Two Harbors Investment Corp.

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TWO HARBORS
Investment Corp.
A Pine River Capital Managed Company

Mark DeVries: Good afternoon. Thank you all for joining us for this fireside chat with Two Harbor's CEO, Bill Greenberg; and CFO, Mary Riskey. We have a number of prepared questions we'll be going through. But if anyone in the audience would like to ask a question, click on the Ask A Question button in the upper right-hand corner of your screen and follow the prompts to submit your question, and we'll do our best to address those in the time that we have today. We also prepared a number of audience polling questions that we would encourage you to answer during the presentation, and we'll be publishing the results in our report, summarizing the takeaways from the conference for joining us. First of all, just dispense with the book value question. Any updates you can provide us on a book value per share as quarter-to-date?

Mary Riskey: Sure. Our quarter-to-date through August 31st, we estimate that our total return on book value is around 2.5%.

Mark DeVries: Okay, great. Next, what's the current outlook for returns on agency mortgages in the environment with the kind of moves we've seen here in spreads since you last reported?

William Greenberg: Yeah. Thanks for that question, Mark. And thanks for having us here today. It's a pleasure to be here. We see returns on agency mortgages to be in the mid-single to a high-single-digits in returns, depending on coupon and story. Of course, a common theme this year has been the attractive role specialness in the low coupons. And so their returns can be higher if you assume that role specialness lasts forever, which, of course, it won't. But we think if you do assume it, that on 2s is probably right around 10% and then 2.5% is probably in the mid-teens. But if you assume that it's going to end in some period of time, then that's probably not that different than where we see specified pools, as I said in the mid- to high-single digits.

Mark DeVries: Okay. That's helpful.

William Greenberg: But if I could add one thing there, Mark, is that, as I think we focus on what we like to call the paired construction with agency MSR, right? And the paired construction, depending on what coupon story, can certainly be in the low teens with where we're seeing servicing today.

Mark DeVries: Okay. Given some of the comments you made about TBAs and the returns kind of depending on your view of how long specialists persist, how attractive did you view those returns relative to particularly pools with the current construction?

William Greenberg: Well, I'm not sure I understand the question. I mean, the roll specialness has been attractive and powerful for a long time. And it's a little bit of a statement about how long do you think is going to persist. And when it ceases to be attractive or starts to be less attractive, how is the coupon going to behave as people, as the demand for that coupon becomes less because the roll specialness is less because, surely, on a spread basis, the coupon is not as attractive as it was compared to historical returns.

I think everyone knows that agency RMBS on a spread basis say is 10 basis points or so tighter, richer than previous periods where the Fed has been involved and is probably something like 30 basis points richer when compared with periods that the Fed has not been involved. And so the roll specialness has been an important part of contributing to returns in this period of tight spreads.

Mark DeVries: Okay. And how long would you expect roll specialness to kind of persist at or near current levels?

William Greenberg: Well, if I knew that, then I would be happier than I am. But I think it's intimately intertwined with the Fed taper and the removal of that accommodation. And of course, it's not a surprise. We're not the only ones who know that the Fed is going to taper. And so lots of market participants are underweight mortgages here. And so it's an interplay between the Fed removing support and the desire for those who are underweight to be buying if and when mortgage spreads widen somewhat.

Mark DeVries: Okay. Got it. What coupons do you currently find attractive for your agency MBS portfolio?

William Greenberg: Yes, that's a good question. We see spreads across the coupons stack to be pretty similar, static spreads to be pretty similar, but the risks are pretty different.

In the high coupons, there is uncertainty with regards to prepayments and so forth, but convexity is lower. And then we've seen some of the effects of that prepayment uncertainty in the second quarter, where faster-than-expected prepayments and faster-than-expected prepayment expectations caused a widening in those assets. And so we think a lot of that repricing has already occurred. And to the extent that there is prepayment uncertainty has been our view that it's just as likely, maybe more likely that prepayments will surprise to the slow side than they will to the fast side.

And the low coupons, the story is exactly opposite. That a repricing has not occurred, the prepayments are largely known or expected to be known, right? But what's unknown there is the convexity is, right? How is the price going to react as interest rates move and as the Fed removes accommodation?

William Greenberg: And so we, generally, in our positioning, we hedge our lower coupons, exposures and mortgages with our servicing. And we have this high coupon exposure, which we think has already experienced the repricing as a result of the risks inherent in those assets. But on a static basis, they're all pretty similar, which gives, as I said, mid to high single digits depending on everything.

Mark DeVries: Okay. Have you done any kind of material repositioning across coupon stacks since you last reported?

William Greenberg: No, I wouldn't say so. It's been mostly maintenance in terms of moving things around a little bit. We continue to add servicing and local on mortgages on the margins.

