

Two Harbors Investment Corp.
Form 10-Q
August 05, 2010

**UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR
15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended: June 30, 2010

Commission File Number 001-34506

TWO HARBORS INVESTMENT CORP.

(Exact Name of Registrant as Specified in Its Charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

27-0312904
(I.R.S. Employer
Identification No.)

601 Carlson Parkway, Suite 330
Minnetonka, Minnesota

55305

(Address of Principal Executive Offices)

(Zip Code)

(612) 238-3300

(Registrant's Telephone Number, Including Area Code)

not applicable

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non accelerated filer or smaller reporting company. See definition of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of August 5, 2010 there were 26,067,590 shares of registered common stock, par value \$.01 per share, issued and outstanding.

TABLE OF CONTENTS

TWO HARBORS INVESTMENT CORP.

INDEX

	Page
PART I FINANCIAL INFORMATION	
<u>Item 1.</u>	
<u>Financial Statements (unaudited)</u>	1
<u>Consolidated Balance Sheets at June 30, 2010 and December 31, 2009</u>	1
<u>Consolidated Statements of Income (Loss) for the Three and Six Months Ended June 30, 2010 and 2009</u>	2
<u>Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss) for the Six Months Ended June 30, 2010 and 2009</u>	3
<u>Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2010 and 2009</u>	4
<u>Notes to Consolidated Financial Statements</u>	5
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	36
<u>Item 4.</u>	
<u>Controls and Procedures</u>	40
PART II OTHER INFORMATION	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	41
<u>Item 1A.</u>	
<u>Risk Factors</u>	41
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	41
<u>Item 3.</u>	
<u>Defaults Upon Senior Securities</u>	41
<u>Item 4.</u>	
<u>[Removed and Reserved]</u>	41
<u>Item 5.</u>	
<u>Other Information</u>	41

Item 6.

41

Exhibits

Signatures

42

Index of Exhibits

43

i

TABLE OF CONTENTS**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****TWO HARBORS INVESTMENT CORP.****CONSOLIDATED BALANCE SHEETS**

	June 30, 2010 (unaudited)	December 31, 2009
ASSETS		
Available-for-sale securities, at fair value	\$977,883,587	\$494,464,867
Cash and cash equivalents	71,440,655	26,104,880
Total earning assets	1,049,324,242	520,569,747
Restricted cash	18,647,316	8,913,048
Accrued interest receivable	3,756,737	2,579,695
Due from counterparties	20,764,619	4,877,463
Derivative assets, at fair value	32,632,941	363,666
Prepaid expenses	118,167	571,584
Deferred tax assets	894,523	
Prepaid tax asset	632,514	490,206
Total Assets	\$1,126,771,059	\$538,365,409
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	\$866,278,174	\$411,892,510
Derivative liabilities, at fair value	21,635,709	
Accrued interest payable	460,302	113,788
Deferred tax liabilities		123,646
Accrued expenses and other liabilities	2,422,221	1,030,342
Dividends payable	8,621,650	3,484,356
Total liabilities	899,418,056	416,644,642
Stockholders' Equity		
Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized; no shares issued and outstanding		
Common stock, par value \$0.01 per share; 450,000,000 shares authorized and 26,067,590 and 13,379,209 shares issued and outstanding, respectively	260,676	133,792
Additional paid-in capital	238,520,624	131,756,484
Accumulated other comprehensive income (loss)	1,822,388	(949,728)
Cumulative earnings (losses)	3,679,813	(5,735,425)
Cumulative distributions to stockholders	(16,930,498)	(3,484,356)
Total stockholders' equity	227,353,003	121,720,767

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

Total Liabilities and Stockholders Equity	\$1,126,771,059	\$538,365,409
---	-----------------	---------------

The accompanying notes are an integral part of these consolidated financial statements.

1

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	(unaudited)		(unaudited)	
Interest income:				
Available-for-sale securities	\$9,087,917	\$	\$15,241,235	\$
Cash and cash equivalents	37,509	7,185	42,980	55,432
Total interest income	9,125,426	7,185	15,284,215	55,432
Interest expense	863,242		1,381,452	
Net interest income	8,262,184	7,185	13,902,763	55,432
Other income:				
Gain on sale of investment securities, net	833,545		2,030,518	
Loss on interest rate swap agreements	(4,053,781)		(5,601,193)	
Gain on other derivative instruments	152,568		1,099,029	
Total other income	(3,067,668)		(2,471,646)	
Expenses:				
Management fees	748,330		1,205,309	
General and administrative	746,915	230,101	1,393,763	310,503
Directors and officers insurance	123,000	31,720	239,008	56,894
Professional fees	262,345	1,123,886	486,562	1,338,712
Total expenses	1,880,590	1,385,707	3,324,642	1,706,109
Net income (loss) before income taxes	3,313,926	(1,378,522)	8,106,475	(1,650,677)
Benefit from income taxes	774,356	154,798	1,308,763	246,785
Net income (loss)	4,088,282	(1,223,724)	9,415,238	(1,403,892)
Accretion of trust account income relating to common stock subject to possible conversion		(37,312)		(68,149)
Net income (loss) attributable to common stockholders	\$4,088,282	\$(1,261,036)	\$9,415,238	\$(1,472,041)
Basic earnings (loss) per weighted average common share	\$0.18	\$(0.05)	\$0.53	\$(0.06)
Diluted earnings (loss) per weighted average common share	\$0.18	\$(0.05)	\$0.52	\$(0.06)
Dividends declared per common share	\$0.33	\$	\$0.69	\$
Weighted average number of shares of common stock:				
Basic	22,438,121	24,936,558	17,933,689	24,936,558
Diluted	22,466,691	24,936,558	17,959,072	24,936,558

The accompanying notes are an integral part of these consolidated financial statements.

