



Two Harbors Investment Corp. First Quarter 2021 Earnings Call Transcript

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TWO HARBORS
Investment Corp.

PREPARED REMARKS

Operator: Good day and welcome to the Two Harbors Investment Corporation's First Quarter 2021 Financial Results Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Paulina Sims, Senior Director of Investor Relations. Please go ahead

Paulina Sims: Good morning everyone and welcome to our call to discuss Two Harbors' first quarter 2021 financial results. With me on the call this morning are Bill Greenberg, our President and CEO; Mary Risky, 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 may be accessed in the investor relations section of our website.

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

I will now turn the call over to Bill.

Bill Greenberg: Thank you, Paulina. Good morning everyone and welcome to our first quarter earnings call. Today, I will go over our quarterly results at a high level and share some thoughts on the market environment including the meaningful shift in interest rates during the quarter. Mary, will give more details on our financial results as well as our capital structure and financing activities, and finally Matt will discuss our portfolio composition, activity, and risk profile as well as our outlook.

Please turn to slide 3.

At quarter end, book value was \$7.29 per share, representing a negative 2.2% total economic quarterly return. The first quarter performance was largely driven by roughly flat portfolio returns - with a significant increase in MSR values hedging the decrease in RMBS prices. Lower coupons underperformed higher coupons, specified pool performance was mixed, as our high coupon securities, where we are mostly positioned, outperformed their hedges. This

quarterly performance also includes the impact of the actions we took to optimize our liability and capital structure as we execute on our long-term strategy.

During the quarter, with spreads tightening beyond historic levels and volatility increasing, we reduced our RMBS position somewhat – primarily in 2 and 2.5 percent coupons - given the unattractive risk-reward proposition. Given these conditions, we'd expect to maintain a low exposure to mortgage spread risk. Ultimately, we believe the rapid pace of economic recovery will lead to a moderation of Fed support and spread normalization – at which time, we expect to increase leverage and deploy excess cash into investments at more attractive levels than what are available today.

As we mentioned last quarter, the MSR market is healthy with pricing and activity at pre-crisis levels. We continue to benefit from the strong relationships with our originator partners, settling on \$21.3 billion UPB in our flow-sale program and adding another \$1.1 billion UPB through bulk purchases. I would reemphasize our view that MSR provides strategic value both as a hedge to mortgage spread risk and an asset that, on its own, delivers a low double-digit levered return – and this is where we expect to continue to deploy capital while keeping spread risk low.

In this environment where the short-term direction of mortgage spreads remains highly uncertain, we are confident that the Agency + MSR strategy can continue to deliver attractive risk-adjusted returns over time. So with more than a single quarter in mind, we declared a common stock dividend this quarter of 17 cents per share. As always, we will continue to evaluate the dividend within the context of market conditions and return expectations.

On slide 4, we highlight some of the noteworthy market dynamics and rate movements during the quarter. A substantially improved market outlook for the US economy drove interest rates sharply higher - with 10 year swap rates rising from 93bps to 178bps and 5y forward 10y rates climbing all the way to 2.50%. During this period, the mortgage current coupon rose 66 bps from 1.38% to 2.04%.

Looking at the bottom left chart, the spread between primary and secondary mortgage rates continued to compress to more historical levels, especially over the last two quarters, meaning that the gain on sale profit for originators has also come down to more normalized levels and any further increases in interest rates will likely be passed on to borrowers as higher mortgage rates.

The chart on the top right shows the distribution by mortgage rate of Fannie mortgages in the blue bars, which we believe is a good proxy for the Agency universe as a whole. At the end of December, roughly 85% of all mortgages had at least 25 basis points of refinance incentive, as shown by the gray circle. With the rise in interest rates and mortgage rates now hovering around 3.17%, the percentage of mortgages that are refinance-able with at least 25 basis points of

incentive has declined to about 64%, as shown by the green circle in the chart. Additionally, those 64% of borrowers have for some reason not taken advantage of refinancing when rates were lower so their sensitivity to refinancing is not precisely known.