Mark DeVries: Okay. I'm curious to get your kind of thoughts on just spreads here, kind of the direction you think they've widened out about it?

William Greenberg: I'm not sure who's frozen, if it is me or Mark.

Mark DeVries: As much as you're going to or do you see more [crosstalk].

William Greenberg: I'm sorry, the connection wasn't very good. Can you repeat the question?

Mark DeVries: Yeah, sure. The question was just kind of what your thoughts are on the direction of mortgage spreads here that they've been widening out over the last couple months. Do you think that's done mostly priced in? Or do you see more room for volatility there?

William Greenberg: I do see more of a volatility as the Fed removes accommodation. One thing that's different, I think, today than what you saw on the taper tantrum in 2013 is that most asset classes are rich at historical tight levels, right? And so I do think it's unlikely that mortgages can widen in isolation of other things. There's just too much money on the sidelines waiting for investments. But I mean, I think that when the Fed stops buying $40 billion every month and prepayments are still zipping along, someone's going to have to buy that amount of mortgages or mortgages will widen. And so I do think that will occur, as I said, compared to historical levels, 10 basis points tighter than where the Fed has been involved, 30 basis points tighter than where they've not been involved. I

do expect that to happen, whether it happens in an orderly fashion or disorderly fashion, I guess, I don't know, but I would be surprised if it didn't.

Mark DeVries: Okay. How are you thinking about the relative attractiveness versus of generic versus specified pools here?

William Greenberg: Well, by generic, do you mean generic specified pools? Or by generic, you mean TBAs?

Mark DeVries: Yeah. Just TBAs or, yeah, more generic collateral.

William Greenberg: Yeah. Well, as I already mentioned, the attractiveness of the roll specialness is still there for this month or next month or the month after that through December. The rolls are still special. As things change, that is going to come off. And one will have to rely on the inherent spread of the assets in the low coupons, which, as I said, are mid- to high-single-digits by themselves, which aren't bad, but have been wider and more attractive, as I said.

Should rates rise, right? The prepayment protection embedded in some of the specified pools will become less valuable, but everybody knows that, then we hedge to longer duration is to reflect that. One thing that I think would be true for our portfolio and maybe many other portfolios out there in the world is that because the rolls have been so special, we have a fairly large TBA position, right? And as that changes, especially if current coupon spreads widen and specified pools widen, and I think you will probably expect to see our relative positioning move away from TBAs towards specified pools as that occurs, but we'll need to see some more signs that that's happened before we do that.

Mark DeVries: Okay. How are you thinking about the appropriate amount of leverage in the current environment?

William Greenberg: So we think about leverage maybe a little bit differently than many people. The way I like to say it is this, for portfolios without MSR in it, leverage and risk are really the same thing. And you can easily go back and forth between one another. Because of the properties of MSR, which hedges the current coupon mortgage exposure of our portfolio, it's not the same thing, right?

And so I always ask really, when you're asking the question where do I think leverage can go, I think you're really asking how much money do we think we can lose, right? And when we have a whole bunch of servicing, we can withstand. We talked about this just a moment ago. If I expect spreads on lower coupon, current coupon mortgages to widen, we are very well hedged with regards to those spreads because of the presence of MSR in our portfolio. We

are exposed, as we discussed in the second quarter, to spreads in the higher coupon sector. But our low coupon, current coupon mortgage exposure is very well hedged.

William Greenberg: And so our leverage is low right now, but the way I like to say it is our exposure to mortgage spreads is also very low, right? And in our earnings materials every quarter, we have a little chart that shows what will the book value exposure be for a 25 basis point spread widening and current coupon mortgages, and that number is very low. And because of our view on Fed tapering and removal of accommodation, we're keeping it very low.

That said, should we buy more MSRs? Should current coupon mortgages widen out as we think they might? Then you should expect to see us add more mortgages, right, which will increase our leverage somewhat. So if our leverage right now is in the six area, which is what we disclosed last quarter, we're very comfortable seeing that number move up to eight or nine times in an environment where mortgages are more attractive.

Mark DeVries: Okay, great. In the second quarter, you increased your MSR portfolio allocation from 15% to roughly 20%. What do you view as the appropriate mix of MBS and MSR when it comes to capital allocation?

William Greenberg: Yeah. I think it's a dynamic question and it changes with market environments and with interest rate levels and so forth. Among the factors that we look at are the hedge properties of the MSR or the hedge properties of the MBS relative to the MSR in different environments and where that could move should things change. So we don't have a target in mind, but we can certainly accommodate more MSR here, and we're actively in the market trying to buy more MSR.