TABLE OF CONTENTS

**TWO HARBORS INVESTMENT CORP.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS
EQUITY
AND COMPREHENSIVE INCOME (LOSS)**

The accompanying notes are an integral part of these consolidated financial statements.

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Six Months Ended	
	June 30,	
	2010	2009
	(unaudited)	
Cash Flows From Operating Activities:		
Net income (loss)	\$9,415,238	\$ (1,403,892)
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Amortization of premiums and discounts net	1,773,691	
Gain on sale of investment securities, net	(2,030,518)	
Equity based compensation expense	64,934	
Net change in:		
Increase in accrued interest receivable	(1,177,042)	
Increase in deferred income taxes	(1,018,169)	
Increase in due from counterparties	(15,887,156)	
Increase in fair value of derivative assets, net	(10,633,566)	
Increase in prepaid tax asset	(142,308)	(201,853)
Decrease in prepaid expenses	453,417	168,982
Increase in accrued interest payable	346,514	
Increase in accrued expenses and other liabilities	1,391,879	676,796
Net cash used in operating activities	(17,443,086)	(759,967)
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	(706,619,302)	
Proceeds from sales of available-for-sale securities	176,089,669	
Principal payments on available-for-sale securities	50,139,860	
Net increase in restricted cash	(9,734,268)	(227,164)
Net decrease in cash held in trust account, interest and dividend income available for working capital and taxes		120,162
Net cash used in investing activities	(490,124,041)	(107,002)
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	1,651,660,731	
Principal payments on repurchase agreements	(1,197,275,071)	
Proceeds from issuance of common stock, net of offering costs	106,826,090	
Dividends paid on common stock	(8,308,848)	
Net cash provided by financing activities	552,902,902	
Net decrease in cash and cash equivalents	45,335,775	(866,969)
Cash and cash equivalents at beginning of period	26,104,880	2,778,143
Cash and cash equivalents at end of period	\$71,440,655	\$ 1,911,174
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	\$1,034,938	\$

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

Cash paid for taxes	\$	\$
Non-Cash Financing Activity:		
Dividends declared but not paid at end of period	\$8,621,650	\$
Accretion of trust account income relating to common stock subject to conversion	\$	\$(68,149)

The accompanying notes are an integral part of these consolidated financial statements.

TABLE OF CONTENTS

TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements

Note 1. Organization and Operations

Two Harbors Investment Corp. (the Company) is a Maryland corporation formed to invest primarily in residential mortgage-backed securities (RMBS). The Company is externally managed and advised by PRCM Advisers LLC, a subsidiary of Pine River Capital Management L.P. (Pine River), a global multi-strategy asset management firm. The Company's common stock and warrants are listed on the NYSE Amex under the symbols TWO and TWO.WS, respectively.

The Company intends to qualify as a real estate investment trust (REIT) for U.S. federal income tax purposes commencing with its initial taxable period ended December 31, 2009. As long as the Company continues to comply with a number of requirements under federal tax law and maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income tax to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that the disclosures included in these interim financial statements are adequate to make the information presented not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at June 30, 2010 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2010 should not be construed as indicative of the results to be expected for the full year.

The consolidated financial statements of the Company have been prepared on the accrual basis of accounting in accordance with GAAP. The preparation of financial statements in conformity with GAAP requires us to make a number of significant estimates and assumptions. These estimates include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation

changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material.

The consolidated financial statements of the Company include the accounts of all subsidiaries; intercompany accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.

5

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 2. Basis of Presentation and Significant Accounting Policies (continued)****Recently Issued and/or Adopted Accounting Standards****Broad Transactions**

Fair Value Measurements and Disclosures (Accounting Standards Codification ASC 820). On January 21, 2010, the FASB issued an accounting standard update, or ASU, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, which provides guidance on how investment assets and liabilities are to be valued and disclosed. Specifically, the amendment requires reporting entities to disclose: (i) the input and valuation techniques used to measure fair value for both recurring and nonrecurring fair value measurements, for Level 2 or Level 3 positions, (ii) transfers between all levels (including Level 1 and Level 2) on a gross basis (i.e., transfers out are disclosed separately from transfers in) as well as the reason(s) for the transfer and (iii) purchases, sales, issuances and settlements on a gross basis in the Level 3 rollforward, rather than as one net number. The effective date of the amendment is for interim and annual periods beginning after December 15, 2009; however, the requirement to provide the Level 3 activity for purchases, sales, issuances and settlements on a gross basis will be effective for interim and annual periods beginning after December 15, 2010. The impact of adopting this ASU will not have a material impact on the Company's consolidated financial condition or results of operations.