Nevertheless, higher interest rates, higher mortgage rates, tighter primary/secondary spreads, and lower numbers of mortgages being refinanced will inevitably lead to slower prepayment speeds which should be beneficial to our Agency + MSR strategy.

Although rates have shifted higher, and prepayment expectations have moderated, RMBS valuations continue to be very rich. We acknowledge that there are powerful technical factors at play such as continued roll specialness in the 2.5% coupon and, not unrelatedly, large-scale purchase demand from the Federal Reserve as well as large banks, as those entities added \$380 billion and \$180 billion of RMBS, respectively, in the first quarter alone.

Looking at the chart on the bottom right of Slide 4, the option adjusted spread on an index of Agency RMBS currently sits at 6 basis points as of the end of the quarter. Although you cannot see from the chart, current spread levels are the tightest they have been since 2006.

However, we do not expect these favorable technical forces to last forever. With the virus receding and the economy gaining strength, the Federal Reserve will one day begin to moderate their asset purchases. Most market participants expect that that “Fed Taper” will occur sometime in early 2022, and Chairman Powell has said he will be careful to telegraph those intentions to the market well in advance, and so that communication could come this year. Given the pace of economic rebound, it is our view that the risk to that conventional forecast is to shorter timelines not longer. Furthermore, while the Fed has been clear that they will wait until they see the results of quickening economic growth, the large banks will in all likelihood act sooner to divert capital from investment to making loans, and so a “Bank Taper” could occur even sooner.

As we discussed on our fourth quarter earnings call, data analysis of historical spreads suggests that spreads are typically mean reverting once they reach extreme levels. As a result, we view the risk of spread widening to be significantly higher than the likelihood of spread tightening. With a long term mean of 35 basis points over the last ten years, spreads have room to materially widen.

Without the benefit of roll specialness, the fundamentals of owning RMBS are not very attractive today. With spreads being where they are, the hedge-adjusted carry on the asset only leads to mid- to high-single digit gross returns. Given these rich valuations and higher price volatility that we have seen recently, the investment thesis of buying a rich asset and expecting that the Fed and the Banks keep buying at higher prices does not seem sustainable to us. Indeed, as Matt will discuss later, the total quarterly performance on the TBA

coupons that the Fed and banks have been buying was essentially zero, meaning that we did not give up any economic performance by being underweight those coupons.

We intend to be patient and deliberate in executing our strategy. We are continuing to add MSR at attractive levels which, when paired with RMBS, keeps our exposure to mortgage spreads low. One benefit of the Agency + MSR strategy is that it allows us to keep exposure to spreads low when spreads are tight, and to increase exposure when spreads are attractive. This is what we intend to do over time.

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

Mary Risky:

Thank you, Bill and good morning everyone

Please turn to slide 5, to review our financial results for the first quarter. Comprehensive income was negative \$48.5 million, representing an annualized return on average common equity of negative 9.3% and our book value was \$7.29 per share compared to \$7.63 at December 31st, resulting in a total economic return of negative 2.2%.

Book value decline was mainly a function of flat portfolio performance net of core operating expenses, with an increase in MSR valuation offset by the impact of lower RMBS prices. A higher tax provision and the premium related to the convertible debt repurchase contributed to the overall decline. We recognized a higher tax provision driven by the dramatic increase in the mark-to-market of our MSR assets. As a reminder, a portion of our MSR asset is required to be held in a taxable REIT subsidiary. Although we record tax provisions or tax benefits every quarter, the amount this quarter was more impactful on our results. Although we focus on limiting our ultimate tax obligations which have been historically low, GAAP to tax differences can result in current period impact to earnings and book value.

Moving on to slide 6, Core Earnings was \$0.17 per share compared to \$0.30 in Q4. Interest income decreased from \$72.5 million to \$56.1 million, in conjunction with lower asset balances resulting from prepayments and asset sales. Interest expense rose modestly due in part to a higher convertible debt balance, reflecting the portion of debt maturing in January 2022 which was not redeemed, and also due to increased usage of revolving credit facilities to fund MSR. Gain on other derivatives declined from \$43.5 million to \$18.9 million driven by lower TBA dollar roll income as we reduced our positions. We also saw a smaller benefit from roll specialness which contributed \$.02 to Core Earnings compared to \$0.06 in Q4.

