% and 4% coupons, a result of the specified pool activity I mentioned earlier.

The lower left-hand chart shows our common book value exposure to 25 basis points spread widening or tightening and it indicates that book value would decrease by only 2.7% in an instantaneous 25 basis points spread widening. We are combining the effect of structured IO with MSR in this calculation today, which we had not done in prior periods due to smaller position sizes. In aggregate, this 2.7% exposure is lower than in recent quarters due to the reduction in specified pools and TBA positioning.

Moving to slide 13, here we see our interest rate and curve exposure. Both are low and in line with our historical positioning. I would call out again that the Agency plus MSR portfolio provides significant interest rate offsets, which you can see by comparing the gray bars to the blue bars in both charts.

Let's turn to slide 14. Let’s look at some data that highlights the attractiveness of the Agency plus MSR portfolio construction. As we discussed, QE4 has impacted mortgage spreads significantly, which today are at the tight end of the range. To illustrate let's go over the first chart. What we have here is 10 years of daily option adjusted spread data on the JP Morgan mortgage index with the X axis being the OAS. It's important to also point out that this data includes previous periods of quantitative easing when the Federal Reserve were also active buyers of mortgages. The scatter plot shows the change in OAS spread over a one-year time horizon for any given starting spread. Dots that are above the X axis indicate that spreads were wider one year later from where they began and dots below the X axis indicate that spreads were tighter one year later. You can see a clear pattern, which is quite intuitive that when spreads are tight, they tend to widen and when spreads are wide, they tend to retrace tighter. Mortgage spreads are typically mean reverting. As of January 4th, the OAS was 16 basis points and is highlighted by the vertical blue line. This data shows that it's quite common for spreads to widen 20 or 30 basis points in the year that follows. In fact, in the past 10 years, there are exactly zero instances when spreads were unchanged, let alone tighter one year later.

The lower chart quantifies our preference for the Agency plus MSR portfolio construction. Again, the X axis is the starting OAS, same as the other chart. The Y axis in this case shows the expected returns on the same one-year time horizon using the average of the one-year spread change data as just described. In particular, we assume that the spread change occurs immediately and the portfolio earns the higher yield for the next one year. We have plotted an Agency-only portfolio, which represents Agency MBS hedged with swaps, which is the light blue line. The Agency plus MSR portfolio is represented by the black line. You can see that at the OAS level of 16 basis points, historically we've observed spreads move around 20 basis points wider over the next year. And in that case, the one-year return would be expected to be negative around down 1% in the Agency-only example. But because of the mortgage spread widening protection embedded into the Agency plus MSR construction, the expected return for the paired strategy is much better and gets you into the mid high single digits. The flat slope of the Agency plus MSR line relative to the Agency only portfolio is what we mean when we talk about our stable expected return on book value profile and it's particularly powerful in tight mortgage spread environments like today.

We're not saying spreads are necessarily going to widen and there's certainly strong supporting technical factors, but valuations are rich and history suggests limited further upside.

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've seen in the last two quarters, we see gross returns for specified RMBS paired with swaps as being 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, albeit at less attractive levels. New investments in flow MSR paired with RMBS today can also drive returns in the high single digits to low teens, and if you assume roll specialness on the RMBS component, can be even higher. We continue to focus on our strong partnerships with MSR sellers and internal platform, which gives us the ability to source significant volumes, especially in today's prepay environment.

And now I'll turn it back to Bill.

Bill Greenberg: Thanks for that discussion, Matt.

To conclude, we feel very good about our Agency plus MSR portfolio and the forward outlook. As Mary highlighted, our capital and liquidity position remains very strong and we took steps subsequent to quarter end to further optimize our capital structure with the benefits are accruing over time to our common shareholders and as Matt said, new investments in specified pools are less compelling today with spreads near the tight end of the long-term ranges, and we have reduced risk and leverage somewhat given the environment. However, as we discussed, we still see returns for our strategy to be supportive of current dividend levels and this tight spread environment is one where our Agency plus MSR strategy is especially attractive.