Note 3. Available-for-Sale Securities, at Fair Value

The following table presents the Company's available-for-sale, or AFS, investment securities by collateral type, which were carried at their fair value:

	June 30, 2010	December 31, 2009
U.S. Treasuries	\$ 145,436,132	\$
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	285,479,494	255,669,015
Federal National Mortgage Association	327,545,073	155,729,386
Government National Mortgage Association	24,748,217	6,421,615
Non-agency	194,674,671	76,644,851
Total mortgage-backed securities	832,447,455	494,464,867
Total	\$ 977,883,587	\$ 494,464,867

At June 30, 2010 and December 31, 2009, the Company pledged investment securities with a carrying value of \$934.1 and \$444.8 million, respectively, as collateral for repurchase agreements. See Note 8 Repurchase Agreements.

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

At June 30, 2010 and December 31, 2009, the Company did not have any securities purchased from and financed with the same counterparty that did not meet the conditions of ASC 860, *Transfers and Servicing*, to be considered linked transactions and therefore classified as derivatives.

6

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 3. Available-for-Sale Securities, at Fair Value (continued)**

The following table presents the amortized cost and carrying value (which equals fair value) of AFS securities by collateral type as of June 30, 2010 and December 31, 2009:

	June 30, 2010			
	U.S. Treasuries	Agency	Non-agency	Total
Face Value	\$ 145,000,000	\$ 771,379,596	\$ 381,659,951	\$ 1,298,039,547
Unamortized premium		32,740,311		32,740,311
Unamortized discount				
Designated credit reserve			(96,624,251)	(96,624,251)
Net, unamortized		(169,959,439)	(88,283,255)	(258,242,694)
Amortized Cost	145,000,000	634,160,468	196,752,445	975,912,913
Gross unrealized gains	436,132	6,455,600	4,181,913	11,073,645
Gross unrealized losses		(2,843,284)	(6,259,687)	(9,102,971)
Carrying Value	\$ 145,436,132	\$ 637,772,784	\$ 194,674,671	\$ 977,883,587

	December 31, 2009		
	Agency	Non-agency	Total
Face Value	\$ 534,878,857	\$ 166,580,309	\$ 701,459,166
Unamortized premium	18,535,106		18,535,106
Unamortized discount			
Designated credit reserve		(50,186,623)	(50,186,623)
Net, unamortized		(133,343,316)	(174,393,054)
Amortized Cost	420,070,647	75,343,948	495,414,595
Gross unrealized gains	1,081,947	2,020,339	3,102,286
Gross unrealized losses	(3,332,578)	(719,436)	(4,052,014)
Carrying Value	\$ 417,820,016	\$ 76,644,851	\$ 494,464,867

The following tables present the carrying value of the Company's AFS investment securities by rate type as of June 30, 2010 and December 31, 2009:

	June 30, 2010			
	U.S. Treasuries	Agency	Non-agency	Total
Adjustable Rate	\$	\$ 298,177,904	\$ 127,151,177	\$ 425,329,081
Fixed Rate	145,436,132	339,594,880	67,523,494	552,554,506
Total	\$ 145,436,132	\$ 637,772,784	\$ 194,674,671	\$ 977,883,587

	December 31, 2009		
	Agency	Non-agency	Total
Adjustable Rate	\$ 305,441,270	\$ 34,848,759	\$ 340,290,029
Fixed Rate	112,378,746	41,796,092	154,174,838
Total	\$ 417,820,016	\$ 76,644,851	\$ 494,464,867

When the Company purchases a credit-sensitive AFS security at a significant discount to its face value, the Company often does not amortize into income a significant portion of this discount that the Company is entitled to earn because it does not expect to collect it due to the inherent credit risk of the security. The Company may also record an other-than-temporary impairment, or OTTI, for a portion of its investment in the security to the extent the Company believes that principal losses will exceed the discount. The amount of

7

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 3. Available-for-Sale Securities, at Fair Value (continued)**

principal that the Company does not amortize into income is designated as a credit reserve on the security, with net unamortized discounts or premiums amortized into income over time using the interest method in accordance with ASC 320.

The following table presents the changes for the six months ended June 30, 2010, of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

	Designated Credit Reserve	Unamortized Net Discount	Total
Beginning balance at January 1, 2010	\$(50,186,623)	\$(41,049,738)	\$(91,236,361)
Acquisitions	(67,130,634)	(61,123,650)	(128,254,284)
Accretion of net discount		3,570,119	3,570,119
Realized credit losses	955,998	7,838	963,836
Transfers (to) from	2,286,900	(2,286,900)	
Sales, calls, other	17,465,331	12,583,853	30,049,184
Ending balance at June 30, 2010	\$(96,609,028)	\$(88,298,478)	\$(184,907,506)

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position and not deemed to be other than temporarily impaired as of June 30, 2010 and December 31, 2009.

	Unrealized Loss Position for:		
	Less than 12 Months		
	Amortized Cost	Gross Unrealized Losses	Estimated Fair Value
June 30, 2010	\$ 168,537,808	\$ (9,102,971)	\$ 159,434,837
December 31, 2009	\$ 417,008,390	\$ (4,052,014)	\$ 412,956,376

At June 30, 2010, the Company held 250 AFS securities, of which 74 were in an unrealized loss position. At December 31, 2009, the Company held 112 AFS securities, of which 61 were in an unrealized loss position. There were no unrealized loss positions for twelve consecutive months or longer due to the Company beginning its operations in the fourth quarter of 2009.