Mark DeVries: Okay. And how is supply of MSR? I mean, we were just speaking to one of the larger acquirers of it half an hour ago, and they commented on finally starting to see a really healthy increase in supply. A lot of originators are not generating the same positive cash flow they were before now. We're kind of being forced to become [crosstalk].

William Greenberg: I think you're frozen again, Mark.

Mark DeVries: More active sellers. Is that kind of consistent for MSR here?

William Greenberg: Yeah. I think that's largely true. I mean, to put some numbers around that, so maybe go back from it, so we acquire MSR really through, and probably many people, through two channels. We have a flow channel and, of course, we participate in bulk auction market. The flow channel, we have a network of

between one and two dozen flow sellers. Some provide more loans to us during some times, some during other times. But generally, I would say, as a rule, the flow volumes that we experienced largely track with prepayments. And so when prepayments were at their peak, we were seeing very heavy flow volumes. Now that they've come off a little bit, we're seeing somewhat less. The bulk market has been very active for the reason that I think that you just mentioned that we've talked about in the past that many servicers, when MULTS were low and rates were low and primary, secondary spreads were wide, didn't have the need or the desire to sell into the market at those levels and then retain them.

William Greenberg: And I think the normalization of the primary, secondary spread today as well as rates, while they were a lot higher, as everyone knows, but rising rates has allowed these guys who hadn't hedge potentially to monetize a little bit to recognize some multiple expansion and make some extra money there. So I think we are seeing some of that come to market, and they started to say to put some numbers around it. If an average year in bulk volumes is, say, $200 billion to $250 billion of supply, we saw about $55 billion of supply in the first quarter. We saw about, I forget, $130 billion or so in the second. Then we've seen $100 billion already in the third, right? So we're already north of $300 billion in bulk supply from small guys, medium-sized, big guys. And I expect that to continue through the balance of the year.

Mark DeVries: Got it. How was the demand for that supply lined up? Have you seen some attractive pricing, given that strong supply?

William Greenberg: It's competitive. There's lots of buyers in the world for bulk servicing. And it's interesting, some packages that I think should have high demand have less than some that I think are less have high demand. And so it's situational, and we participate in them. We don't buy every package for sure, but we're targeting certain returns and we're able to achieve that. And so we're pretty satisfied with our activity there.

Mark DeVries: Okay. And can you talk a little bit more about the number of flow partners you have and how the mix you're saying between flow and bulk has been?

William Greenberg: We have north of a dozen flow partners right now that are delivering to us. And I said, the flow that we have moves with prepayments, and it largely offsets are runoff. And then we can be active in the bulk market. So we can't predict when packages are going to come to market and what they're going to look like and whether we're going to be the best fit and so forth. So that's more opportunistic in a way the flow right now is more predictable.

Mark DeVries: Okay. Understood. Moving on to prepay speeds. How have those been tracking this quarter? And how does that compare to kind of like recent expectations?

William Greenberg: So again, I think the prepayment market is a tale of two stories. The low coupons, I think, have shown themselves. As I said, everyone has expected them to be very reactive to even small changes in rates. And so over the last six to nine months, as we've seen rates go from the low to the highs and back to lower rates, we've seen prepay speeds on, on 2s and 2.5s. And the current coupon complex in general react quickly to those changes. Loan sizes are up in those areas. And so they're very reactive.

William Greenberg: In a high coupon sector, I think, some time ago people had called burnout to be elusive. And certainly, prepay speeds were stubbornly fast for some period of time. But I think what happened there was that their lack of initial reactivity caused some market participants to declare burnout over or absent and to project those fast feeds far into the future. And I think what we've seen over the last couple of reports is that prepay speeds at high coupons have started to slow. They've slowed more than day counts would suggest. And so I think those have generally been a little bit slower than expected. Mary indicated that we're up a little bit this quarter so far, and really the drivers of that have been the performance of the higher coupons as result of moderating high coupon speeds.

Mark DeVries: Okay, great. Turning to the Fed and the imminent taper. Can you just talk about what your expectations there for when, how long and what pace and yeah, how you think the market ultimately reacts to all this?

William Greenberg: I have no special insight into that, that other people don't have. So I mean, it doesn't matter what I think. It sounds like it's soon, right? Maybe we'll get an announcement next week about a start date. But even if they don't start in November, they'll probably start in December. All the general consensus is that they should be done on the mortgage side by the middle of next year. I have no reason to think anything different than that. As I said, I mean, the removal of $40 billion per month of buying is significant. And someone else is going to have to buy that or spreads are going to widen.

Mark DeVries: Okay. I think as you've indicated, obviously, you don't think that's the way price went up. How does that impact how you've kind of positioned the portfolio here?

