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TWO - Q4 2015 Two Harbors Investment Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors Investment Corp.'s fourth-quarter 2015 financial results conference call.

(Operator Instructions)

As a reminder this conference is being recorded.

I would like to introduce your host for today's conference Ms. July Hugen, Director of Investor Relations. Ma'am, please go ahead.

July Hugen - *Two Harbors Investment Corp. - Director of IR*

Thank you and good morning. Welcome to our fourth quarter 2015 financial results conference call. With me this morning are Tom Siering, President and Chief Executive Officer, Brad Farrell Chief Financial Officer, and Bill Roth Chief Investment Officer.

After my introductory comments, Tom will provide a recap of our fourth-quarter and full-year 2015 results, Brad will highlight some key items from our financials, and Bill will review our portfolio performance. The press release and financial tables associated with today's conference call were filed yesterday with the SEC. If you do not have a copy you may find them on our website and the SEC's website.

This call is being broadcast live over the Internet and may be accessed on our website in the investor relation section under the events and presentations link. We encourage you to reference the accompanying presentation to this call, which can be found on our website in the same location.

Reconciliation of non-GAAP financial measures to GAAP can also be found in the appendix of the accompanying presentation. We wish to remind you that remarks made by Management during this conference call and the supporting slide presentation may include forward-looking statements.



Forward-looking statements reflect our views regarding future events and are typically associated with the use of words such as anticipate, target, expect, estimate, believe, assume, project and should, or other similar words. We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties and actual results may differ materially from expectations.

We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC's website at www.sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate.

I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Thank you July. Good morning and thank you for joining us today.

Let's begin with a summary of our fourth-quarter and annual financial results which can be found on slide 3. Book value at December 31 was \$10.11 per share which represents a total return on book value of 0.7% for the fourth quarter and 0.5% for 2015. For the full year we realized a comprehensive loss of \$4.5 million, or \$0.01 per share, while generating Core and GAAP earnings of \$0.89 and \$1.35 per share respectively.

In the fourth quarter we realized a comprehensive loss of \$3.2 million, or \$0.01 per share, while generating Core and GAAP earnings of \$0.20 and \$0.59 per share respectively. We repurchased 12.3 million shares in the fourth quarter at an average purchase price of \$8.37 per share for an aggregate cost of approximately \$102.7 million.

During the full year we repurchased 13.7 million shares at an average purchase price of \$8.43 per share for an aggregate cost of approximately \$115.2 million. Subsequent to quarter-end we have repurchased additional shares and announced that our board authorized an additional 50 million shares for repurchase.

We continue to evaluate share buybacks with consideration to a number of factors, not the least of which is our prevailing share price relative to book value in the spectrum of investment alternatives.

Turning to slide 4, 2015 was a successful year for our business. We sponsored seven securitizations with a total UPB of approximately \$2.0 billion, obtaining our goal of sponsoring 6 to 10 securitizations during the year, while also expanding our originator partner network.

We added six MSR flow sellers, achieving our goal of adding 5 to 10 flow sellers in 2015 and closed on four bulk MSR acquisitions with a total UPB of \$8.5 billion. Finally the build out of our commercial real estate team was completed and we closed on 18 loans with a carrying value of \$661 million at December 31.

Moving to slide 5 from a macro perspective this was a challenging year. Interest-rate volatility was elevated as the market waited on the Fed's decision to raise interest rates which finally occurred in December. Agency and credit asset spreads widened during the year.

We expect future interest-rate policy to be subject to both domestic and international economic considerations, but for right now lower for longer seems the most likely scenario, as the US is for the time being bereft of any meaningful inflationary pressures. We strive to be a thought leader and remain engaged on regulatory and policy related topics that directly impact our business including credit risk transfer, the private label securities market and the role of private capital in mortgage market.

Before I turn the call over to Brad for a review of our financial results I would like to briefly comment on the FHFA's filing ruling on federal home loan bank membership, which now precludes captive insurers from ongoing membership eligibility. We are obviously disappointed with the FHFA's final decision as we believe our interests align directly with the mission of the home loan bank system and that are secured financings are consistent with their safety and soundness mantra.

Since we were admitted as the member in 2013, prior to the proposed rulemaking, we have a five-year grace period on our membership. Therefore we do not believe the ruling will have an impact to our financing model in the near or intermediate term.

Brad will discuss our financing profile with more granularity. With that I will now turn the call over to Brad.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Thank you Tom and good morning everyone.

Let's turn to slide 6. Book value ended of the year at \$10.11 per share versus \$10.30 at September 30 and \$11.10 of the beginning of 2015. We had a comprehensive loss of \$3.2 million, or \$0.01 per share in the fourth quarter and \$4.5 million, or \$0.01 per share for the full year.