Evaluating AFS Securities for Other-than-Temporary Impairments

In 2009, the Company adopted the provisions of ASC 320 to evaluate AFS securities for OTTI. This evaluation requires us to determine whether there has been a significant adverse quarterly change in the cash flow expectations

for a security. The Company also considers whether there has been a significant adverse change in the regulatory and/or economic environment as part of this analysis. For the three and six months ended June 30, 2010, the Company did not recognize any other-than-temporary impairments on AFS securities in the Company's consolidated statements of income (loss).

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain on sale of investment securities, net in the Company's consolidated statements of income (loss). For the three and six months ended June 30, 2010, the Company sold AFS securities for \$165.7 and \$176.1 million with an amortized cost of \$164.9 and \$174.1 million, for a net realized gain of \$0.8 and \$2.0 million, respectively, which included sales of U.S. Treasuries with an amortized cost of \$150.8 million for the three and six months ended June 30, 2010.

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 3. Available-for-Sale Securities, at Fair Value (continued)**

The following table presents the gross realized gains and losses on sales of AFS securities for the three and six months ended June 30, 2010:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Gross realized gains	\$ 1,085,484	\$	\$ 2,306,273	\$
Gross realized losses	(251,939)		(275,755)	
Total realized gains (losses) on sales, net	\$ 833,545	\$	\$ 2,030,518	\$

Note 4. Restricted Cash

The following table presents the Company's restricted cash balances and the purposes of the balances:

	June 30, 2010	December 31, 2009
Restricted cash balances held by:		
Broker counterparties for securities trading activity	\$ 9,000,000	\$ 8,000,000
Broker counterparties for derivative trading activity	7,184,647	
Repurchase counterparties as restricted collateral	2,462,669	913,048
Total	\$ 18,647,316	\$ 8,913,048

As of June 30, 2010 and December 31, 2009, the Company is required to maintain certain cash balances with counterparties for broker activity and collateral for the Company's repurchase agreements in non-interest bearing accounts.

Note 5. Accrued Interest Receivable

The following table presents the Company's accrued interest receivable by collateral type:

	June 30, 2010	December 31, 2009
Accrued Interest Receivable:		
U.S. Treasuries	\$ 92,110	\$
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	1,272,191	1,227,847

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

Federal National Mortgage Association	1,472,386	808,648
Government National Mortgage Association	236,797	128,469
Non-agency	683,253	414,731
Total mortgage-backed securities	3,664,627	2,579,695
Total	\$ 3,756,737	\$ 2,579,695

9

TABLE OF CONTENTS

TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements

Note 6. Derivative Instruments and Hedging Activities

The Company expects to enter into a variety of derivative and non-derivative instruments in connection with its risk management activities. The Company's primary objective for executing these derivatives and non-derivative instruments is to mitigate the Company's economic exposure to future events that are outside its control. The Company's derivative financial instruments are utilized principally to manage market risk and cash flow volatility associated with interest rate risk (including associated prepayment risk) related to certain assets and liabilities. As part of its risk management activities, the Company may, at times, enter into various forward contracts including short securities, agency to-be-announced securities (TBAs), options, futures, swaps and caps. In executing on the Company's current risk management strategy, the Company has entered into interest rate swap agreements and TBA positions. The Company has also entered into a number of non-derivative instruments to manage interest rate risk, principally U.S. Treasuries and Agency interest-only securities.

The following summarizes the Company's significant asset and liability classes, the risk exposure for these classes, and the Company's risk management activities used to mitigate certain of these risks. The discussion includes both derivative and non-derivative instruments used as part of these risk management activities. While the Company uses non-derivative and derivative instruments to achieve the Company's risk management activities, it is possible that these instruments will not effectively mitigate all or a substantial portion of the Company's market rate risk. In addition, the Company might elect, at times, not to enter into certain hedging arrangements in order to maintain compliance with REIT requirements.

Interest Rate Sensitive Assets/Liabilities

Available-for-sale Securities The Company's RMBS investment securities are generally subject to change in value when mortgage rates decline or increase depending on the type of investment. Rising mortgage rates generally result in an increase in slowing of refinancing activity, which slows prepayments and results in a decline in the expected value of the Company's fixed-rate agency pools. To mitigate the impact of this risk, the Company maintains a portfolio of financial instruments, primarily fixed-rate interest-only securities, which increase in value when interest rates increase. In addition, the Company has initiated a limited number of TBA positions to further mitigate its exposure to increased prepayment speeds. The primary objective is to minimize the overall risk of loss in the value of the investment securities due to the change in fair value caused by interest rate changes and their interrelated impact on prepayments.

As of June 30, 2010 and December 31, 2009, the Company had outstanding fair value of \$14.0 million and \$16.5 million, respectively, of interest-only securities in place to economically hedge its investment securities. These interest-only securities are included in available-for-sale securities, at fair value, in the consolidated balance sheet. In addition, the Company holds \$135.0 and \$150.0 million of long and short notional TBA positions, respectively, as of June 30, 2010. The Company discloses these on a net basis in accordance with master netting arrangements resulting, in a net fair market value of negative \$16.8 million as of June 30, 2010, which are included in derivative liabilities, at fair value, in the consolidated balance sheet.