William Greenberg: Well, in terms of our leverage, as we said, it's lower than it could be. Should spreads widen out, I would expect that to increase. But as long as spreads are where they are, we find attractive opportunities in the paired construction of

owning MSR with RMBS where we don't care what happens to the spreads, right? I can put together a package when we buy MSR and hedge it with current coupon mortgages in the low-teens returns, and I don't care whether mortgages widen or not a little bit. That said, our leverage is low. We have significant dry powder to put to work should mortgages widen out some in order for us to take advantage of that.

Mark DeVries: Okay. Got it. Yeah. Just given the opportunity you said you see here, how are you thinking about the prospects of raising more capital? Is the investment today attractive enough that if you get an opportunity with the shares above book to issue more that you'd be active?

William Greenberg: Yeah. Well, we recently did raise capital, right? The thinking there was that we wanted to be able to react quickly to changing market environment. That's still true. We always think about whether a capital raise would be good for shareholders, if you have something to do with the money. And if we see that opportunity again, right, you might expect us to behave similarly. And we see plenty attractive opportunities in the MSR market in particular, but especially when paired with RMBS.

Mark DeVries: Got it. How are you thinking about the kind of the proper balance between common preferred equity in the capital structure?

William Greenberg: Yeah, that's a good question. Well, I mean everyone knows preferred is really leveraged to the common shareholder and, of course, the cost of that capital acts as a hurdle rate for your marginal investments that you have to make more than that, otherwise. But if you do that, that's accretive to the common. If you don't, then it's dilutive to the common. We're very happy with our relative mix at the moment. I think as you know, Mark, we be called some of our preferred shares earlier in the year that brought out our ratio of preferred stock to total stockholder's equity down to around 25%, which, we think is the right amount for our portfolio mix and our portfolio composition. MSR, again, going back to the leverage question a little bit or statement, as I said, preferred can be thought of right as just leverage to common. And so if I can put together a package of more servicing with RMBS, which has very little risk relative to mortgage spreads, that's a perfect use for preferred, right, as opposed to common. But we think that the mix that we have is the right amount for now.

Mark DeVries: Okay. Great. Anything interesting happening around on the financing side, whether it be on your repo costs, ability to extract, a little bit of leverage out of your servicing assets worth talking about?

William Greenberg: Yeah. Maybe I'll let Mary do that one, if that's okay.

Mary Riskey: Sure. So we have several MSR facilities in place. We are continually in conversations with our counterparties to have those reflected at market rates. We have plenty of capacity. And so that market's looking really good and as is the agency repo market has been very stable.

Mark DeVries: Okay, great. Just talk about the outlook for the dividend here, giving kind of the current level of core earnings and ROEs that you expect to generate from the investment portfolio.

Mary Riskey: Sure. Our dividend philosophy really hasn't changed. We set the dividend to reflect the economic returns of the portfolio over time. And with more than one quarter of mind, we feel good about our current level. Estimated gross returns on new investments at the MSR paired with RMBS are in the low to mid-teens, and we will continue to evaluate the dividend in the context of those return expectations.

Mark DeVries: Got it. And anything in D.C. that you guys are following from a broader policy or a mortgage and housing-related policy that you're keeping a close eye on that could potentially have an impact on the portfolio?

William Greenberg: Well, sure. I mean, there's news reports yesterday about a new FHFA director. I think I've read the same newspaper articles as everyone else. So I can't tell you more than about him other than what I've read. That could potentially be interesting to see how that impacts GSE reform or privatization or guarantee fees and their potential impact on prepayments and all of those things. So there's a lot there to pay attention to. I'm not sure that there's that much that we're going to actively do as a result of those things. We're still sitting here executing our strategy of buying servicing and hedging it with agency RMBS. So I don't think there's anything there that would cause us to change that.

William Greenberg: Another related set of things that are out there in the world are in the CFPB or other potential regulatory postures that they could take that will change or that will impact servicers. I don't particularly think, again, that will change the way that we think about our servicing portfolio or profile. I think us and many of the servicing industries are already operating in a heightened compliance environments and are doing everything they can to be borrower-friendly and to help ours through the stress they have during this crisis. So even though as we switch from one administration to the next, where maybe the postures are slightly different, I don't think that will change the way that we think about our portfolio either. But obviously, we want to pay attention to all these things to

see whether it does change our risk or increase our risk or provide opportunities for us to take advantage of certain things.

Mark DeVries: Okay. Great. Well, it's certainly been a very helpful conversation. I think we'll end on that note. But let me thank you both for your time and insights. We really appreciate it.

William Greenberg: Thanks very much for having us, Mark. Appreciate it.

Mary Riskey: Thank you, Mark.

Mark DeVries: Thanks.

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