Our comprehensive loss in the fourth quarter was primarily driven by unrealized losses on both our agency and non-agency RMBS securities, partially offset by gains on our hedging instruments. The Company also declared a dividend of \$0.26 per share for the fourth quarter, resulting in total dividends of \$1.04 per share for the full year.

Stock repurchases work accretive to book value by over \$0.06 per share for the quarter and \$0.07 per share for the year. Next I would like to discuss our taxable income. Dividend distributions and the 1099 treatment of those distributions all of which are highlighted on slide 7.

In 2015 the REIT generated taxable income of \$404.8 million, which included taxable realized gains of \$261.1 million on the sale of certain RMBS securities. Since our 2015 dividend declarations of \$376 million did not exceed taxable income, our dividends will be treated as taxable to stockholders, with 61.7% deemed long-term capital gains.

Importantly we distributed 92.9% of our taxable income to meet our REIT Compliance while carrying over \$28.8 million of ordinary income into 2016. All these metrics align with our financial projections and tax planning efforts throughout 2015. For additional information regarding the distributions and the tax treatment reference the dividend information found in the investor relations section of our website.

Please turn to slide 8. Core earnings were \$0.20 per share in the fourth quarter, representing an annualized return on average equity of 7.8%. Core earnings for the full year were \$0.89 per share, representing an annualized return on average equity of 8.2%.

On the left-hand side of this slide we have provided a detailed quarter-over-quarter analysis of Core earnings. I'd remind everyone that Core earnings are not viewed by Management as a key performance measure or dividend indicator.

We focus on total return, which on occasion can reduce Core earnings in the near-term as we protect our portfolio against book value volatility. Interest income decreased 12.6% quarter-over-quarter primarily due to the reallocation of capital within our portfolio.

Transitioning capital within a portfolio is not a linear process as it takes time to sell an asset, reinvest the funds, and finance the new investment. While we have a team that ensures we execute that transition as efficiently as possible, the sizable shift of capital into commercial real estate created a drag on Core earnings.

Our swap cost decreased 35.3% during the fourth quarter due to a smaller average notional balance and lower swap rates, resulting in less interest spread expense. Our other operating expense ratio for the quarter was 1.7% of average equity up modestly from 1.6% in the third quarter.

The ratio increased as expenses were roughly flat but stockholders equity decline due to the share repurchases. I will note however that we have added human and technological resources to support the conduit, MSR, and commercial real estate. These factors combined with variable transaction expenses and the potential for further share repurchases may result in a higher expense ratio in 2016.

Please turn to slide 9 for an overview of our financing profile. Our repurchase agreements totaled \$5 billion at year-end down from \$8 billion at September 30th due to sales during agency RMBS securities.



Despite tighter balance sheet conditions on the Street in the fourth quarter, the repo market for RMBS continues to operate in a normal manner for us as we leverage our counter party relationships and negotiate a reduced portfolio. Our FHLB advances totaled \$3.8 billion at year end and we are pleased with the ongoing collateral shift as we onboard mortgage and commercial loans.

Specifically we have \$1.4 billion and \$0.2 billion financing conduit assets and senior commercial loans respectively at year end. I would also like to comment on the FHFA's ruling regarding FHLB membership. The final rule subjects us to a five-year membership grace period and limits our outstanding advances during this period to 40% of the assets of our captive insurer. It also prohibits new advances or renewals that mature beyond the five-year period.

That being said we expect our existing advances maturing beyond the five-year period will remain in place in accordance with their terms. While we are disappointed that our membership will end in five years we are comfortable with the 40% asset requirement, and as Tom noted do not expect the ruling to have a near or intermediate term impact. During the fourth quarter we also secured a \$250 million repo facility for senior and mezzanine commercial real estate loans, expanding and diversifying our financing capabilities.

Whether it is FHLB, repo, or warehouse lending we spend a great deal of time managing our liquidity risk to counterparties market and regulatory events. The optionality afforded by our financing tools allows us to navigate these variables seamlessly. For more detail on our borrowings please see appendix slide 26.

Next Bill will discuss the portfolio.

Bill Roth - *Two Harbors Investment Corp. - CIO*

Thanks Brad.

Let's turn to slide 10 to review our fourth-quarter portfolio performance and yields. Our annualized net interest spread was 3.26%, up 43 basis points from the third quarter. Net interest spread was positively impacted by the shift in our asset composition toward higher yielding assets, strong IO and MSR performance, as well as solid yields across our credit and Commercial Real Estate portfolio. From a book value perspective, agency spreads were mixed throughout the quarter, credit spreads widened dramatically, and swap spreads remained negative to treasuries. All in all these variables put negative pressure on book value. Due to the uncertainty in the market we believe it is prudent to continue to maintain low overall interest rate exposure and leverage.

Let's turn to slide 11 to discuss the composition and allocation of capital. As of December 31st the portfolio was 11.1 billion in assets with roughly 49% of capital allocated to the rate strategy, 43% to the credit strategy and 8% to commercial real estate. Approximately 38% of our capital was dedicated to retained interest from our securitization, our loan pipeline, MSR and commercial real estate assets up significantly from 22% at 2014 year end.

Over the past year we reduced the capital allocation to Agency and non-Agency RMBS from 78% to 62%, as we sold RMBS with an amortized cost of \$6.6 billion throughout the year. The transition of capital within our portfolio during 2015 was an exceptional accomplishment. We believe we have laid the foundation for higher risk-adjusted returns for our stockholders over time.

Now let's turn to slide 12 and spend a moment on the conduit and MSR. We're excited about the development of our Agate Bay brand. According to our research Agate Bay was a leading issuer in the private label securities market, accounting for roughly 16% of the total new prime jumbo issuance in 2015.

Investor interest in our program and participation has been broad with over 50 different participants since inception, many of whom have invested in multiple deals. Finally deal execution improved during the year, allowing us to generate attractive expected ROEs on the assets we retained.

Our conduit program is supported by high-quality originator partners, 44 of whom were active at year end. The strength of these partnerships affords us the ability to maintain a solid pipeline, which includes loans and interest rate lock commitments of \$1 billion at December 31.

During the fourth quarter we sponsored one Agate Bay securitization totaling \$332.8 million and we completed our first securitization of 2016 in January totaling \$299.3 million. With regard to MSR we expanded our flow sale arrangements and added approximately \$4.7 billion UPB via bulk and flow purchases in the fourth quarter.

Furthermore yields on MSR remained attractive and we realized a gross yield of 7.2% in the quarter not including any hedging benefits. MSR continues to be an attractive asset for our portfolio and we were happy to be able to invest approximately \$124 million in new MSR assets throughout 2015.

Over the long term we believe the success of our MSR platform will be driven by the organic expansion of our flow sale arrangements within our originator partner network, and we are concentrating our resources on cultivating these relationships.

Please turn to slide 13. We deployed significant capital to the commercial real estate strategy during the fourth quarter as we added nine assets. This was a great finish to a remarkable year for our commercial real estate platform.

At December 31 we had a total of 18 commercial real estate assets with a total carrying value of \$661 million. These assets are secured by a diverse group of properties throughout the US and have an initial -- average initial LTV of 72.3% and average spread over LIBOR of 507 basis points.

We plan on having a variety of financing capabilities to support the strategy, including the \$250 million facility Brad previously mentioned and the FHLB to finance senior loans. Opportunities in the commercial real estate market remain attractive and we expect to deploy additional capital to this business throughout 2016.

I will now turn the call back over to Tom.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Thanks, Bill.

Please turn to slide 14 and let's discuss the future for Two Harbors. In 2016 we plan to continue to reallocate capital in sectors with more attractive returns, including our mortgage loan conduit, MSR and commercial real estate.

This will be accomplished by keeping our agency exposure low unless market conditions change, and by selectively harvesting positions from our legacy non-Agency portfolio. We also constantly evaluate the economics of share repurchases. We believe the diversification of our portfolio will allow us to deliver high-quality returns over the long term while dampening volatility and minimizing risk.

From a dividend perspective we anticipate issuing a quarterly dividend of \$0.23 per share in March subject to the discretion and approval of our board. We expect this quarterly dividend amount to be sustainable throughout the year. As you know we do not typically provide guidance on dividends or other financial results.

However, given extraordinary market conditions we feel it is beneficial at this time to give stockholders more insight into what we are expecting for 2016. We do not expect, necessarily, to provide regular updates on our dividend outlook and future earning cycles. We're excited to build upon our accomplishments in 2016 and look forward to updating you over the coming quarters.

I will now turn the call over to Michelle for questions.



QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Our first question comes from the line of Doug Harter with Credit Suisse.

Tom Siering - Two Harbors Investment Corp. - President and CEO

Doug, we certainly hope you are not a hater today.

Doug Harter - Credit Suisse - Analyst

No worries. I was hoping you could talk about the relative attractiveness of agency. Obviously you guys sold a lot of assets in the fourth quarter some of your competitors are talking about with lower for longer becoming more likely. That this being an attractive time to add assets or overtake on a little additional risk, just wanted to hear your commentary on that.

Bill Roth - Two Harbors Investment Corp. - CIO

Yeah, Hey , Doug, it's Bill. Thanks for joining us. Yes, look agencies have cheapened out somewhat and obviously as you guys all remarked in your comments hurts book value that's good for future spreads. However, given that we have so many different options to deploy capital to agency is still sort of not at the top of our list. We still happen to like commercial MSR and developing a conduit we still think those are better returns for our shareholders.

The other thing is given we're at such low rates in order to generate sort of mid-teens you have to take some reasonable duration risk and given where we are in the rate cycle -- I mean it's possible we stay lower for longer but it's a little dicey to be taking a bunch of rate risk when the 10 year is at, you know, [1.85%]. So I'd say that yes it's more interesting today than it was before but probably does not crack our top two or three things to deploy capital to right now.

Doug Harter - Credit Suisse - Analyst

Got it. And on the commercial real estate, given increased concerns around risk assets and the health of the economy, how are you thinking about credit quality and where we are in that cycle and whether now is the right time to be adding those assets?

Bill Roth - Two Harbors Investment Corp. - CIO

Yeah sure, that's another good question. Basically if you look at -- we look at each asset on an individual basis. We do substantial underwriting including LTV debt service coverage et cetera and we are -- while there has been a lot written about commercial real estate and particularly in some of the key markets whether it's London or New York city or whatever.

Not all markets have experienced the run-off that those have and the way to protect against that is to make really high-quality loans where the coverage is there and the LTVs are low. So we are still very comfortable and the diligence is done on the loans that we are making is extremely high. Like anything else, you look at a lot of loans but you only make a few of them.



Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Doug, it's Tom. Commercial real estate the risk embedded it is very idiosyncratic right? So the key is just really robust underwriting and we are committed to that.

Doug Harter - *Credit Suisse - Analyst*

Great. Thank you.

Operator

Bose George with KBW.

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

Hey guys, good morning. First, you talked about the drag from capital relocation. I don't know if there's a way to quantify that. Was there some sort of way to think about how much excess capital you carried while that transition was happening?

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

I can take a response to that. There's not a simple way to offer that for that calculation. As you know investing, reinvesting throughout a quarter is quite complex and fluid so to try to quantify the impact would be more estimate than actual math.

But to give us some color and maybe how you can model it or think about it is in simple terms while a CUSIP can settle T plus 2, T plus 3, we're going to be looking to sell those assets where there's an opportunity where the value is in the market and so that could not -- that might not necessarily connect right to when we want to onboard a CRS.

Meanwhile when we secure or lock a CRE loan, that can take anywhere between 1 to 2 months to negotiate and to do the due diligence and as Tom mentioned. And that settlement is very fluid. If you think about the timing there can be call it two-to-four-week windows where we've seen an opportunity to sell out of an agency or other type of asset where we've settled the CRE, and then on the financing side our financing counterparty need to do their own processes, and with the FHLB that process can take anywhere between 20 to 30 days and with any other street counterparty it could also take a period of time.

Maybe that a high-level to give you some thoughts on how that sequence plays out and we do everything we can do to minimize that timeline. But when you're redeploying that amount of capital there is impact.

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

Great. That's very helpful. Thanks. And then switching over to book value quarter to date can you give us an update or sort of puts and takes that we should think about?

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Sure Bose, it's Tom. Thanks for the question. It's intra-quarter it's our policy not to comment on book value unless we think there's some move of significant one way or the other. And we -- those conditions don't exist. January was on an unextraordinary month I would say.

Bose George - Keefe, Bruyette & Woods - Analyst

Okay, great, thanks. Actually just one more. Just wanted to confirm on the \$2.3 billion of FHLD advances you guys have with the 20 year maturity, so that stays outstanding for those 20 years and you can substitute collateral as stuff rolls off over there?

Brad Farrell - Two Harbors Investment Corp. - CFO and Treasurer

Based on our understanding of the rulemaking and discussions we believe that's going to be out there for 20 years. At the same time just with all advances it's all about collateral.

It's a pool funding so you can replace collateral as you see fit based on advanced rates et cetera. So yes that's a correct understanding.

Bose George - Keefe, Bruyette & Woods - Analyst

Okay great thank you.

Operator

Trevor Cranston with GMP Securities.

Trevor Cranston - JMP Securities - Analyst

Thanks, good morning. First on the commercial real estate side given the progress you guys made especially over the second half of 2015, have you guys rethought kind of the capital allocation target for that business or can you give us some context on how you're thinking about that for 2016?

Tom Siering - Two Harbors Investment Corp. - President and CEO

Trevor, this is Tom, good morning, especially good morning to you, you're quite early there. I would say that Bill and I and the investment team think about reallocation constantly. That's amongst other things what we're paid to do.

So it's certainly possible that allocation goes up but it's just going to depend upon as we go along what the investment alternatives are for us. Obviously we want to optimize return for shareholders and so it's something that we constantly evaluate.

Trevor Cranston - JMP Securities - Analyst

That's helpful. And then looking at the 2016 outlook slide, one of the goals there it says is to broaden financing capabilities. I was wondering if you could just expand on the various ways you think you'd be able to achieve that, whether or not you guys have considered doing anything like potentially forming a broker-dealer or anything like that. Thanks.

Tom Siering - Two Harbors Investment Corp. - President and CEO

Sure. You know, there's a lot obviously going on with the street from a regulatory and a capital standpoint. We're not really prepared to roll out any sort of bold new alternative today but it's something that we're working very diligently on.

If you look at our financing options today as Brad laid them out, we have repo, we have warehouse lines, we have the home loan bank. I feel very good about where we are but it's something that you always have to constantly strive to reconsider because the world is changing constantly and



the environment for the street is challenged right now and so we continue to work on other options. Today I don't have anything definitive to say about that but it's something we constantly work on.

Trevor Cranston - *JMP Securities - Analyst*

Okay. Thank you. Appreciate the comments.

Operator

Rick Shane, JPMorgan.

Rick Shane - *JPMorgan - Analyst*

I think I got my phone changed this morning.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Good morning Rick.

Rick Shane - *JPMorgan - Analyst*

Good morning, guys. Trevor don't worry I'm still here, you are still there. Anyway just wanted to ask a little bit about the implications of the dividend for 2016. Implicitly you are looking at about a 9% ROE based on where book value is.

Given the transition in the strategy basically to what I would describe as an absolute return strategy going forward is that the right way to be looking at it? Is at about a 9% to 10% ROE or do you think there will be environments where you can do better in this is sort of a trough?

Bill Roth - *Two Harbors Investment Corp. - CIO*

Hey Rick. Good morning. This is Bill. As you know you followed this sector for a long time. If you look back a number of years, right, we had expected ROEs on agencies and on non-agencies in a variety of things that were in the mid-teens or even potentially higher than that and that was just a function of the spreads that were available at that time. So what we've seen in the last several years particularly as it relates to agencies with the Fed buying assets and compressing the spread but also that filtering over into other asset categories is if there's less spread, then there's less expected ROEs and that's just -- that's just math. There's no other way around it.

If you look at what we're trying to do in deploying capital in what we think are the higher absolute as well as higher quality ROE, today what we are seeing is the ones that are the most interesting to us our sort of low double digits and low maybe potentially mid-double-digit so when you take that and you knock off the cost of operating our business, it gets that gets you into that as you call it 9%.

Frankly if you're not taking a lot of risk and you're not taking a lot of interest rate risk et cetera, that sort of the way the math works, and that doesn't mean that going forward the spreads won't be more attractive. I will say this, one thing that we've seen going on the market lately particularly if you look at CMBS and high-yield and other sectors, their spreads are starting to widen out quite a bit.

So it could very well be the case that this is a trough but that will really depend on what spreads are available going forward. Our goal is to drive the best risk-adjusted return while protecting book value. That's what we've tried to do over the last six years and what we'll try to do going forward.



Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Rick, obviously the easiest way for us to move the needle is through the agency space, right? That's without question. And agency spreads, while they are more attractive than they were a bit ago, still by historic standards aren't anything to shout about.

To the extent that Bill and I remain convinced that there will be a sunnier day in the agency market and that's why we are maintaining a low risk profile in the agency space and playing for that sunnier day. It may never develop but at this point the risk reward we think is certainly is tilted toward keeping spread duration low, keeping risk low and that's the way we position the portfolio.

Rick Shane - *JPMorgan - Analyst*

Got it. That's helpful. Thank you. And to follow up on that just a little bit, you guys point out the drag this quarter from the transition of the portfolio and I assume that over time the whole opportunity here is to reallocate capital. Is it fair to say this was a quarter where it was more of a -- I guess structural change in the portfolio and that going forward you would expect sort of incremental that if you see opportunity for example in agency land, it will be more about taking leverage up or down there and that we wouldn't really necessarily expect to see that type of drag going forward?

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

In respect to the drag, for the quarter I would certainly say that to try to quantify that would be perhaps challenging and maybe a tickle disingenuous. Because it frankly is more art than it would be science but without a doubt there was a drag from our relocation capital.

So if you look -- it was bit of a transition period in respect to commercial real estate effort because we were onboarding loans to Federal Home Loan Bank which was something somewhat new, and also we obtained this warehouse financing facility so I would say in respect to the financing of commercial real estate it was a period of transition and without a doubt it created drag on the Core earnings for the fourth quarter.