Repurchase Agreements The Company monitors its repurchase agreements, which are generally floating rate debt, in relationship to the rate profile of its investment securities. When it is cost effective to do so, the Company may enter into interest rate arrangements to align the interest rate composition of its investment securities and debt portfolios, specifically repurchase agreements with maturities of less than 6 months. Typically, the significant terms of the interest rate swaps match the terms of the underlying debt, resulting in an effective conversion of the rate of the related repurchase agreement from floating to fixed.

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 6. Derivative Instruments and Hedging Activities
(continued)**

As of June 30, 2010 and December 31, 2009, the Company had the following outstanding interest rate derivatives that were utilized as economic hedges of interest rate risk associated with the Company's short-term repurchase agreements:

Maturity Date	Fixed Interest Rate in Contract	Notional Amounts	
		June 30, 2010	December 31, 2009
12/15/2011	1.168 %	100,000,000	100,000,000
1/11/2013	1.965 %	50,000,000	
4/27/2013	1.821 %	100,000,000	
	Total	250,000,000	100,000,000

The Company has also entered into interest rate derivatives in combination with U.S. Treasuries to hedge funding cost risk. As of June 30, 2010, the Company holds \$145.4 million in fair market value of U.S. Treasuries and the following outstanding interest rate derivatives:

Maturity Date	Fixed Interest Rate in Contract	Notional Amounts	
		June 30, 2010	December 31, 2009
5/27/2012	1.280 %	150,000,000	

All of the Company's interest rate swap contracts receive interest at a 3-month LIBOR rate.

The Company has not applied hedge accounting to its current derivative portfolio held to mitigate the interest rate risk associated with its debt portfolio. As a result, the Company is subject to volatility in its earnings due to movement in the unrealized gains and losses associated with its interest rate swaps and its other derivative instruments.

Foreign Currency Risk

In compliance with the Company's REIT requirements, the Company does not have exposure to foreign denominated assets or liabilities. As such, the Company is not subject to foreign currency risk.

Non-Risk Management Activities

The Company has entered into certain financial instruments that are considered derivative contracts under ASC 815 that are not for purposes of hedging. These contracts are currently limited to inverse interest-only residential mortgage securities. These securities with a carrying value of \$32.6 million are accounted for as derivative financial instruments in the consolidated financial statements.

Credit Risk

The Company has limited its exposure to credit losses on its U.S. Treasuries and Agency portfolio of investment securities because these securities are issued by the U.S. Department of the Treasury or government sponsored entities, or GSEs. The payment of principal and interest on the FHLMC and FNMA mortgage-backed securities are guaranteed by those respective agencies, and the payment of principal and interest on the GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

For non-Agency investment securities, the Company currently does not believe it is cost effective or beneficial to the Company's REIT status to hedge credit risk with derivative instruments and, accordingly, the Company does not hold derivative instruments to specifically hedge credit risk. However, the Company has processes and controls in place to monitor, analyze, manage and mitigate its credit risk with respect to non-Agency RMBS.

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 6. Derivative Instruments and Hedging Activities
(continued)**

Derivative financial instruments contain an element of credit risk if counterparties are unable to meet the terms of the agreements. Credit risk associated with derivative financial instruments is measured as the net replacement cost should the counterparties that owe the Company under contracts completely fail to perform under the terms of these contracts, assuming there are no recoveries of underlying collateral, as measured by the market value of the derivative financial instruments. As June 30, 2010, the market value of derivative financial instruments as an asset and liability position was \$32.6 and \$21.6 million, respectively.

The Company mitigates the credit risk exposure on derivative financial instruments by limiting the counterparties to those major banks and financial institutions that meet established credit guidelines, and the Company seeks to transact with several different counterparties in order to reduce the exposure to any single counterparty. Additionally, the Company reduces credit risk on the majority of its derivative instruments by entering into agreements that permit the closeout and netting of transactions with the same counterparty upon occurrence of certain events. To further mitigate the risk of counterparty default, the Company maintains collateral agreements with certain of its counterparties. The agreements require both parties to maintain cash deposits in the event the fair values of the derivative financial instruments exceed established thresholds. The Company has not received cash deposits from counterparties at June 30, 2010. The Company has placed cash deposits of \$7.3 million as of June 30, 2010 in accounts maintained by counterparties, of which the amounts are classified as restricted cash or due from counterparties on the consolidated balance sheet.

In accordance with ASC 815, as amended and interpreted, the Company records derivative financial instruments on its consolidated balance sheet as assets or liabilities at fair value. Changes in fair value are accounted for depending on the use of the derivative instruments and whether they qualify for hedge accounting treatment. Due to the volatility of the credit markets and difficulty in effectively matching pricing or cash flows, the Company has elected to treat all current derivative contracts as trading instruments.

Balance Sheet Presentation

The following table represents the gross fair value and notional amounts of the Company's derivative financial instruments treated as trading instruments as of June 30, 2010 and December 31, 2009.

	Derivative Assets		Derivative Liabilities	
	Fair Value	Notional	Fair Value	Notional
June 30, 2010	\$ 32,632,941	241,889,518	\$ 21,635,709	416,209,766
December 31, 2009	\$ 363,666	100,000,000	\$	

The following table provides the average monthly outstanding notional amounts of the Company's derivative financial instruments treated as trading instruments for the six months ended June 30, 2010.