As we discussed last quarter, we are taking actions to optimize our capital and liability structure, and as a part of that, are adding funding capacity in the form of revolvers for MSR. As we utilize the capacity in these facilities, we expect

interest expense to increase once again in the second quarter. While it may not be intuitive to draw up MSR facilities while we are in a strong cash position, it's important to note that these revolving structures take a significant amount of time to set up compared to standard repo facilities. They are multi-year funding and they typically have minimum use requirements. It is essential to our MSR strategy that we consider our long-term funding needs and long-term expectations for portfolio assets and construction, and plan ahead accordingly. As a reminder, the liability and capital actions taken this quarter - inclusive of the convertible debt issuance, optimization of MSR financing and redemption of preferred stock - is expected to deliver an annual net benefit of \$0.04 per share beginning in 2022.

Turning to the table on the lower right, our portfolio yield in the quarter was relatively flat at 2.25% and our net spread decreased by 11 basis points to 1.65% due to higher cost of funds related to increased convertible debt and MSR financing. Net spread "as of" March 31, which reflects our estimate for the near term, is expected to increase driven primarily by a higher yield due to lower prepayment expectations and a higher proportion of MSR in the portfolio.

Turning to Slide 7, we continue to maintain a strong liquidity and capital position. Our unrestricted cash balance totaled \$1.2 billion at quarter end. The weighted average maturity of our Agency repo positions increased to 100 days as of March 31st, reflecting the flat term structure market and the attractiveness of longer dated repos. We increased the unused committed capacity in our MSR asset financing facilities to \$392 million with the closing of an additional revolver in the quarter. And we also have \$180 million in committed capacity for servicing advances should forbearance or defaults rise as the forbearance programs and foreclosure moratoriums wind down in the future.

Finally, turning to leverage, our economic debt-to-equity at quarter end declined to 6.4x from 6.8x at December 31st. And our quarterly average economic debt-to-equity was 6.5x in Q1, compared to 7.5x in the fourth quarter.

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 8, let's discuss our quarterly portfolio activity and composition. As Bill noted, volatility picked up in both the rate and mortgage markets, with rates moving sharply higher, and mortgages experiencing several bouts of spread widening during the quarter. If you only looked at the quarter-over-quarter performance of current coupon RMBS, you might assume it was a quiet period; however, that was far from true and I will spend some time discussing the volatility during the quarter shortly. Ultimately, RMBS performance was driven by very strong and continued demand from both the Federal Reserve and the banking system.

As Mary discussed, we continued to decrease balances during the quarter, reflected by lower economic debt-to-equity of 6.4 times. This was in part from sales and pay-downs in our specified pool portfolio, where valuations in some stories and coupons have become less attractive. We also reduced our overall TBA exposure from \$5.5 billion to \$5.0 billion. Part of our TBA activity was rotating into higher coupons and reducing exposure to the 2 percent coupon, due to both an unattractive valuation and a significant decrease in roll specialness.

We continue to source substantial volumes of new MSR assets through our flow program at attractive levels, and have largely maintained the size of our portfolio in this fast prepay environment. Additionally, we opportunistically added around \$130 million market value of interest-only securities, or IO, during the quarter. As we highlighted last quarter, IO positions provide portfolio benefits that are similar to MSR when paired with RMBS in reducing mortgage spread exposure.

Moving to slide 9, I'd like to take a moment to provide some color on the positioning in current coupon TBA mortgages in today's environment, where, in our view, duration-hedged carry no longer provides adequate compensation for elevated risk. Starting with the upper graph, we show the duration-hedged carry, in ticks, for TBA 2s and 2.5s. Notably, carry on the 2 coupon has decreased significantly from over 6 ticks per month to around 2 and a half ticks at the end of March, caused mostly by the decrease in roll specialness. The graph on the lower left shows the monthly price volatility of the same instruments, also measured in ticks per month. During the quarter, we witnessed significantly higher spread volatility than observed in the prior two quarters. Monthly volatility in the 2 coupon nearly tripled from around 10 ticks to around 28 ticks. Putting these ideas together, investors can risk 28 ticks per month in a one standard deviation move for the opportunity to earn 2 and a half ticks per month. The final graph shows this in terms of how many months of carry are at risk, and you can see that for 2s, 11 months of carry are at risk each month, assuming the observed first quarter volatility. This is significantly longer than we typically observe in the mortgage market by a factor of 2. With current coupon mortgages at or near all-time tight spreads, we believe the value proposition is quite challenging in the near term.

Please turn to slide 10, as we discuss our specified pool positioning and prepayments. In the lower left-hand chart, you can see that performance was a mixed bag, with lower coupon specifieds generally underperforming TBA and higher coupons outperforming somewhat. In general, the performance across the stack wasn't particularly notable quarter-over-quarter, but as discussed, that doesn't speak to the intra-quarter volatility.

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, by coupon, of observed prepayment speeds from pools delivered into TBA contracts to observed prepayment speeds on our specified portfolio.

The slower prepayment speeds as compared to delivered TBA pools highlights the reason they command a significant price premium over TBA.

Moving to slide 11, you can see that our MSR portfolio was valued at \$2.1 billion as of March 31st, based on \$187 billion of UPB and with a gross coupon of 3.6%. That translates into a price of about 110 cents or right around a 4.2 multiple. The balances from the end of 2020 are also shown here, and I would highlight the significant increase in value during the quarter. As the yield curve steepened with the rise in long-term rates, the value of the servicing portfolio increased by over 30% and the multiple increased from 3.2 to 4.2. Multiple expansion is a natural consequence of rising rate environments as forward interest rates and mortgage rates increase, and prepayment expectations slow, increasing future cash-flow to the servicing strip.

We settled \$21.3 billion UPB of new MSR through our flow program during the quarter, which was enough to offset runoff in the period. Activity in the bulk market continues at pace, and we continue to find valuations to be situational, with some packages trading at pre-crisis yields while some are clearing at wider spreads. Around \$50 billion UPB in bulk transactions came to market during the quarter, which is a fairly average volume, and we committed to purchasing \$13 billion UPB year to date.

In the lower right hand chart, we compare our servicing prepayment speeds in blue vs TBA collateral in grey. Currently a majority of the underlying loans in our servicing portfolio have some form of seasoning or prepayment protection, which is why our speeds are slightly slower than the through-the-box speeds.

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, MSR and IO as of March 31st as compared to our positioning at the end of 2020 as indicated by the diamond bullets. There are two main differences; one is the significant reduction in exposure to the 2 percent coupon as discussed earlier, while increasing exposure to the 2.5 and 3.0 coupon in TBA. The second item of interest is that the current coupon equivalents displayed on the middle chart shifted up from the 1.5 and 2.0 percent coupons to become mostly concentrated in the 2.5 coupon. On net you can see that we are slightly short the current coupons, while maintaining long positions in 3 coupons and up.

The lower left hand chart shows our common book value exposure to 25 basis point spread widening or tightening and it indicates that book value would decrease by 4.2% in an instantaneous 25 basis point spread widening. 4.2% represents an increase in exposure from the prior quarter, despite our reduction in specified pools and TBA. It is due to the extension in mortgage durations that comes along with higher rates and steeper curves. We still believe this a low and manageable risk, and is certainly lower than the book value risk that would accompany a RMBS portfolio without the presence of MSR.

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 + MSR strategy provides significant interest rate offsets, which you can see by comparing the grey bars to the blue bars in both charts.

Finally, I'd like to take a look at our outlook for Two Harbors and our return expectations for new investments on slide 14. Working from the bottom up, we believe gross returns for specified RMBS paired with swaps are less attractive than they were and expect returns to be in the range of mid- to high-single digits, depending on coupon and story. TBA returns in the 2.5 coupon 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 or low-teens, and if you assume roll specialness on the RMBS component, can be even higher. As Bill mentioned, we are focusing our efforts on adding new servicing paired with RMBS.

We continue to focus on our strong partnerships with MSR sellers and internal platform, which gives us the ability to source significant volumes. RMBS valuations are rich, and the near term technical of Fed and bank demand are formidable. Nevertheless, it is our expectation that we are nearer to the end of QE4 than the beginning and our portfolio is well-constructed for eventual future mortgage spread widening. Our cash position is strong and we look forward to the normalization of mortgage spreads and the opportunity to deploy that cash into more attractive spreads. Despite this quarter's challenges, we continue to believe that longer term returns are attractive for our Agency + MSR portfolio construction.

And now I'll turn it back to Bill....

Bill Greenberg:

Thanks for that discussion Matt. We continue to be excited about our unique portfolio construction and the benefits that MSR bring to the paired Agency + MSR strategy. In particular, with Agency mortgages having reached decade-low tight spreads, we think that our portfolio with low exposure to widening mortgage spreads 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:

Ladies and gentlemen, if you just ask a question at this time, please signal by pressing star one on your telephone keypad. Please ensure that the mute function on your telephone is switched off to allow your signal to reach our equipment. Again, please press star one to ask a question. Our first question today comes from Doug Harter.

- Doug Harter: Thanks. Just to get to get some clarity Matt on what you were just talking about, continuing to work to pair to pool Agency with MSRs. Does that mean as you continue to grow servicing, you would look to kind of add back to the Agency portfolio or you're kind of waiting for a better opportunity there and just continuing to grow the servicing portfolio today?
- Matt Koeppen: Yeah, good morning, Doug. Thanks for that question and thanks for joining today.
- I think the answer is largely, yes, actually. So we are very focused, like you said, on adding to the servicing asset. I think there's reasons to believe that, that we'll see increased flows here in the coming months, given the shift higher in rates. I would think there would be more for sale and we'd see increased bulk sales.
- And with respect to how we would hedge it, I think at the moment, we would likely hedge it with TBAs probably TBA 2.5 in particular, given the attractive roll specialness that still exists there, and that would as you know that paired construction will continue to keep our mortgage spread duration low in aggregate, but put interest income into the portfolio.
- Doug Harter: Okay, and then just on the on the margin that you talked about, that the margin today is higher than the quarter average. Can you just talk about what are the assumptions that kind of go into the prepays for that quarter end margin versus kind of what you're currently experiencing in prepays?
- Matt Koeppen: I'm sorry, Doug, I'm not following which margin are you referring to exactly?
- Doug Harter: The net interest margin that's on the slide six or the net interest spread. I'm sorry. Where you show the 194 spread as of March 31 versus the 165 realized?
- Bill Greenberg: Yeah, Mary do you want to maybe take that one?
- Mary Risky: Sure. I mean, the as of yields as of March 31st, which, of course, is based on a static portfolio, we do expect yields to go up and that is primarily due to lower prepayment assumptions and a greater proportion of MSR in the portfolio. Are you asking specifically what the prepayment assumptions are?
- Doug Harter: I guess just curious if that's using prepay speeds that you're currently seeing or if that is based on prepay speeds declining further from here or like using a lifetime assumption just trying to understand. So if that higher yield is going to come through in 2Q or its going to take longer to achieve?
- Mary Risky: Go ahead, Matt.
- Matt Koeppen: Well, I was just going to say that yield does include expected future prepayment speeds, and we expect that, right. So the increase in rates hasn't quite made its way through into prepayment speed, but it will in Q2.

We expect speeds from April coming through this month to be down 20%, say 15% in the months following that, all from the rate effect, and that is what is embedded into the yield assumptions that you see in that calculation.

Doug Harter: Great, thank you.

Operator: The next question comes from Rick Shane.

Charlie: Hey, good morning, guys. This is Charlie on for Rick today. Thanks for taking the questions.

First, I was wondering if we could just get a update on where our book value has trended through, I guess, the end of April. And then kind of more broadly, I had a question on sourcing MSR's going forward. As you mentioned, you've continued to grow that portfolio even in a pretty fast prepayment environment. As we look ahead and consider the possibility of rising rates and slower prepayments, I'm wondering if the way that you source MSR is going to change in anyway. Or, I guess said differently, how should we think about the mix between flow arrangements, which I assume is a big part of kind of replacing that runoff and also the bulk purchases as prepayments begin to slow down and that environment changes?

It seems like you've kind of already laid the foundation here with the additional capacity, but just curious to think about how that rate of change might evolve over time and if growth can really accelerate from here.

Matt Koeppen: Sure, I'll start with that one. Charlie, thanks for the question and I'll hand it off to Bill for the second part.

But in terms of April, we haven't quite closed the books altogether on April, but at the moment, we are estimating a total return through the end of the month, about down 1% and I will let Bill comment on MSR sourcing.

Bill Greenberg: Yeah, thanks, Matt, and thanks for the question, Charlie, good to have you on the call today. You're a 100% right that a lot of our MSR acquisitions in recent months have come from our flow channels and relationships as a result of fast prepays and fast current production. As rates rise, we do expect that to decline, but we do also expect the number of and volume of bulk packages available in the market to increase to offset that.

This is something that you often see when rates rise and origination profit declines that many small and midsize originators need to or want to sell servicing in order to generate cash to fund their businesses. And so that's a dynamic that we think is in play and we think our platform is really well suited to switch opportunistically between an acquisition channel of flow and bulk as market conditions change, and so we feel pretty good about our ability to be able to continue to source the amounts of servicing that we like.

- Charlie: Makes sense, thanks so much guys, appreciate the color.
- Bill Greenberg: Thank you.
- Operator: We can now move on to Bose George.
- Bose George: Hey, good morning. Actually, just follow-up on the last question, did you just get the book value update is been down 1% percent quarter-to-date and then just when we think about –
- Bill Greenberg: That is correct.
- Bose George: Okay, thanks. And then, just the positioning on the book, I guess, it's safe to say if spreads, don't tighten from here, your book value is probably has limited downside and the positioning is if spreads widened then that's where you essentially outperform.
- Bill Greenberg: Yeah, I would say in general at the moment, as Matt discussed in his prepared remarks, we're currently keeping our mortgage spread low in general, right and so I would expect that no matter what spreads do you hear at the moment, we would have low book value volatility as a result of mortgage spreads.
- One of the nice things about, and I think we said this in the prepared remarks also, one of the nice things about the strategy is the presence of MSR in the portfolio allows us to flex the amount of mortgage spread risk that we have so that when spreads are tight like they are today, we can keep our mortgage spreads very low and when spreads become more attractive, which we believe they will in the future one day, we can increase that somewhat and still have low mortgage spread compared to a portfolio without MSR, but greater than we do today in order to take advantage of those more attractive mortgage spreads.
- Bose George: Okay, great, thanks. And then actually, can you just remind us why some of the MSR needs to be held in a TRS? Does that change the return profile?
- Bill Greenberg: I'll let Mary take that one.
- Mary Risky: Sure. Good morning, Bose.
- Bose George: Hi Mary.
- Mary Risky: So we purchased our MSR into our servicing entity, which is a taxable REIT subsidiary. That's the named servicer with the GSEs and then they kind of dictate how much they allow the excess servicing to be sold into the REIT. So both Freddie and Fannie have required amounts that need to be held in the actual servicing entity, which is the taxable REIT subsidiary.
- Bose George: Okay great, that makes sense. Thanks.

Operator: We can go to Eric Hagen.

Eric Hagen: Thanks, good morning, how are you guys? So you've got the MSR, which you noted essentially equivalent to being short lower coupon TBAs, which I think seems to make sense. And you're also long some lower coupon TBAs that at quarter end, which I think you noted aren't really as attractive from a carry standpoint anymore.

Can you maybe just discuss what your footprint looks like there now? And if you're still long with those coupons, what you're picking up by being long when you're basically short the MSR, so long the MSR short the TBA.

Matt Koeppen: Thanks for the question, Eric. So when we were talking about the position rotation, we're mostly talking about the 2% coupon that was the one that that really in particular had much less attractive hedged-adjusted carry and the roll specialness [inaudible] quite a bit during the quarter.

The 2.5 coupon actually still is rolling pretty special. I think that dynamic could last in that coupon for some time. Recently, it's rolls have cleared in let's say 40 basis point, -40 basis points range or so, so that 50 to 55 through repo funding, which is still pretty attractive. And so like we said earlier, I can see us adding to that position against new servicing purchases as we go forward here.

Eric Hagen: Got it. Thank you for clarifying that. And then the swap portfolio, looks like it has pretty short duration, I think that also makes sense. Pay downs are still elevated for specified pools, and the MSR duration, I think, is at the longer end of the curve, but how do you think about beefing up the swap portfolio if rates pick up a little further? Do you think about just delevering a little bit more?

Matt Koeppen: Well, I think I mean, our swap portfolio is pretty small in general, I would say. Some duration hedging on the short side in the front end and we need to be long a little bit of duration in the longer end. You can see that on slide 13, actually, of the presentation that most of the rate exposure is handled by the servicing asset. And the swap book is quite small. As you know, we tend to keep a very tight leash on durations and curve. So I think we would expect to see that going forward as well.

Bill Greenberg: I can add a little bit more color to that Eric if I can. As Matt said on page 13, the parallel shift duration as you see in the lower left chart is largely offset between MSR and RMBS.

But if you look at what the curve exposure is, when you pair those two, it's generally a curve steepener. And Matt said this, that most of our swap book is receiving in the long end in order to offset that, but the natural position of the paired construction is to have a curve steepener on, and so our hedges are mostly meant to offset that.

- Eric Hagen: Got it, thank you very much. Thank you.
- Operator: As a reminder, ladies and gentlemen, if you would like to ask a question, please press star one. Our next question comes from Trevor Cranston.
- Trevor Cranston: Hey, thanks. I have a couple question on prepays. They're related to the slide you guys showed with the percentage of the market, the refinanceable. And I think you made the point that, it's still something like 60%, but there's a lot of borrowers who, for whatever reason, haven't refi'ed so far.
- So I was curious to get your thoughts on the program the FHFA announced last week to try and help lower income borrowers have more access to refinancing. How impactful you think that could be to prepay speeds in the spec pool market? And if you think there's a risk that more programs like that come out over the course of the year. Thanks.
- Matt Koeppen: Sure, that's a good question, Trevor, thanks for that one. I'll take a stab at it. I think, that's a fairly new announcement came out last week. So I don't think we know or processed all the impacts from it.
- But as you mentioned, the idea, of course, is that low income borrowers haven't been able to take advantage of low mortgage rates here. So a couple of things I could say is that I think, early estimates are that it could affect to say, I don't know, 10% to 20% of GSE borrowers.
- I think we'd expect that impact to be fairly small for lower coupon RMBS, right, maybe some impact of an additional CPR for some period of time. It could be more impactful for higher coupons, right, like we can maybe estimate it as being as much as a 5 CPR increase for some time period.
- But that would require a very high implementation and a very high pull-through rate. So it remains to be seen how aggressively it's pushed through the originator community and also how it's received by borrowers.
- Trevor Cranston: Okay, got it, that makes sense. Thanks for the comments.
- Bill Greenberg: Thank you.
- Operator: As there are no further questions, I'd like to hand the call over to Bill for any additional or closing remarks.
- Bill Greenberg: I want to thank everyone for joining us today and thank you as always, for your support of Two Harbors.
- Operator: Ladies and gentlemen, that concludes today's conference call. We thank you for your participation. You may now disconnect.

CONTACT INFORMATION

Paulina Sims, Senior Director, Investor Relations
Two Harbors Investment Corp.
612-446-5431
Paulina.Sims@twoharborsinvestment.com.