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 if you would like to ask a question, please signal by pressing star one on your telephone keypad. If you are using a speaker phone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Again, that is star one to ask a question and our first question will come from Doug Harter. Please go ahead.

Doug Harter: Thanks and good morning. Can you talk about the relative sizing of your MSR and Agency portfolio today? If I look at slide 13, it looks like the interest rate sensitivity from both is they're relatively kind of matched up. Can you just talk about kind of your expectations and willingness to kind of continue to grow the relative size of each?

Bill Greenberg: Sure. Good morning, Doug and thanks for joining us. That's a good question. So as you point out on slide 13, on the left hand chart, you do see the interest rate sensitivity of the Agency RMBS and the MSRs being roughly equal and offsetting. But if you go to slide 12, you see that there's a little bit of a difference between the mortgage spread exposure between the MSR and the RMBS. So interest rate hedged is not exactly the same as mortgage spread hedged exactly. You know, the relative sizing amount of the MSR depends on level of interest rates as well as relative pricing. We don't particularly have a target of what the terminal size of MSR is. That's a dynamical thing and we manage it actively.

Doug Harter: Got it. And then how do you think about the current sizing of the flow program relative to the expected run off? Is it kind of sized for growth or is it sized to kind of replace runoff at this point?

Bill Greenberg: I'd say again, it's market-dependent. We're very pleased with the amount of flow servicing that we're acquiring, which as Matt said is largely offsetting the runoff. We do, as we've noted in the past, have recapture programs with our existing sub-servicers as well. And that's part of what we're doing also. The amount of relative size that we acquire in any period is a function of the price that we are showing to our seller partners. If we were to increase our price substantially, we would get substantially more MSR volumes. And so it's a balance between attractiveness of the price that we're looking to see and the volumes that we're getting.

Doug Harter: Thanks.

Bill Greenberg: Thanks for joining us.

Operator: And our next question will come from Rick Shane. Please go ahead.

Rick Shane: Hey everybody. Good morning. One quick housekeeping question and then a couple of other questions. Have you guys provided a book value quarter to date?

Matt Koeppen: Good morning, Rick. Thanks for joining. We did not provide it, but through the end of last week- it's early in the quarter, but through the end of last week, we are up a little north of 2% so far in the quarter. So that's coming again from spread tightening in up-in-coupon. So that's where we are so far.

Rick Shane: Perfect. Thank you. And thank you for all the technical stuff. It's a really interesting call and the materials are helpful. I'd love to understand slide 11 a little bit better in terms of MSR pricing. It's consistent with what we've heard anecdotally, which is that with the big supply of MSR available due to production that pricing remains benign. How do we think about what we're seeing on slide 11 in context of the marginal tightening of MSR spreads that you guys have referred to as well? I just need to understand the dynamic between that slide and that comment.

Bill Greenberg: Sure. Good morning, Rick. Nice to have you here. I'll take that one. Well, you know, I mean, I see in the chart in the lower left the price multiple of new flow that we're acquiring is a little north of three multiple. We did say that the MSR spread has tightened marginally, maybe only 50 basis points, that doesn't have a big impact on the price. Maybe the price went up from 3 to 3.1 mult or something like that. So it's a pretty small effect, but noticeable in the returns.

Rick Shane: Got it. Okay. And then last question for me. You increase modestly the allocation to IO. Can you help us in, again, just putting this in context of what we saw last year, think about liquidity and funding for those assets and does this create a risk that we should be considering?

Matt Koeppen: Sure. I'll take that one. I guess we're looking at it on an opportunistic basis here. It's atypical for us to be able to source significant quantities of IO. It's coming sort of as a function of the huge demand for stripped down bonds that's happening today. The spreads on the asset are a little bit tighter than what we're seeing on servicing by maybe a couple hundred basis points, but there's an advantage in cusiped IO and in the funding aspect of things where the haircuts are lower and the funding rates are significantly lower. In terms of the liquidity of them, I mean, they're certainly far more liquid than servicing. Like I said, they're cusips – they trade on T+2, if you want to sell servicing - that's a long drawn out process. So it's an improvement in liquidity and I think, you know, overall, the thing to keep in mind is the addition of the cusiped IO really is just an extension of the portfolio construction. They really provide the same exposure as servicing does when we're looking at them.

Rick Shane: Terrific. Thank you guys for all of the detail and hope you're all well.

Bill Greenberg: Thanks for joining us.

Operator: The next question will come from Eric Hagen. Please go ahead.

Eric Hagen: Hey, good morning guys. Good to hear from you. A couple of questions here. Can you talk about where sub-servicing costs are right now and how they may have changed over the last, call it a few months? And then on the funding and hedging side, are you seeing opportunities to take advantage of the flatter term structure by adding longer-term repo? And then on the hedging, where along the yield curve, do you think it makes the most sense to focus on right now?

Bill Greenberg: Sure. Good morning, Eric. Good to hear from you too. And thanks for joining us. I'll take the first question, then I'll let Matt talk about the repo question. Sub-servicing costs have been stable. When we enter into our sub-servicing agreements, we have a pre-determined cost of service schedule that sets out what the costs are for performing loans and non-performing loans and so forth.

And so that really hasn't changed at all in recent months. Our cost of service for performing loans is still in the, call it, $6 to $7 per loan per month area and there was some activity around the cost in terms of the CARES Act and the forbearances as that came online, but as we've discussed before, that's been very benign and lower than expected. And I'll let Matt talk about the term structure of repo rates now.

Matt Koeppen: Thanks, Eric. The repo markets have been terrific. Like you noted, it is very flat. The term structure is very flat with rates in the 20 to 25 basis points is only a little at the higher end for longer term. I think we typically have a pretty termed out repo book and I think it was down around 60 days weighted average at the end of Q4. I think you'd expect to see that stretch out to more typical ranges for us, which is more like in the 70 to 80 days weighted average. I think we've seen, since last year, with increasing term markets sort of fully redeveloped, we're seeing one-year repo at attractive rates from multiple counterparties. So I think we'll continue to ladder on maturities as we typically do.

Eric Hagen: Great. That was really helpful color. And then on the four bulk transactions over the quarter, can you give some sense or some kind of market color, if you will, around the competition in the market for those transactions and really what, in your opinion, would catalyze potential additional bulk sales to take place going forward?

Bill Greenberg: Yeah, thanks, Eric. I think as we've said in the past, we find the pricing and bulk transactions to be situational. There are some packages that we think are pretty tight and some that that are attractive. The competition for bulk packages is pretty good right now. I mean, it's competitive. There's, I would say, that market has healed in a way there's probably as many market participants trading in the bulk market as there was pre-crisis. Competition probably is if anything, continuing to increase a little bit. That's one reason why we prefer the flow market. You know, these are relationships that we have built over time and have in place with approximately two dozen sellers that sell to us on a daily basis and that, in environments like this, can be more stable and constant stream of flow products. Throughout this whole episode, what we've seen is, you know, with primary, secondary spreads being so wide, the need to sell in bulk for servicers has been diminished in general. And so I think you won't see more packages come to market until you see a significant rate rise is my belief.

Eric Hagen: Really interesting. Thank you very much. Appreciate it.

Bill Greenberg: Thank you.

Operator: Our next question will come from Bose George. Please go ahead.

Bose George: Good morning. I just wanted to go back to the IO versus MSR, and it seems like one benefit of the IO would just be, I guess, less operational risks. So I guess, net-net is that the preferred place to be.

Bill Greenberg: Good morning Bose. Thanks for asking that question. I think that's certainly true. You don't need the operations in order to manage the IO position, but the financial risks are certainly similar to the MSR position in terms of managing the interest rate risk, the pre-pay risk, the convexity risk that we have. As Matt said, you know, we view this as really an opportunistic sort of environment where the demand from banks and other participants for more stripped down coupons leaves behind an attractive looking IO. This doesn't always happen. There's normally not as much IO in the market. The amount of the stripped down CMOs being created is historically very high and so they're attractive today. They give us the portfolio characteristics that we like. They have good financing characteristics. They're pretty liquid. And so for those reasons, we like them. But I wouldn't call it a strategic change in what we're doing at all.

Bose George: Okay, great. Helpful. Thanks. And then just on the roll specialness, you guys noted it’s down in January. Can you just talk about, you know, where it stands now relative to year-end? And then just, what do you expect? Do you think you could see improvement in specialness in the near term?

Matt Koeppen: Good morning. It’s Matt. I mean, it has come off significantly. I think the main thing that's caused that is that the Fed really changed their purchasing activity. They pushed their purchases out into the back months, which more matches origination sales. So for example, we talked about this in Q3 earnings. At the time we were seeing, for example, the advantage for TBA 2s for example, as being about a hundred basis points through repo rates at the time. And I think the roll rates for that coupon today are indicating something only like 20 or 25 basis points through. So it's off dramatically. That level will certainly be a function of the Fed's activity in their buying. They've modified their activity a little bit. I guess I would expect a continuation kind of the level that we're seeing today in the near term unless they change something, but it's probably being able to expect something similar to what I've seen today.

Bose George: Okay, good. Thanks. Just one last one. The issue with the Pine River, the litigation. Is there any timeline for when there's resolution on that?

Bill Greenberg: I'm sorry. I was on mute there. Excuse me. The situation is active and as I'm sure you can appreciate, I can't really say much more than that. The board continues to believe the issue is without merit and we're in early stages of this process. And again, I'm sure you can appreciate, I can't really say much more than that.

Bose George: Yep. Definitely understand. Thanks a lot.

Bill Greenberg: Thank you.

Operator: Our next question will come from Trevor Cranston. Go ahead.

Trevor Cranston: Thanks. Good morning. You briefly talked about primary-secondary spreads in the opening remarks. I was curious a couple of things. First, with respect to where MSR valuations are today, do you think that significant compression of primary-secondary spreads is already reflected in those valuations and more generally sort of how we should think about the overall impact of the portfolio if that spread does continue to compress over the course of the year? Thanks.

Bill Greenberg: Sure, Trevor, thanks very much for that question and thanks for joining us. Yeah, certainly, a compression in primary-secondary spreads is baked into current MSR pricing. That's one reason why we've said in the past that while optically servicing prices might seem lower today than they did pre-crisis, most of that reason is because the primary-secondary is so wide and valuations are building in that compression. And so if you look at yields or spreads or things of that nature that incorporate that mean reverting of that spread, you would find that the pricing is similar to what it was pre-crisis.

Trevor Cranston: Okay. Got it. And then one more question, looking at slides, 13 or 14 on spread exposure and the level of spreads today versus historical levels. I think generally they've continued to tighten in January. If you guys continue to find opportunities to add more either through MSR or IO, in light of where spreads are today, would you consider taking sort of the net spread exposure to kind of overall short position, or is that something you guys try and keep a pretty tight band around zeroish? Thanks

Bill Greenberg: Yeah, that's a good question. Again, we don't have a target for that number. Like when we talk about our other interest rate exposures, we think the net exposure to mortgage spreads is already low. We are finding the ability to sell these strip down CMOs at low to negative option adjusted spreads, which allow us to retain the attractive IOs, the MSR as you point out that we're creating, especially on a flow basis is very attractive, which serves to reduce that more. So again, we don't have a target for that number. It's driven entirely by the opportunities, but I think the idea, and as you know, the whole thesis of our strategy is to maintain a portfolio where that exposure is low and that's what we're trying to do.

Trevor Cranston: Okay. Appreciate the comments. Thank you.

Bill Greenberg: Thank you.

Speaker: That will conclude today's question and answer session. I would now like to turn the call back to Mr. Bill Greenberg for any additional or closing remarks.

Bill Greenberg: Thank you very much to everyone for joining us today and thank you for your interest in Two Harbors.

Operator: This will conclude today's conference. Thank you for your participation and you may now disconnect.

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## CONTACT INFORMATION

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