	Six Months Ended June 30,	
Trading Instruments	Derivative Assets	Derivative Liabilities
Inverse interest-only securities	171,011,470	
TBAs	17,142,857	28,626,374
Interest rate swap agreements		279,120,879
Short treasuries		5,549,451

12

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 6. Derivative Instruments and Hedging Activities
(continued)****Income Statement Presentation**

The following table summarizes the location and amount of gains and losses on derivative instruments reported in the consolidated statement of income on its derivative instruments.

Trading Instruments	Location of Gain/(Loss) Recognized in Income on Derivatives	Amount of Gain/(Loss) Recognized in Income on Derivatives Six Months Ended June 30,	
		2010	2009
Risk Management Instruments			
Interest Rate Contracts			
Investment securities	RMBS	\$416,908	\$
Investment securities	U.S. Treasuries	(1,048,097)	
Repurchase agreements		(4,553,096)	
Non-Risk Management Instruments		682,121	
Total		\$ (4,502,164)	\$

Note 7. Fair Value**Fair Value Measurements**

ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices available in active markets (i.e., observable inputs) and the lowest priority to data lacking transparency (i.e., unobservable inputs). Additionally, ASC 820 requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability.

ASC 820 establishes a three level hierarchy to be used when measuring and disclosing fair value. An instrument's categorization within the fair value hierarchy is based on the lowest level of significant input to its valuation.

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

Following is a description of the three levels:

Level 1 Inputs are quoted prices in active markets for identical assets or liabilities as of the measurement date. Additionally, the entity must have the ability to access the active market and the quoted prices cannot be adjusted by the entity.

Level 2 Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs that are observable or can be corroborated by observable market data by correlation or other means for substantially the full-term of the assets or liabilities.

Level 3 Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management's best assumptions of how market participants would price the assets and liabilities. Generally, Level 3 assets and liabilities are valued using pricing models, discounted cash flow methodologies, or similar techniques that require significant judgment or estimation.

13

TABLE OF CONTENTS

TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements

Note 7. Fair Value (continued)

Following are descriptions of the valuation methodologies used to measure material assets and liabilities at fair value and details of the valuation models, key inputs to those models and significant assumptions utilized.

Available-for-sale securities The Company holds a portfolio of available-for-sale securities that are carried at fair value in the consolidated balance sheet. Available-for-sale securities are primarily comprised of U.S. Treasuries, Agency and non-Agency RMBS. The Company determines the fair value of its U.S. Treasuries and Agency RMBS based upon prices obtained from third-party pricing providers or broker quotes received using bid price, which are deemed indicative of market activity. In determining the fair value of its non-Agency RMBS, management judgment is used to arrive at fair value that considers prices obtained from third-party pricing providers, broker quotes received and other applicable market data. If observable market prices are not available or insufficient to determine fair value due to principally illiquidity in the marketplace, then fair value is based upon internally developed models that are primarily based on observable market-based inputs but also include unobservable market data inputs (including prepayment speeds, delinquency levels, and credit losses). The Company classified 100% of its U.S. Treasuries as Level 1 fair value assets at June 30, 2010. The Company classified 100% of its RMBS available for sale securities reported at fair value as Level 2 at June 30, 2010. Available-for-sale securities account for 96.8% of all assets reported at fair value at June 30, 2010.

Derivative instruments The Company may enter into a variety of derivative financial instruments as part of its hedging strategies. The Company principally executes over-the-counter (OTC) derivative contracts, such as interest rate swaps. The Company utilizes internally developed models that are widely accepted in the market to value their over-the-counter derivative contracts. The specific terms of the contract are entered into the model, as well as market observable inputs such as interest rate forward curves and interpolated volatility assumptions. As all significant inputs into these models are market observable, the Company classified 100% of the interest rate swaps reported at fair value as Level 2 at June 30, 2010.

The Company also enters into certain other derivative financial instruments, such as TBAs and inverse interest-only securities. These instruments are similar in form to the Company's available-for-sale securities and the Company utilizes broker quotes to value these instruments. The Company classified 95.0% of these derivative assets reported at fair value as Level 2 and 5.0% of these derivative assets reported at fair value as Level 3 at June 30, 2010. The Company reported 100% of its derivative liabilities as Level 1 or Level 2 as of June 30, 2010.

The Company's Risk Management Committee governs trading activity relating to derivative instruments. The Company's policy is to minimize credit exposure related to financial derivatives used for hedging, by limiting the hedge counterparties to major banks, financial institutions, exchanges, and private investors who meet established capital and credit guidelines, as well as by limiting the amount of exposure to any individual counterparty.

The Company has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association, or ISDA. Additionally, both the Company and the counterparty are required to post cash collateral based upon the net underlying market value of the Company's open

positions with the counterparty. Posting of cash collateral typically occurs daily, subject to certain dollar thresholds.

Due to the existence of netting arrangements, as well as frequent cash collateral posting at low posting thresholds, credit exposure to the Company and/or to the counterparty is considered materially mitigated and based on the Company's assessment, there is no requirement for any additional adjustment to derivative valuations specifically for credit.