Rick Shane - *JPMorgan - Analyst*

Okay. Thank you guys.

Operator

Ken Bruce with Bank of America Merrill Lynch.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Thanks. Good morning. It seems like we've got all the San Francisco analyst on at the same time. My first question really is kind of directed towards the reallocation or just the change in the portfolio mix.

There's clearly some concerns around the state of the US economy if you, especially if you look at the equity market and I guess I'd like to know how you're thinking about the continuation of acquiring credit assets if there's a probability of going into a recession and maybe you don't believe that but if you could maybe comment on some of the discussion around inverted curves and the implications for the portfolio that would be helpful. Thank you.

Bill Roth - *Two Harbors Investment Corp. - CIO*

So are you guys all gathered in a coffee shop somewhere in your just passing the --



Ken Bruce - *BofA Merrill Lynch - Analyst*

We could but unfortunately we're not.

Bill Roth - *Two Harbors Investment Corp. - CIO*

So can, I think I heard two questions in there so the first one was around the credit assets. First of all as you can see our residential credit continues to decline. Commercial credit is obviously -- in the grand scheme of things a small part of our book but we are seeing really good opportunity there to make -- basically to make loans at what we believe to be very solid LTVs and coverages. So. Tom said it's idiosyncratic.

There's the commercial real estate sector is huge and certainly like I said before there's been some run up in say premier properties in New York, but if you look in our disclosure at the back you're going to see generally smaller to mid-size loans and so we are actually very comfortable with that. On the residential credit, we continue to sell, that's declined because -- we've been selling those assets.

You know, could there be a point at which we start to get nervous on the commercial side? I guess but we are not anywhere near that at this point. The second part of your question you referred to an inverted curve? Could you elaborate on that a bit so I can try and answer the question appropriately?

Ken Bruce - *BofA Merrill Lynch - Analyst*

Sure. I'm not a rates expert by any measure but at least some of the folks at our shop that are looking at the current yield curve and some of the issues around its shape relative to a zero bound and are suggesting that it's actually quite a bit further -- flatter than the nominal curve suggests. An the implication there is that it's a precursor to a recession so I guess really I'm interested in terms of not only how you think the credit assets perform to the degree that relationship stands but also how the portfolio as a whole is positioned if in fact you get more of a flattener or an inversion going forward.

Bill Roth - *Two Harbors Investment Corp. - CIO*

Sure. So there's a bunch of things in there, so I would say first of all while our residential credit book has been declining due to sales I would also note it's certainly still a big part of the portfolio to the extent you get -- I mean a recession certainly you would expect to see homeowners potentially some of them anyway having trouble but if you look at what we have, right? The composition is the bulk of the legacy that we have, those loans are typically on average maybe 10 years old and if you look at gas prices, the amount of money that's flowing through to the pockets of homeowners is much higher because they are spending much less on gasoline so actually lower gas prices, lower rates actually benefit residential borrowers.

And then the conduit assets, if you look at those and you look at the average LTVs on the Agate Bay deal, those are ludicrously low and I'm not saying we won't have any delinquencies there but so far we don't have a single loan 60 days. And so and what we have had but we don't have any currently, and so basically if you look at that we think the credit quality there is extremely high. So, I mean look, we just have to keep our eyes on it and see how things play out but we are very comfortable with our -- with our exposures there.

In terms of the curve, we're at very low rates the Fed raise rates maybe they are done the market sort of indicated that they might be done for the year in terms of repricing the front end. You know look, we could have a situation where the curve is extremely flat at low interest rate levels and that will produce its own challenges.

From our standpoint in the agency side where you would expect to see very fast prepay the bulk of what we still have is still highly prepay protected. There's a bunch of information on that in the appendix. Our prepaid speeds are still very low and typically we are not as you know today or historically inclined to take a lot of interest rate risk and curve exposure, and so as a result we think if you get into that situation from a rate and curve standpoint that we will be in reasonable shape.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Thank you. I -- for my own perspective sorry

Bill Roth - *Two Harbors Investment Corp. - CIO*

I was going to say that's a mouthful, but I hope I --

Ken Bruce - *BofA Merrill Lynch - Analyst*

It was somewhat of an academic questions so I apologize for that, but there's quite a bit of concern in signaling out of the market as to what may be coming through within the US economy, you can point to a lot of different things that maybe cause all that, but we're just trying to understand how, what the implications are for the portfolio and then I guess we'll just have to kind of stay tuned to how things kind of shape up.

Maybe just lastly, this kind of gets into a little bit of a broader discussion around some of the strategic direction of the Company. Whether you look at it from a CRE point of view, whether look at it from a conduit point of view, a lot of these businesses are obviously operating businesses and I'm wondering if you think that there's a particular competitive advantage that you have in any one of them or how should we really think about if you will the value generation within those businesses? It's independent of obviously kind of what the investment by product is that you hold in the portfolio. Thank you.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Sure. It's Tom. I'll tackle that one. With respect to your question about the curve if I could just say a few things about that. The investment team does a really remarkable job of hedging spots along the curve and as the interest rate curve moves or around that's really critical to the existing book. Now obviously as an inverse that creates challenges for future allocations of that space but the critical thing is as the curve moves around it's not just to kind of hedge your interest rate exposure, it's to pristinely hedge exposure along the interest rate curve so just to make that point.

And secondly, with respect to our competitive advantage if you look at what we think -- how it exist within the MSR and the conduit business, it's by providing capital solution to our originator partners and then working very effectively to onboard MSR and prime jumbo. So we are dedicated to being best in class and respective of our interaction with our counterparties. Working efficiently and constructively with our originator partners and we really do think that's a competitive advantage. Obviously both of those markets are competitive but on the margin being a preferred counterparty definitely has its advantage and gives us edge.

In respect to commercial real estate we think our edge is this -- that we have hired a crackerjack team with many, many years of experience they've lived through a number of cycles. And then in respect to financing I think we've done a really good job in that space. So obviously we can use the home loan bank we have a warehouse facility but I really think our competitive advantage there is our team and we're quite excited about that opportunity.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Okay, thank you very much. I appreciate it.

Operator

Brock Vandervliet with Nomura Securities.



Brock Vandervliet - *Nomura Securities Intl - Analyst*

Thank you, good morning. The question is for Bill in terms of the MSR investments that you are pursuing. The world has changed so radically I think we are about 35 basis points lower on the 10 year versus mid December. How do you look at this as such a profoundly rate-sensitive asset? Do you lean into it and build that portfolio more or are you more likely to hang back and build it more slowly at this point?

Bill Roth - *Two Harbors Investment Corp. - CIO*

Hello, Brock, good morning. That's a great question.

I mean, MSR is a terrific asset for our portfolio, right? It has negative duration and yes it can be volatile but you have the same volatility with any other hedge if you had swaps. For each fall, you're going to lose on swaps. It's another hedging tool. It also throws off an attractive yield certainly compared to the negative spread you have on swaps, and lastly it hedges the mortgage basis, so to the extent that mortgages widen versus swap, MSR looks at the mortgage rate in terms of its price not the swap rate so it's really an ideal asset for us.

In terms of our plans are to continue doing what we're doing, and in fact you could argue that as rates have moved lower it's actually a better time because at some point if rates continue to go lower the MSR you're acquiring is more likely to stay outstanding for much longer. So we haven't really changed our plans. We are still looking at bulk packages as you know we picked some up a number of times last year.

We are continuing to work on adding flow sellers where you are providing daily liquidity to originator partners we have no -- the rate environment hasn't changed our outlook. The prices are still attractive and we are still interested in adding.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Hedging with interest-rate swaps -- hedging on market portfolio with interest-rate swaps always has its challenges in respect of not only the basis but also convexity because obviously the interest-rate swap has to defined duration where a mortgage is dynamic in its duration profile. And so interest rates, hedging today with interest-rate swaps is particularly challenging because there's been some dislocation versus historic relations between that and treasuries and mortgages, and therefore MSR from a basis standpoint and from a convexity standpoint are certainly as attractive as they've ever been. That being said obviously we are price-sensitive and we won't buy MSR at any price but at the prevailing prices we continue to be quite interested in them.

Brock Vandervliet - *Nomura Securities Intl - Analyst*

Just as a follow-up to that comment, Tom. Is there anything you are doing differently with respect to hedging and hedging strategy given the tightening of swap spreads?

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

It is something that we continually -- continuously evaluate but adding MSR at an attractive price makes more sense than ever and I will certainly say that given the challenges that exist within the interest rate swap market today. It's something -- like anything else we don't want to be married to a particular hedging strategy. It just depends upon the prevailing prices for swaps for swaptions for [IOs] for MSR, and it is something we constantly reshuffle depending on market prices.

Brock Vandervliet - *Nomura Securities Intl - Analyst*

Okay, Thank you.

Operator

Joel Houck with Wells Fargo.

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

Thanks and good morning guys. A lot of the technical questions have been asked. Let me maybe shift gears and ask more of a theoretical question and how you guys think about the macro in the rate environment.

Today five-year rates are negative in Germany, Switzerland in Japan and obviously that's not the case in the US and the UK. But it seems to me like the risk of a recession and also as Ken pointed out, a flattening or inverted curve, heaven forbid we see negative rates in the US, but how do you handicap that the fact that increasingly seems like the US is not going to decouple from the rest of the world. And how does the allocation of capital at all change is for example you're sitting here year from now and the 10 year is at [1.25%]. Because I asked the question, I think the prevailing sentiment and it's not just Two Harbors, I think it's analyst the investment community, is that rates are low and eventually they will go up, but the flip side of that is we could be in a long, long period of time where we just had toward Germany, Switzerland in Japan are already at.

Bill Roth - *Two Harbors Investment Corp. - CIO*

Hello, Joel. It's Bill. Thank you. Look that's certainly a non-zero possibility right? As you mentioned many mainline economies have zero or negative rates. I think it clearly will depend on the growth outlook and not just how the US does but how the rest of the world does. We talk about this all the time, in terms of protecting our book value against whether it's, I think it was a year ago everybody was concerned about super high rising rates and now it seems like every question is related to rates going lower and the curve flatter. So this is stuff we talk about all the time.

We think about protecting our book value in either of those scenarios and in terms of what that will mean for asset spreads or potential returns going forward that remains to be seen. I think as I've said a couple times on this call while we do have a significant amount of the portfolio that has credit exposure if you look at the retained interest from Agate Bay the average LTVs on those are in the 60s, FICOs are in the -- I don't have it exactly in front of me but extremely high FICOs, those are pristine prime jumbo loans.

The legacy non-agency is these are guys that they're still in the pool, been in their house 10 years or so, so very seasoned loans and as I talked a couple times about the credit, the commercial portfolio. I don't know what that environment would bring. Certainly on the agency side we would expect it to bring extremely high prepayments which would be associated with a much lower mortgage rate and so that's something that Tom alluded to, we are keeping fairly low because from a historical basis if you look at the price of agency MBS it's not super attractive to us now but it could be in the future.

I think our primary thing is that if you look at our leverage its low, our general exposures are low, and we are trying to be very protective as we transition capital

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

And as I said earlier the key is to hedge exposure along the curve and there's not a zero probability that US rates move lower still. The bane of mortgage book is not localized moves its shocks one way or the other, right? And then key there is to hedge your curve exposure appropriately and also build optionality into the interest-rate hedging profile and that's something we constantly review and tweak dependent upon what options we have in respect to hedging interest-rate exposure but it's something we work on constantly and I think we feel very comfortable where we are today.



Joel Houck - Wells Fargo Securities, LLC - Analyst

Yes. I think -- I appreciate the color. I think people aren't necessarily think -- I think people think you guys do a good job at hedging those shock type events. I guess I was more going towards if we are in an environment like that whereas I think you pointed out even agency returns may not, if the whole curve compresses you're just in a really low ROE environment is that -- how do you think I guess the second part of the question is how do you think about share buybacks?

In other words if this were persisted for a long, long time, I assume there's capacity to increase the buybacks but how would you look at that versus continuing to own or reinvest to keep your balance sheet constant in a lower compressed ROE environment? I guess the question is there are there a point where ROEs are so low that it just makes sense to buy back the maximum amount of stock you can in a given quarter or year?

Tom Siering - Two Harbors Investment Corp. - President and CEO

Sure. With Respect to reinvestment obviously our prepayment seeds are quite low so we have less reinvestment to do than a typical mortgage rate. I would make that point firstly.

Secondly we've shown a commitment to repurchasing shares. Obviously we bought over 3% of our outstanding shares in the fourth quarter, and so yes if ROEs stink and our shares are depressed relative to book value we are committed to repurchasing shares.

Again, I'm not going to get into a discussion about the maximum number of shares and so forth but obviously we've shown a dedication to that. We previously socialized on this call that we continue to buy shares in this quarter and we will continue to do that if ROEs are depressed and our share prices are cheap relative to book value.

Joel Houck - Wells Fargo Securities, LLC - Analyst

All right, great, thanks for the color.

Tom Siering - Two Harbors Investment Corp. - President and CEO

Thank you.

Operator

Thank you, and I'm showing no further questions at this time. I would like to turn the conference back over to President and CEO, Mr. Tom Siering for any closing remarks.

Tom Siering - Two Harbors Investment Corp. - President and CEO

Thank you, Michelle. Thank you for joining our fourth-quarter conference call today.

We will be attending the Credit Suisse Financial Services Forum in Miami Florida on February 9. We would welcome the opportunity to speak with you at this event have a wonderful day. Thank you.

Operator

Ladies and gentlemen thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone have a great day.



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