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 7. Fair Value (continued)****Recurring Fair Value**

The following tables display the Company's assets and liabilities measured at fair value on a recurring basis. The Company often economically hedges the fair value change of its assets or liabilities with derivatives and other financial instruments. The table below displays the hedges separately from the hedged items, and therefore does not directly display the impact of the Company's risk management activities.

	Recurring Fair Value Measurements			
	At June 30, 2010			
	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	\$ 145,436,132	\$ 832,447,455	\$	\$ 977,883,587
Derivative assets		30,989,757	1,643,184	32,632,941
Total assets	\$ 145,436,132	\$ 863,437,212	\$ 1,643,184	\$ 1,010,516,528
Liabilities				
Derivative liabilities	\$ 16,821,569	\$ 4,814,140	\$	\$ 21,635,709
Total liabilities	\$ 16,821,569	\$ 4,814,140	\$	\$ 21,635,709

The valuation of Level 3 instruments requires significant judgment by the third-party pricing providers and/or management. The third party pricing providers and/or management rely on inputs such as market price quotations from market makers (either market or indicative levels), original transaction price, recent transactions in the same or similar instruments and changes in financial ratios or cash flows to determine fair value. Level 3 instruments may also be discounted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the third party pricing provider in the absence of market information. Assumptions used by the third party pricing provider due to lack of observable inputs may significantly impact the resulting fair value and therefore the Company's financial statements. The Company's valuation committee reviews all valuations that are based on pricing information received from a third party pricing provider. As part of this review, prices are compared against other pricing or input data points in the marketplace, along with internal valuation expertise, to ensure the pricing is reasonable. In addition, the Company performs back-testing of pricing information to validate price information and identify any pricing trends of a third party price provider.

In determining fair value, third party pricing providers use various valuation approaches, including market and income approaches. Inputs that are used in determining fair value of an instrument may include pricing information, credit data, volatility statistics, and other factors. In addition, inputs can be either observable or unobservable.

The availability of observable inputs can vary by instrument and is affected by a wide variety of factors, including the type of instrument, whether the instrument is new and not yet established in the marketplace and other characteristics particular to the instrument. The third party pricing provider uses prices and inputs that are current as of the measurement date, including during periods of market dislocations. In periods of market dislocation, the availability

of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified to or from various levels within the fair value hierarchy.

Securities for which market quotations are readily available are valued at the bid price (in the case of long positions) or the ask price (in the case of short positions) at the close of trading on the date as of which value is determined.

Exchange-traded securities for which no bid or ask price is available are valued at the last traded price.

OTC derivative contracts, including interest rate swaps, are valued by the Company using observable inputs, such as quotations received from the counterparty, dealers or brokers, whenever available and considered reliable. In instances where models are used, the value of an OTC derivative depends upon the

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 7. Fair Value (continued)**

contractual terms of, and specific risks inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, yield curves, credit curves, volatility measures, prepayment rates and correlation of such inputs. Certain OTC derivatives, such as swaps, have inputs which can generally be corroborated by market data and are therefore classified within Level 2.

The table below presents the reconciliation for all of the Company's Level 3 assets and liabilities measured at fair value on a recurring basis. The Level 3 items presented below may be hedged by derivatives and other financial instruments that are classified as Level 1 or Level 2. Thus, the tables below do not fully reflect the impact of the Company's risk management activities.

Level 3 Recurring Fair Value Measurements
Three Months Ended June 30, 2010

	Total Net Gains/(Losses) Included in Net Income						
	April 1, 2010 Level 3 Fair Value	Realized Gains (Losses)	Unrealized Gains (Losses)	Other Comprehensive Income	Purchases, Sales and Settlements, Net	Net Transfers Into/(Out of) Level 3	End of Period Level 3 Fair Value
Assets							
Available-for-sale securities	\$4,976,789	\$	\$	\$ (a)	\$	\$(4,976,789)	\$
Derivative assets		(7,436)	(16,640)		1,667,260		1,643,184
Total assets	\$4,976,789	\$(7,436)	\$(16,640)	\$	\$1,667,260	\$(4,976,789)	\$1,643,184

(a) Change in unrealized gains (losses) on available-for-sale securities recorded in equity as accumulated other comprehensive (loss) income.

The Company did not incur transfers between Level 1 and Level 2 for the three months ended June 30, 2010. The Company did incur a minimal amount of transfer activity from Level 3 to Level 2 during the three months ended June 30, 2010 as a result of obtaining third-party broker prices for the respective securities and qualitative and quantitative support for the liquidity of those instruments. Transfers between Levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.

The Company did not have any assets or liabilities recorded at fair value for the three and six months ended June 30, 2009.

Nonrecurring Fair Value

The Company may be required to measure certain assets or liabilities at fair value from time to time. These periodic fair value measures typically result from application of certain impairment measures under GAAP. These items would constitute nonrecurring fair value measures under ASC 820. As of June 30, 2010, the Company did not have any assets or liabilities measured at fair value on a nonrecurring basis.

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 7. Fair Value (continued)****Fair Value of Financial Instruments**

In accordance with ASC 820, the Company is required to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the consolidated balance sheet, for which fair value can be estimated.

The following describes the Company's methods for estimating the fair value for financial instruments. Descriptions are not provided for those items that have zero balances as of the current balance sheet date.

Available-for-sale securities, derivative assets and liabilities are recurring fair value measurements; carrying value equals fair value. See discussion of valuation methods and assumptions within *the Fair Value Measurements* section of this footnote.

Cash and cash equivalents and restricted cash have a carrying value which approximates fair value because of the short maturities of these instruments.

The carrying value of repurchase agreements approximates fair value due to the maturities of less than one year of these financial instruments. The Company's repurchase agreements have floating rates based on an index plus a spread. These borrowings have been recently entered into and the credit spread is typically consistent with those demanded in the market. Accordingly, the interest rates on these borrowings are at market and thus carrying value approximates fair value.

Note 8. Repurchase Agreements

The Company had outstanding \$866.3 million of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of \$144.3 million. Excluding the debt associated with the Company's U.S. Treasuries and the effect of the Company's interest rate swaps, the repurchase agreements had a weighted average borrowing rate of 0.6% and weighted average remaining maturities of 51 days as of June 30, 2010. The Company had outstanding \$411.9 million of repurchase agreements with a weighted average borrowing rate of 0.4% excluding the effect of the Company's interest rate swaps, and weighted average remaining maturities of 90 days as of December 31, 2009. The debt associated with the Company's U.S. Treasuries had a weighted borrowing rate of 0.2%.

At June 30, 2010 and December 31, 2009, the repurchase agreements had the following characteristics:

Collateral Type	June 30, 2010		December 31, 2009		
	Amount Outstanding	Weighted Average Borrowing Rate	Amount Outstanding	Weighted Average Borrowing Rate	
U.S. treasuries	\$ 144,275,000	0.21 %	\$		
Agency RMBS	603,108,942	0.40 %	395,641,510	0.37 %	

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

Non-Agency RMBS	97,147,687	1.95	%	16,251,000	1.94	%
Agency derivatives	21,746,545	1.07	%			
Total	\$ 866,278,174	0.56	%	\$ 411,892,510	0.43	%

17

TABLE OF CONTENTS**TWO HARBORS INVESTMENT CORP.****Notes to the Consolidated Financial Statements****Note 8. Repurchase Agreements (continued)**

At June 30, 2010 and December 31, 2009, the repurchase agreements had the following remaining maturities:

	June 30, 2010	December 31, 2009
Within 30 days	\$ 178,564,075	\$ 207,050,239
30 to 59 days	176,313,848	
60 to 89 days	78,408,232	
90 to 119 days	98,231,625	
Over 120 days	190,485,394	204,842,271
Open maturity	144,275,000 ⁽¹⁾	
Total	\$ 866,278,174	\$ 411,892,510

⁽¹⁾ Repurchase agreements collateralized by U.S. Treasuries include an open maturity period (i.e., rolling 1-day maturity) renewable at the discretion of either party to the agreements.

The following table summarizes assets at carrying value that are pledged or restricted as collateral for the future payment obligations of repurchase agreements:

	June 30, 2010	December 31, 2009
Available-for-sale securities, at fair value	\$ 934,149,813	\$ 444,833,063
Restricted cash	2,462,669	913,048
Due from counterparties	4,905,331	1,736,952
Derivative assets, at fair value	30,549,308	
Total	\$ 972,067,121	\$ 447,483,063

Although the repurchase agreements are committed borrowings until maturity, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls.

The following table summarizes certain characteristics of the Company's repurchase agreements and counterparty concentration at June 30, 2010:

	Amount Outstanding	Net Counterparty Exposure ⁽¹⁾	Percent of Equity
Barclays Capital Inc.	\$ 284,819,996	\$ 49,216,060	22 %
Banc of America Securities LLC	55,480,000	26,661,847	12 %

Edgar Filing: Two Harbors Investment Corp. - Form 10-Q

All other counterparties	525,978,178	33,440,144	15	%
Total	\$ 866,278,174	\$ 109,318,051		

Represents the net carrying value of the securities sold under agreements to repurchase, including accrued interest (1) plus any cash or assets on deposit to secure the repurchase obligation, over the amount of the repurchase liability, including accrued interest.

18

TABLE OF CONTENTS

TWO HARBORS INVESTMENT CORP.

Notes to the Consolidated Financial Statements

Note 9. Stockholders Equity

Public offering

On April 26, 2010, the Company completed its public offering of 11,500,000 shares of its common stock and subsequently issued an additional 1,188,381 shares of common stock pursuant to the underwriters over-allotments at a price of \$8.90 per share, for gross proceeds of approximately \$113.0 million. Including the over-allotment shares, the Company has 26,067,590 shares of common stock outstanding as of June 30, 2010. Net proceeds to the Company from the offering were approximately \$106.8 million, net of issuance costs of approximately \$6.2 million.

Distributions to stockholders

On June 14, 2010, the Company declared dividends to common stockholders totaling \$8.6 million, or \$0.33 per share. The following table presents cash dividends declared by the Company on its common stock from October 28, 2009 through June 30, 2010:

Declaration Date	Record Date	Payment Date	Cash Dividend Per Share
June 14, 2010	June 30, 2010	July 22, 2010	\$ 0.33
March 12, 2010	March 31, 2010	April 23, 2010	\$ 0.36
December 21, 2009	December 31, 2009	January 26, 2010	\$ 0.26

Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) at June 30, 2010 and December 31, 2009 was as follows: