Two Harbors Investment Corp.
Form 10-Q
May 05, 2011

UNITED STATES
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: March 31, 2011
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)

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 x No o
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 o No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer x	Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
As of May 5, 2011 there were 69,257,344 shares of outstanding common stock, par value $.01 per share, issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	March 31, 2011 (unaudited)	December 31, 2010
ASSETS		
Available-for-sale securities, at fair value	$2,882,992	$1,354,405
Trading securities, at fair value	299,262	199,523
Cash and cash equivalents	302,263	163,900
Total earning assets	3,484,517	1,717,828
Restricted cash	38,991	22,548
Accrued interest receivable	11,010	5,383
Due from counterparties	21,459	12,304
Derivative assets, at fair value	106,153	38,109
Other assets	574	1,260
Total Assets	$3,662,704	$1,797,432
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	$2,616,031	$1,169,803
Accrued interest payable	1,305	785
Due to counterparties	338,148	231,724
Accrued expenses and other liabilities	2,997	2,063
Dividends payable	16,200	10,450
Other liabilities	2,455	159
Total liabilities	2,977,136	1,414,984
Stockholders' Equity		
Preferred stock, par value $0.01per share; 50,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, par value $0.01per share; 450,000,000 shares authorized and 69,251,757 and 40,501,212 shares issued and outstanding, respectively	693	405
Additional paid-in capital	654,514	366,974
Accumulated other comprehensive income	31,734	22,619
Cumulative earnings	52,397	30,020
Cumulative distributions to stockholders	(53,770)	(37,570)
Total stockholders' equity	685,568	382,448
Total Liabilities and Stockholders' Equity	$3,662,704	$1,797,432

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except share data)

	Three Months Ended March 31,	
	2011	2010
	(unaudited)	
Interest income:		
Available-for-sale securities	$19,535	$6,153
Trading securities	272	—
Cash and cash equivalents	63	6
Total interest income	19,870	6,159
Interest expense	2,499	518
Net interest income	17,371	5,641
Other income:		
Gain on investment securities, net	1,539	1,197
Gain (loss) on interest rate swap and swaption agreements	1,939	(1,547)
Gain on other derivative instruments	5,347	946
Total other income	8,825	596
Expenses:		
Management fees	1,550	457
Other operating expenses	1,512	987
Total expenses	3,062	1,444
Net income before income taxes	23,134	4,793
Benefit from (provision for) income taxes	(757)	534
Net income attributable to common stockholders	$22,377	$5,327
Basic and diluted earnings per weighted average common share	$0.49	$0.40
Dividends declared per common share	$0.40	$0.36
Basic and diluted weighted average number of shares of common stock	45,612,376	13,401,368

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(in thousands, except share data)

	Common Stock						
	Shares	Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (unaudited)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity
Balance, January 1, 2010	13,401,368	$134	$131,756	$ (950)	$(5,735)	$(3,484)	$ 121,721
Net income	—	—	—	—	5,327	—	5,327
Net change in unrealized gain on available-for-sale securities	—	—	—	3,500	—	—	3,500
Total other comprehensive income	—	—	—	3,500	—	—	—
Total comprehensive income							8,827
Common dividends declared	—	—	—	—	—	(4,825)	(4,825)
Non-cash equity award compensation	—	—	33	—	—	—	33
Balance, March 31, 2010	13,401,368	$134	$131,789	$ 2,550	$(408)	$(8,309)	$ 125,756
Balance, January 1, 2011	40,501,212	$405	$366,974	$ 22,619	$30,020	$(37,570)	$ 382,448
Net income	—	—	—	—	22,377	—	22,377
Net change in unrealized gain on available-for-sale securities	—	—	—	9,115	—	—	9,115
Total other comprehensive income	—	—	—	9,115	—	—	—
Total comprehensive income							31,492
Net proceeds from issuance of common stock, net of offering costs	28,750,545	288	287,478	—	—	—	287,766
Common dividends declared	—	—	—	—	—	(16,200)	(16,200)
Non-cash equity award compensation	—	—	62	—	—	—	62
Balance, March 31, 2011	69,251,757	$693	$654,514	$ 31,734	$52,397	$(53,770)	$ 685,568

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended March 31,	
	2011	2010
	(unaudited)	
Cash Flows From Operating Activities:		
Net income	$22,377	$5,327
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums and discounts on RMBS, net	2,467	1,416
Gain on investment securities, net	(1,539)	(1,197)
Gain on termination of interest rate swaps and swaptions	(1,253)	—
Unrealized (gain)/loss on interest rate swaps and swaptions	(3,838)	1,129
Unrealized gain on other derivative instruments	(1,971)	(656)
Equity based compensation expense	62	32
Net change in:		
(Increase)/decrease in accrued interest receivable	(5,627)	79
Decrease/(increase) in deferred income taxes, net	482	(526)
Increase in prepaid tax asset	—	(8)
Decrease/(increase) in prepaid expenses	204	(31)
Increase in accrued interest payable, net	520	269
Increase in income taxes payable, net	275	—
Increase in accrued expenses and other liabilities	934	346
Net cash provided by operating activities	13,093	6,180
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	(1,636,366)	(58,965)
Proceeds from sales of available-for-sale securities	71,405	10,378
Principal payments on available-for-sale securities	44,659	26,164
Purchases of other derivative instruments	(70,302)	(3,479)
Proceeds from sales of other derivative instruments	11,342	16,618
Purchases of trading securities	(299,337)	—
Proceeds from sales of trading securities	199,500	—
Increase/(decrease) in due to/from counterparties, net	97,269	(18,462)
Increase in restricted cash	(16,443)	(13,680)
Net cash used in investing activities	(1,598,273)	(41,426)
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	3,131,249	458,203
Principal payments on repurchase agreements	(1,685,022)	(420,135)
Proceeds from issuance of common stock, net of offering costs	287,766	—
Dividends paid on common stock	(10,450)	(3,484)
Net cash provided by financing activities	1,723,543	34,584
Net increase/(decrease) in cash and cash equivalents	138,363	(662)
Cash and cash equivalents at beginning of period	163,900	26,105
Cash and cash equivalents at end of period	$302,263	$25,443
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$1,980	$249

Cash paid for taxes	$1	$—
Non-Cash Financing Activity:		
Dividends declared but not paid at end of period	$16,200	$4,824

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

TWO HARBORS INVESTMENT CORP.
Notes to the Condensed Consolidated Financial Statements

Note 1. Organization and Operations
Two Harbors Investment Corp., or the Company, is a Maryland corporation formed to invest primarily in residential mortgage-backed securities, or RMBS. The Company is externally managed and advised by PRCM Advisers LLC, a subsidiary of Pine River Capital Management L.P., or Pine River, a global multi-strategy asset management firm. The Company's common stock is listed on the NYSE and its warrants are listed on the NYSE Amex under the symbols "TWO" and "TWO.WS," respectively.
The Company has elected to be treated as a real estate investment trust, or 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, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or 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, 2010. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2011 and results of operations for all periods presented have been made. The results of operations for the three months ended March 31, 2011 should not be construed as indicative of the results to be expected for the full year.
The condensed 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 condensed 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 condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation.
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 is effective for interim and annual periods beginning after December 15, 2010. The impact of adopting this ASU, including the Level 3 activity requirement, did not have a material impact on the Company's consolidated financial condition or results of operations.

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TWO HARBORS INVESTMENT CORP.
Notes to the Consolidated Financial Statements - (continued)

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 as of March 31, 2011 and December 31, 2010:

(in thousands)	March 31, 2011	December 31, 2010
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	$839,433	$396,888
Federal National Mortgage Association	1,443,406	556,609
Government National Mortgage Association	75,149	62,972
Non-Agency	525,004	337,936
Total mortgage-backed securities	$2,882,992	$1,354,405

At March 31, 2011 and December 31, 2010, the Company pledged investment securities with a carrying value of $2.5 billion and $1.1 billion, respectively, as collateral for repurchase agreements. See Note 9 - Repurchase Agreements.
At March 31, 2011 and December 31, 2010, 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.
The following tables present the amortized cost and carrying value (which approximates fair value) of AFS securities by collateral type as of March 31, 2011 and December 31, 2010:

	March 31, 2011		
(in thousands)	Agency	Non-Agency	Total
Face Value	$2,995,682	$890,910	$3,886,592
Unamortized premium	76,126	—	76,126
Unamortized discount			
Designated credit reserve	—	(233,465)	(233,465)
Net, unamortized	(719,884)	(158,111)	(877,995)
Amortized Cost	2,351,924	499,334	2,851,258
Gross unrealized gains	15,181	29,641	44,822
Gross unrealized losses	(9,117)	(3,971)	(13,088)
Carrying Value	$2,357,988	$525,004	$2,882,992

	December 31, 2010		
(in thousands)	Agency	Non-Agency	Total
Face Value	$1,306,655	$594,306	$1,900,961
Unamortized premium	41,651	—	41,651
Unamortized discount			
Designated credit reserve	—	(145,855)	(145,855)
Net, unamortized	(334,979)	(129,992)	(464,971)
Amortized Cost	1,013,327	318,459	1,331,786
Gross unrealized gains	9,308	21,503	30,811
Gross unrealized losses	(6,166)	(2,026)	(8,192)
Carrying Value	$1,016,469	$337,936	$1,354,405

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TWO HARBORS INVESTMENT CORP.
Notes to the Consolidated Financial Statements - (continued)

The following tables present the carrying value of the Company's AFS investment securities by rate type as of March 31, 2011 and December 31, 2010:

	March 31, 2011		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$264,468	$414,361	$678,829
Fixed Rate	2,093,520	110,643	2,204,163
Total	$2,357,988	$525,004	$2,882,992

	December 31, 2010		
(in thousands)	Agency	Non-Agency	Total
Adjustable Rate	$269,512	$245,517	$515,029
Fixed Rate	746,957	92,419	839,376
Total	$1,016,469	$337,936	$1,354,405

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 principal that the Company does not amortize into income is designated as a credit reserve on the security, with unamortized net 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 three months ended March 31, 2011 and March 31, 2010 of the unamortized net discount and designated credit reserves on non-Agency AFS securities.

	Three Months Ended March 31,					
	2011			2010		
(in thousands)	Designated credit reserve	Unamortized net discount	Total	Designated credit reserve	Unamortized net discount	Total
Beginning balance at January 1	$(145,855)	$(129,992)	$(275,847)	$(50,187)	$(41,050)	$(91,237)
Acquisitions	(96,343)	(38,763)	(135,106)	(8,379)	(30,356)	(38,735)
Accretion of net discount	—	5,376	5,376	—	1,101	1,101
Realized credit losses	771	—	771	590	6	596
Transfers (to) from	(123)	123	—	359	(359)	—
Sales, calls, other	8,085	5,145	13,230	4,812	4,627	9,439
Ending balance at March 31	$(233,465)	$(158,111)	$(391,576)	$(52,805)	$(66,031)	$(118,836)

The following table presents the components comprising the carrying value of AFS securities not deemed to be other than temporarily impaired by length of time the securities had an unrealized loss position as of March 31, 2011 and December 31, 2010. At March 31, 2011, the Company held 608 AFS securities, of which 226 were in an unrealized loss position for less than twelve consecutive months and 9 were in an unrealized loss position for more than twelve consecutive months. At December 31, 2010, the Company held 373 AFS securities, of which 108 were in an unrealized loss position for less than twelve months and 5 were in an unrealized loss position for more than twelve consecutive months.

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TWO HARBORS INVESTMENT CORP.
Notes to the Consolidated Financial Statements - (continued)

	Unrealized Loss Position for Less than 12 Months		12 Months or More		Total	
(in thousands)	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
March 31, 2011	$1,048,853	$(12,587)	$1,756	$(501)	$1,050,609	$(13,088)
December 31, 2010	$310,445	$(7,183)	$1,405	$(1,009)	$311,850	$(8,192)

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. As of March 31, 2011, we did not intend to sell any of the Company's AFS securities in loss positions and the Company believes it is not more likely than not we will be required to sell these securities before recovery of their amortized cost basis. Based on the Company's evaluation, for the period ended March 31, 2011, the Company did not recognize any OTTI on AFS securities in the Company's consolidated statements of income.
Gross Realized Gains and Losses
Gains and losses from the sale of AFS securities are recorded as realized gains (losses) within gain on investment securities, net in the Company's consolidated statements of income. For the three months ended March 31, 2011, the Company sold AFS securities for $71.4 million with an amortized cost of $69.8 million, for a net realized gain of $1.6 million.
The following table presents the gross realized gains and losses on sales of AFS securities for the three months ended March 31, 2011 and 2010:

	Three Months Ended March 31,	
(in thousands)	2011	2010
Gross realized gains	$1,808	$1,221
Gross realized losses	(170)	(24)
Total realized gains (losses) on sales, net	$1,638	$1,197

Note 4. Trading Securities, at Fair Value
During the three months ended March 31, 2011, the Company acquired and sold U.S. Treasuries in its taxable REIT subsidiary and classified these securities as trading instruments due to its short-term investment objectives. As of March 31, 2011 and December 31, 2010, the Company held U.S. Treasuries with an amortized cost of $299.4 million and $200.0 million and a fair value $299.3 million and $199.5 million, respectively, classified as trading securities. For the three months ended March 31, 2011, the Company sold trading securities with an amortized cost of $200.0 million resulting in realized losses of $0.5 million on the sale of these investment securities. The realized losses are recorded as a component of gains on investment securities, net in the Company's consolidated statement of income. At March 31, 2011, the Company pledged trading securities with a carrying value of $299.3 million as collateral for repurchase agreements. See Note 9 - Repurchase Agreements.

Note 5. Restricted Cash

As of March 31, 2011 and December 31, 2010, 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.
The following table presents the Company's restricted cash balances:

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TWO HARBORS INVESTMENT CORP.
Notes to the Consolidated Financial Statements - (continued)

(in thousands)	March 31, 2011	December 31, 2010
Restricted cash balances held by:		
Broker counterparties for securities trading activity	$9,000	$9,000
Broker counterparties for derivatives trading activity	7,367	1,914
Repurchase counterparties as restricted collateral	22,624	11,634
Total	$38,991	$22,548

Note 6. Accrued Interest Receivable
The following table presents the Company's accrued interest receivable by collateral type:

(in thousands)	March 31, 2011	December 31, 2010
Accrued Interest Receivable:		
U.S. Treasuries	$163	$192
Mortgage-backed securities:		
Agency		
Federal Home Loan Mortgage Corporation	2,967	1,509
Federal National Mortgage Association	6,031	2,201
Government National Mortgage Association	696	532
Non-Agency	1,153	949
Total mortgage-backed securities	10,847	5,191
Total	$11,010	$5,383

Note 7. Derivative Instruments and Hedging Activities
The Company enters 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, or TBAs, options, futures, swaps and caps. In executing on the Company's current risk management strategy, the Company has entered into interest rate swap and swaption 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 a slowing of refinancing activity, which slows prepayments and results in an unexpected decline in the 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

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TWO HARBORS INVESTMENT CORP.
Notes to the Consolidated Financial Statements - (continued)

change in fair value caused by interest rate changes and their interrelated impact on prepayments.
As of March 31, 2011 and December 31, 2010, the Company had outstanding fair value of $91.6 million and $18.4 million, respectively, of interest-only securities in place to economically hedge its investment securities. These interest-only securities are included in AFS securities, at fair value, in the consolidated balance sheets. In addition, the Company holds TBA positions with $150.0 million in long notional and $150.0 million in short notional as of March 31, 2011. The Company discloses these on a net basis in accordance with master netting arrangements resulting in a net fair market value of negative $2.2 million as of March 31, 2011, which are included in other liabilities in the condensed consolidated balance sheet. The Company did not hold any long or short notional TBA positions as of December 31, 2010.
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 swap 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 interest receivable terms (i.e., LIBOR) 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.
As of March 31, 2011 and December 31, 2010, the Company had the following outstanding interest rate swaps that were utilized as economic hedges of interest rate risk associated with the Company's short-term repurchase agreements:

(notional in thousands)
March 31, 2011

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	25,000	0.868	%	0.301	%	1.73
2013	725,000	1.023	%	0.307	%	2.02
2014	475,000	1.486	%	0.305	%	3.21
2015	395,000	1.880	%	0.283	%	4.21
2016	90,000	2.260	%	0.306	%	4.91
Total	1,710,000					

(notional in thousands)
December 31, 2010

Swaps Maturities	Notional Amount	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2011	100,000	1.168	%	0.3425	%	0.96
2012	25,000	0.868	%	0.3080	%	1.98
2013	175,000	1.376	%	0.3055	%	2.61
2014	175,000	1.671	%	0.3026	%	3.96
2015	175,000	1.830	%	0.2874	%	4.84
Total	650,000					

The Company has also entered into interest rate swaps in combination with U.S. Treasuries to economically hedge funding cost risk. As of March 31, 2011 and December 31, 2010, the Company held $299.3 million and $199.5 million, respectively, in fair value of U.S. Treasuries classified as trading securities and the following outstanding interest rate swaps:

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(notional in thousands)
March 31, 2011

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2013	300,000	0.930	%	0.3125	%	1.90
Total	300,000					

(notional in thousands)
December 31, 2010

Swaps Maturities	Notional Amounts	Average Fixed Pay Rate		Average Receive Rate		Average Maturity (Years)
2012	200,000	0.557	%	0.278	%	1.80
Total	200,000					

All of the Company's interest rate swap contracts receive interest at a 1-month or 3-month LIBOR rate.
Additionally, as of March 31, 2011 and December 31, 2010, the Company had the following outstanding interest rate swaptions (agreements to enter into interest rate swaps in the future for which the Company would pay a fixed rate) that were utilized as macro-economic hedges:
March 31, 2011

(notional and dollars in thousands)	Option			Underlying Swap				
Swaption	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate		Average Receive Rate	Average Term (Years)
Payer	$11,505	$11,410	10.82	650,000	3.25	%	3M Libor	4.692

December 31, 2010

(notional and dollars in thousands)	Option			Underlying Swap				
Swaption	Cost	Fair Value	Average Months to Expiration	Notional Amount	Average Fixed Pay Rate		Average Receive Rate	Average Term (Years)
Payer	$3,348	$4,028	11.23	100,000	3.52	%	3M Libor	8.5

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 and credit default swaps.

Inverse interest-only securities with a carrying value of $84.2 million, including accrued interest receivable, are accounted for as derivative financial instruments in the consolidated financial statements. The following table presents the amortized cost and carrying value (which approximates fair value) of inverse interest-only securities as of March 31, 2011 and December 31, 2010:

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(in thousands)	March 31, 2011	December 31, 2010
Face Value	$622,651	$219,459
Unamortized premium	—	—
Unamortized discount		
Designated credit reserve	—	—
Net, unamortized	(541,282)	(190,162)
Amortized Cost	81,369	29,297
Gross unrealized gains	2,883	1,902
Gross unrealized losses	(1,298)	(665)
Carrying Value	$82,954	$30,534

As of March 31, 2011 and December 31, 2010, the Company also held credit default swaps where the Company provides credit protection for a fixed premium. The maximum payouts for these credit default swaps are limited to the current notional amounts of each swap contract. Maximum payouts for credit default swaps do not represent the expected future cash requirements, as the Company's credit default swaps are typically liquidated or expire and are not exercised by the holder of the credit default swaps.
The following tables represent credit default swaps where the Company is providing protection held as of March 31, 2011 and December 31, 2010:
(notional and dollars in thousands)
March 31, 2011

Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront Payable	Unrealized Gain/(Loss)
7/25/2036	374.68	77,196	$8,120	$(7,001)	$1,119

(notional and dollars in thousands)
December 31, 2010

Maturity Date	Average Implied Credit Spread	Current Notional Amount	Fair Value	Upfront Payable	Unrealized Gain/(Loss)
7/25/2036	378.47	41,576	$3,137	$(3,554)	$(417)

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.
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 of March 31, 2011, the fair value of derivative financial instruments as an asset and liability position was $106.2 million and $2.2 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

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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 as of March 31, 2011. The Company has placed cash deposits of $17.3 million as of March 31, 2011 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 March 31, 2011 and December 31, 2010.

(in thousands)	March 31, 2011				December 31, 2010			
	Derivative Assets		Derivative Liabilities		Derivative Assets		Derivative Liabilities	
Trading instruments	Fair Value	Notional	Fair Value	Notional	Fair Value	Notional	Fair Value	Notional
Inverse interest-only securities	$84,164	622,651	$—	—	$30,944	219,459	$—	—
Interest rate swap agreements	2,459	2,010,000	—	—	—	—	(158)	850,000
Credit default swap agreements	8,120	77,196	—	—	3,137	41,576	—	—
Swaptions	11,410	650,000	—	—	4,028	100,000	—	—
TBAs	—	—	(2,179)	—	—	—	—	—
Total	$106,153	3,359,847	$(2,179)	—	$38,109	361,035	$(158)	850,000

The following table provides the average monthly outstanding notional amounts of the Company's derivative financial instruments treated as trading instruments for the three months ended March 31, 2011:

(in thousands)	Three Months Ended March 31, 2011	
Trading instruments	Derivative Assets	Derivative Liabilities
Inverse interest-only securities	432,293	—
Interest rate swap agreements	1,285,944	—
Credit default swaps	75,008	—
Swaptions	282,778	—
TBAs	182,222	182,222

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.

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Notes to the Consolidated Financial Statements - (continued)

(in thousands)

Trading Instruments	Location of Gain/(Loss) Recognized in Income on Derivatives	Amount of Gain/(Loss) Recognized in Income on Derivatives Three Months Ended March 31, 2011	2010
Risk Management Instruments			
Interest Rate Contracts			
Investment securities - RMBS	Gain on other derivative instruments	$(258)	$809
Investment securities - U.S. Treasuries	Gain (loss) on interest rate swap and swaption agreements	(410)	—
Repurchase agreements	Gain (loss) on interest rate swap and swaption agreements	2,349	(1,547)
Non-Risk Management Instruments			
Credit default swaps	Gain on other derivative instruments	2,338	—
Inverse interest-only securities	Gain on other derivative instruments	3,267	137
Total		$7,286	$(601)

For the three months ended March 31, 2011, the Company terminated a total of four notional interest rate swap and swaption positions of $350.0 million. Upon settlement of the early terminations, the Company paid $0.4 million in full settlement of its net interest spread liability and received $1.3 million in realized gains on the swaps and swaptions, including an early termination penalty.

Note 8. 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. 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.

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.

Investment securities - The Company holds a portfolio of available-for-sale and trading securities that are carried at fair value in the consolidated balance sheet. Available-for-sale securities are primarily comprised of Agency and non-

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TWO HARBORS INVESTMENT CORP.
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Agency RMBS while the Company's U.S. Treasuries are classified as trading securities. 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 100.0% of its U.S. Treasuries as Level 1 fair value assets at March 31, 2011. The Company classified 99.7% of its RMBS available for sale securities reported at fair value as Level 2 at March 31, 2011. Available-for-sale and trading securities account for 87.7% and 9.1% of all assets reported at fair value at March 31, 2011, respectively.

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, or 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, swaptions and credit default swaps reported at fair value as Level 2 at March 31, 2011.

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 AFS securities and the Company utilizes broker quotes to value these instruments. The Company classified 100% of its inverse interest-only securities at fair value as Level 2 at March 31, 2011. The Company reported 100% of its TBAs as Level 1 as of March 31, 2011.

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. Based on the Company's assessment, there is no requirement for any additional adjustment to derivative valuations specifically for credit.

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 tables below display the hedges separately from the hedged items, and therefore do not directly display the impact of the Company's risk management activities.

	Recurring Fair Value Measurements At March 31, 2011			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$2,873,892	$9,100	$2,882,992
Trading securities	299,262	—	—	299,262

Derivative assets	—	106,153	—	106,153
Total assets	$299,262	$2,980,045	$9,100	$3,288,407
Liabilities				
Derivative liabilities	$2,179	$—	$—	$2,179
Total liabilities	$2,179	$—	$—	$2,179

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	Recurring Fair Value Measurements At December 31, 2010			
(in thousands)	Level 1	Level 2	Level 3	Total
Assets				
Available-for-sale securities	$—	$1,345,805	$8,600	$1,354,405
Trading securities	199,523	—	—	199,523
Derivative assets	—	38,109	—	38,109
Total assets	$199,523	$1,383,914	$8,600	$1,592,037
Liabilities				
Derivative liabilities	$—	$158	$—	$158
Total liabilities	$—	$158	$—	$158

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 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 table below does not fully reflect the impact of the

Company's risk management activities.

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	Level 3 Recurring Fair Value Measurements Three Months Ended March 31, 2011								
		Total Net Gains Included in Net Income							
(in thousands)	Beginning of Period Level 3 Fair Value	Realized Gains	Unrealized Gains	Other Comprehensive Income		Gross Purchases, Sales and Settlements (b)	Gross Transfers Into Level 3	Gross Transfers Out of Level 3	End of Period Level 3 Fair Value
Assets									
Available-for-sale securities	$8,600	$23	$—	$ 477	(a)	$ —	$—	$—	$9,100
Derivative assets	—	—	—	—		—	—	—	—
Total assets	$8,600	$23	$—	$ 477		$ —	$—	$—	$9,100

(a) Change in unrealized gains on available-for-sale securities recorded in equity as accumulated other comprehensive income.
(b) There were no purchases, sales or settlements of the Company's Level 3 assets and liabilities during the three months ended March 31, 2011.

The Company did not incur transfers between Level 1 and Level 2 or Level 2 and Level 3 for the three months ended March 31, 2011. Transfers between Levels are deemed to take place on the first day of the reporting period in which the transfer has taken place.

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 March 31, 2011, the Company did not have any assets or liabilities measured at fair value on a nonrecurring basis.

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, trading 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 9. Repurchase Agreements

The Company had outstanding $2.6 billion of repurchase agreements, including repurchase agreements funding the Company's U.S. Treasuries of $298.9 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 0.58% and weighted average remaining maturities of 81 days as of March 31, 2011. The Company had outstanding $1.2 billion of repurchase agreements with a weighted average borrowing rate of 0.74% excluding the effect of the Company's interest rate swaps, and weighted average remaining maturities of 90 days as of December 31, 2010. As of March 31, 2011 and December 31, 2010, the debt associated with the Company's U.S. Treasuries had a weighted average borrowing rate of 0.22% and 0.28%, respectively.
At March 31, 2011 and December 31, 2010, the repurchase agreements had the following characteristics:

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(dollars in thousands)	March 31, 2011		December 31, 2010	
Collateral Type	Amount Outstanding	Weighted Average Borrowing Rate	Amount Outstanding	Weighted Average Borrowing Rate
U.S. Treasuries	$298,875	0.22 %	$198,750	0.28 %
Agency RMBS	1,929,297	0.33 %	745,861	0.37 %
Non-Agency RMBS	326,306	2.02 %	201,976	2.05 %
Agency derivatives	61,553	0.90 %	23,216	1.07 %
Total	$2,616,031	0.54 %	$1,169,803	0.66 %

As of March 31, 2011, the Company's amounts outstanding under repurchase agreements includes $70.8 million of borrowings under the 364-day repurchase facility with Wells Fargo Bank National Association, or Wells Fargo. The facility provides an aggregate maximum borrowing capacity of $75 million and it is set to mature on August 3, 2011, unless extended pursuant to its terms. The facility is collateralized by non-Agency RMBS and its weighted average borrowing rate as of March 31, 2011 was 1.95%. The facility also subjects the Company to maintain certain financial covenants under the guaranty agreement with Wells Fargo. As of March 31, 2011, the Company is in compliance with these covenants.
At March 31, 2011 and December 31, 2010, the repurchase agreements had the following remaining maturities:

(in thousands)	March 31, 2011	December 31, 2010
Within 30 days	$592,883	$197,286
30 to 59 days	322,605	211,556
60 to 89 days	431,301	117,621
90 to 119 days	560,029	152,433
Over 120 days (1)	410,338	292,157
Open maturity (2)	298,875	198,750
Total	$2,616,031	$1,169,803

(1) Over 120 days includes the amounts outstanding under the Wells Fargo 364-day borrowing facility.
(2) 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:

(in thousands)	March 31, 2011	December 31, 2010
Available-for-sale securities, at fair value	$2,521,201	$1,090,598
Trading securities, at fair value	299,262	199,523
Cash and cash equivalents	15,000	14,467
Restricted cash	22,624	11,634
Due from counterparties	11,381	10,508
Derivative assets, at fair value	80,895	30,534
Total	$2,950,363	$1,357,264

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 March 31, 2011 and December 31, 2010:

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	March 31, 2011			December 31, 2010		
(dollars in thousands)	Amount Outstanding	Net Counterparty Exposure[(1)]	Percent of Equity	Amount Outstanding	Net Counterparty Exposure[(1)]	Percent of Equity
Barclays Capital Inc.	$215,660	$65,471	10 %	$168,291	$45,060	12 %
All other counterparties	2,400,371	263,717	38 %	1,001,512	132,125	35 %
Total	$2,616,031	$329,188		$1,169,803	$177,185	

(1) Represents the net carrying value of the securities sold under agreements to repurchase, including accrued interest plus any cash or assets on deposit to secure the repurchase obligation, over the amount of the repurchase liability, including accrued interest. At March 31, 2011 and December 31, 2010, the Company had $338.1 million and $231.7 million, respectively, in payables due to broker counterparties for unsettled security purchases. The payables are not included in the amounts presented above.

The Company does not anticipate any defaults by its repurchase agreement counterparties.

Note 10. Other Assets

Other assets as of March 31, 2011 and December 31, 2010 are summarized in the following table:

(in thousands)

	March 31, 2011	December 31, 2010
Prepaid expenses	$502	$706
Deferred tax assets	72	554
Total other assets	$574	$1,260

Note 11. Other Liabilities

Other liabilities as of March 31, 2011 and December 31, 2010 are summarized in the following table:

(in thousands)

	March 31, 2011	December 31, 2010
Derivative liabilities, at fair value	$2,179	$158
Income taxes payable	276	1
Total other liabilities	$2,455	$159

Note 12. Stockholders' Equity

Distributions to stockholders

On March 2, 2011, the Company declared dividends to common stockholders totaling $16.2 million, or $0.40 per share. The following table presents cash dividends declared by the Company on its common stock from October 28, 2009 through March 31, 2011:

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Declaration Date	Record Date	Payment Date	Cash Dividend Per Share
March 2, 2011	March 14, 2011	April 14, 2011	$0.40
December 8, 2010	December 17, 2010	January 20, 2011	$0.40
September 13, 2010	September 30, 2010	October 21, 2010	$0.39
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

The Company's dividends declared in 2011, 2010 and 2009 are characterized as ordinary non-qualified dividends.
Accumulated Other Comprehensive Income
Accumulated other comprehensive income at March 31, 2011 and December 31, 2010 was as follows:

(in thousands)	March 31, 2011	December 31, 2010
Available-for-sale securities, at fair value		
Unrealized gains	$44,822	$30,811
Unrealized losses	(13,088)	(8,192)
Accumulated other comprehensive income	$31,734	$22,619

Public offerings
On March 16, 2011, the Company completed a follow-on public offering of 25,000,000 shares of its common stock and subsequently issued an additional 3,750,000 shares of common stock pursuant to the underwriters' over-allotments at a price of $10.25 per share, for gross proceeds of approximately $294.7 million. Net proceeds to the Company from the offerings were approximately $287.8 million, net of issuance costs of approximately $6.9 million.
Dividend Reinvestment and Direct Stock Purchase Plan
The Company sponsors a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of the Company's common stock by reinvesting some or all of the cash dividends received on shares of the Company's common stock. Stockholders may also make optional cash purchases of shares of the Company's common stock subject to certain limitation detailed in the plan prospectus. An aggregate of 7.5 million shares of our common stock has been reserved for issuance under the plan. As of March 31, 2011, 545 shares have been issued under the plan.

Note 13. Operating Expenses
Components of the Company's operating expenses for the three months ended March 31, 2011 and 2010 are presented in the following table:

	Three Months Ended March 31,	
	2011	2010
Operating expenses:		
General and administrative	$1,105	$647
Directors and officers' insurance	141	116
Professional fees	266	224
Total operating expenses	$1,512	$987

Note 14. Income Taxes
For the three months ended March 31, 2011, the Company has recognized $0.8 million of income tax expense related to both current and deferred income tax provisions in its taxable REIT subsidiary, or TRS. The Company's effective tax rate for the three months ended March 31, 2011 was an expense of 3.3%.

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TWO HARBORS INVESTMENT CORP.
Notes to the Consolidated Financial Statements - (continued)

For the three months ended March 31, 2011, the Company has recognized $0.4 million of deferred tax expense related to unrealized gains on derivative instruments, and $0.1 million of deferred tax expense related to unrealized gains on U.S. Treasuries held in its TRS.
For the three months ended March 31, 2011, the Company has recognized current federal tax expense of $0.3 million due to realized net gains on the U.S. Treasuries and derivative instruments the Company holds in its TRS.
The Company currently intends to distribute 100% of its REIT taxable income and comply with all its requirements to continue to qualify as a REIT, and therefore it has not recognized any federal or state tax provisions.

Note 15. Earnings Per Share
The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted earnings per share, or EPS, for the three months ended March 31, 2011 and 2010:

	Three Months Ended March 31,	
(in thousands, except share data)	2011	2010
Numerator:		
Net income to common stockholders for basic and diluted earnings per share	$22,377	$5,327
Denominator:		
Weighted average common shares	45,561,141	13,379,209
Weighted average restricted stock shares	51,235	22,159
Basic and diluted weighted average shares outstanding	45,612,376	13,401,368
Basic and Diluted Earnings Per Share:	$0.49	$0.40

For the three months ended March 31, 2011 and 2010, the Company has assumed that no warrants would be exercised as the weighted average market value per share of the Company's common stock was below the strike price of the warrants and the warrants would be anti-dilutive.

Note 16. Related Party Transactions
The following summary provides disclosure of the material transactions with affiliates of the Company.
In accordance with the Management Agreement with PRCM Advisers LLC, the Company incurred $1.6 million and $0.5 million as a management fee to PRCM Advisers LLC for the three months ended March 31, 2011 and 2010, respectively, which represents approximately 1.5% of stockholders' equity on an annualized basis as defined by the Management Agreement. In addition, the Company reimbursed PRCM Advisers LLC for direct and allocated costs incurred by PRCM Advisers LLC on behalf of the Company. These direct and allocated costs totaled approximately $0.9 million and $0.8 million for the three months ended March 31, 2011 and 2010, respectively.
The Company recognized $62,499 and $32,466 of compensation expense during the three months ended March 31, 2011 and 2010, respectively, associated with the amortization of shares of restricted stock issued to the independent directors.
As of March 31, 2011, there were 33,249,000 publicly-held registered warrants to purchase up to 33,249,000 shares of common stock issued and outstanding. Of the 33,249,000 warrants, 7,000,000 are beneficially owned by the founders of Capitol Acquisition Corp., or Capitol, the Company's TRS and 2,906,918 are beneficially owned by Nisswa Master Fund Ltd. and Nisswa Acquisition Master Fund Ltd., which are investment funds managed by Pine River. The Company is required to maintain a resale registration statement for the warrants and common stock issuable upon exercise thereof that are held by the founders, Nisswa Master Fund Ltd., and Nisswa Acquisition Master Fund Ltd.

Note 17. Subsequent Events
Events subsequent to March 31, 2011 were evaluated through the date these financial statements were issued.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements and accompanying notes included elsewhere in this Quarterly Report on Form 10-Q as well as our Annual Report on Form 10-K for the year ended December 31, 2010.

General

We are a Maryland corporation focused on investing in, financing and managing residential mortgage-backed securities, or RMBS, and related investments. We operate as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code.

We are externally managed by PRCM Advisers LLC. PRCM Advisers is a wholly-owned subsidiary of Pine River Capital Management L.P., which we refer to as Pine River, a global multi-strategy asset management firm with an established track record of investing in our target assets and fixed income securities.

Our objective is to provide attractive risk-adjusted returns to our stockholders over the long term, primarily through dividends and secondarily through capital appreciation. We selectively acquire and manage an investment portfolio of our target assets, which we believe is constructed to generate attractive returns through market cycles. We focus on security selection and implement a relative value investment approach across various sectors within the residential mortgage market. Our target assets include the following:

- Agency RMBS, meaning RMBS whose principal and interest payments are guaranteed by the Government National Mortgage Association (or Ginnie Mae), the Federal National Mortgage Association (or Fannie Mae), or the Federal Home Loan Mortgage Corporation (or Freddie Mac);
- Non-Agency RMBS, meaning RMBS that are not issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac; and
- Financial assets other than RMBS, comprising approximately 5% to 10% of the portfolio.

We seek to deploy moderate leverage as part of our investment strategy. We generally finance our target assets through short-term borrowings structured as repurchase agreements.

We compete with other investment vehicles for attractive investment opportunities. We rely on our management team and Pine River, who have developed strong relationships with a diverse group of financial intermediaries, to identify investment opportunities. In addition, we have benefited and expect to continue to benefit from Pine River's analytical and portfolio management expertise and infrastructure. We believe that our focus on the RMBS area, the extensive RMBS expertise of our investment team, our strong analytics and our disciplined relative value investment approach give us a competitive advantage over our peers.

We have elected to be treated as a REIT for U.S. federal income tax purposes. To qualify as a REIT we are required to meet certain investment and operating tests and annual distribution requirements. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders, do not participate in prohibited transactions and maintain our intended qualification as a REIT. However, certain activities that we may perform may cause us to earn income which will not be qualifying income for REIT purposes. We have designated our subsidiary, Capitol, as a taxable REIT subsidiary, or TRS, as defined in the Code, to engage in such activities, and we may in the future form additional TRSs. We also operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940, as amended, or the 1940 Act.

Forward-Looking Statements

When used in this quarterly report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as “believe,” “expect,” “anticipate,” “estimate,” “plan,” “continue,” “intend,” “should,” “may” or similar expressions, are intended to identif

"forward-looking statements" within the meaning of Section 27A of the 1933 Act and Section 21E of the Securities Exchange Act of 1934, as amended (or 1934 Act), and, as such, may involve known and unknown risks, uncertainties and assumptions.

Statements regarding the following subjects, among others, may be forward-looking: changes in interest rates and the market value of our RMBS; changes in the prepayment rates on the mortgage loans securing our RMBS; our ability to borrow to finance our assets; implementation of or changes in government regulations or programs affecting our business; our ability to maintain our qualification as a REIT for federal income tax purposes; our ability to maintain our exemption from registration under the 1940 Act; and risks associated with investing in real estate assets, including changes in

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business conditions and the general economy. These and other risks, uncertainties and factors, including those described in the annual, quarterly and current reports that we file with the SEC, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors Affecting our Operating Results

Our net interest income will include income from our RMBS portfolio and will reflect the amortization of purchase premiums and accretion of purchase discounts. Net interest income will fluctuate primarily as a result of changes in market interest rates, our financing costs, and prepayment speeds on our assets. Interest rates, financing costs and prepayment rates vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. Our operating results will also be affected by default rates and credit losses with respect to the mortgage loans underlying our non-Agency RMBS.

Fair Value Measurement

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 willing market participants at the measurement date. It also establishes three levels of input to be used when measuring fair value:

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.

We follow the fair value hierarchy set forth above in order to prioritize the data utilized to measure fair value. We strive to obtain quoted market prices in active markets (Level 1 inputs). If Level 1 inputs are not available, we will attempt to obtain Level 2 inputs, observable market prices in inactive markets or derive the fair value measurement using observable market prices for similar assets or liabilities. When neither Level 1 nor Level 2 inputs are available, we use Level 3 inputs and independent pricing service models to estimate fair value measurements. At March 31, 2011, approximately 89.8% of total assets, or $3.3 billion, and $2.2 million of total liabilities consisted of financial instruments recorded at fair value. As of March 31, 2011, we had $9.1 million of total assets reported at fair value using Level 3 inputs. See Note 8 to the Condensed Consolidated Financial Statements, included in this Quarterly Report on Form 10-Q, for descriptions of 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.
A significant portion of our assets and liabilities are at fair value and therefore our consolidated balance sheet and income statement are significantly affected by fluctuations in market prices. Although we execute various hedging strategies to mitigate our exposure to changes in fair value, we cannot fully eliminate our exposure to volatility caused by fluctuations in market prices. Starting in 2007, markets for asset-backed securities, including RMBS, have experienced severe dislocations. While these market disruptions continue, our assets and liabilities will be subject to valuation adjustment as well as changes in the inputs we use to measure fair value.

For the three months ended March 31, 2011, our unrealized fair value gains on interest rate swap agreements, which are accounted for as derivatives trading instruments under GAAP, positively affected our financial results. The change in fair value of the interest rate swaps was a result of changes to LIBOR and corresponding counterparty borrowing rates during the three months ended March 31, 2011. Our financial results for the three months ended March 31, 2011 were favorably affected by unrealized fair value gains on certain U.S. Treasuries classified as trading instruments due to their short-term investment objectives. In addition, our financial results were favorably affected by certain other derivative instruments entered into by us in the first three months of 2011 that were accounted for as trading derivative instruments, i.e., TBAs, credit default swaps and inverse interest-only securities. Any temporary change in the fair value of our

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available-for-sale securities is recorded as a component of accumulated other comprehensive income and does not impact our earnings.

We have numerous internal controls in place to help ensure the appropriateness of fair value measurements. Significant fair value measures are subject to detailed analytics, management review and approval. Our entire investment portfolio is priced by third-party brokers at the “bid side” of the market, and/or by independent pricing providers. We strive to obtain multiple market data points for each valuation. By utilizing “bid side” pricing, certain assets, especially the most recent purchases, may realize a markdown due to the “bid-offer” spread. To the extent that this occurs, any economic effect of this would be reflected in accumulated other comprehensive income. We back test the fair value measurements provided by the pricing providers against actual performance. We also monitor the market for recent trades, market surveys, or other market information that may be used to benchmark pricing provider inputs.

Considerable judgment is used in forming conclusions and estimating inputs to our Level 3 fair value measurements. Level 3 inputs such as interest rate movements, prepayments speeds, credit losses and discount rates are inherently difficult to estimate. Changes to these inputs can have a significant effect on fair value measurements. Accordingly, we cannot be assured that our estimates of fair value are indicative of the amounts that would be realized on the ultimate sale or exchange.

Market Conditions and Outlook

The first three months of 2011 continued to experience regulatory developments in an effort to stabilize economic conditions and increase liquidity in the financial markets. Most recently, in a February 2011 report released by the Department of Treasury and the Department of Housing and Urban Development, three paths were outlined to reform the GSEs, all of which could drastically change the landscape of the U.S. mortgage market. Again, while the reform could take several years to implement, we do expect that there will be opportunities for RMBS investors in 2011 as this develops.

We believe our blended Agency and non-Agency strategies, and our investing expertise, will allow us to navigate the dynamic characteristics of the RMBS environment while these and any future regulatory efforts take shape. Having a diversified portfolio allows us to balance risks, including the volatility and impacts generated by uncertainty in interest rates, changes in prepayments, changes in home prices and homeowner default rates.

We expect that the majority of our assets will remain in whole-pool Agency RMBS, due to the long-term attractiveness of the asset class and the need to preserve our exemption under the 1940 Act. Interest-only Agency securities also provide a complementary investment and risk-management strategy to our principal and interest Agency bond investments. Risk-adjusted returns in our Agency RMBS portfolio may decline if we are required to pay higher purchase premiums due to lower interest rates or additional liquidity in the market.

The following table provides the carrying value of our RMBS portfolio by product type:

(dollars in thousands)	March 31, 2011			December 31, 2010		
Agency Bonds						
Fixed Rate Bonds	$2,093,520	72.6	%	$746,957	55.1	%
Hybrid ARMs	264,468	9.2	%	269,512	19.9	%
Total Agency	2,357,988	81.8	%	1,016,469	75.0	%
Non-Agency Bonds						
Senior Bonds	426,495	14.8	%	268,161	19.8	%
Mezzanine Bonds	98,509	3.4	%	69,775	5.2	%
Total Non-Agency	525,004	18.2	%	337,936	25.0	%
Total	$2,882,992			$1,354,405		

Prepayment speeds and volatility due to interest rates

We do not expect housing prices to fully stabilize in 2011 and this, combined with persistently high unemployment rates, housing inventory increases and the potential end of government support, leads us to expect that there will not be a significant increase in prepayment speeds in 2011. Nonetheless, we believe our portfolio approach is well positioned to respond to a variety of market scenarios.

Although we are unable to predict the movement in interest rates for the remainder of 2011 and beyond, our blended Agency and non-Agency portfolio strategy is intended to generate attractive yields with a low level of sensitivity to yield

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curve, prepayments and interest rate cycles. Our portfolio has a mixture of fixed and hybrid/adjustable rate terms, which we use to manage interest rate risk.

Our Agency bond portfolio is subject to inherent prepayment risk: generally, a decline in interest rates that leads to rising prepayment speeds will cause the market value of our interest-only securities to deteriorate, but will cause the market value of our fixed coupon Agency pools to increase. The inverse relationship occurs when interest rates increase and prepayments slow. We hold a portfolio of Agency securities, which includes bonds with explicit prepayment protection, low loan balances (securities collateralized by loans of less than or equal to $175,000 in principal), high loan-to-value, or LTV, ratios (securities collateralized by loans with greater or equal to 80% LTV), and seasoned bonds reflecting less prepayment risk due to previously experienced high levels of refinancing. We believe these bond characteristics reduce the prepayment risk to the portfolio. We also hold low coupon 15-year pools purchased at a discount to par value, which would benefit from rising prepayment speeds.

The following table provides the carrying value of our Agency bond portfolio by vintage and prepayment protection:

	As of March 31, 2011				
(dollars in thousands)	Fixed Rate	Hybrid ARMs	Total Agency RMBS		
Pre-pay lock-out or penalty-based	$213,534	$46,173	$259,707	11	%
Lower loan balances	743,711	—	743,711	32	%
High LTV	211,089	—	211,089	9	%
Seasoned (2005 and prior vintages)	179,792	161,487	341,279	14	%
2006 and subsequent vintages	131,088	56,808	187,896	8	%
2006 and subsequent vintages - Discount	614,306	—	614,306	26	%
Total	$2,093,520	$264,468	$2,357,988	100	%

We offset a portion of the Agency exposure to prepayment speeds through our non-Agency portfolio. Our non-Agency bond yields are expected to increase if prepayment rates on such assets exceed our prepayment assumptions. To the extent that prepayment speeds increase due to macroeconomic factors, we expect to benefit from the ability to recognize the income from the heavily discounted bond prices that principally arose from credit or payment default expectations.

The following table provides discount information on our non-Agency bond portfolio:

	As of March 31, 2011					
(in thousands)	Senior		Mezzanine		Total	
Face Value	$706,164		$184,746		$890,910	
Unamortized discount						
Designated credit reserve	(175,366	)	(58,099	)	(233,465	)
Unamortized net discount	(123,348	)	(34,763	)	(158,111	)
Amortized Cost	$407,450		$91,884		$499,334	

Credit losses

Although our Agency portfolio is supported by U.S. Government agency and federally chartered corporation guarantees of payment of principal and interest, we are exposed to credit risk in our non-Agency RMBS portfolio. However, the credit support built into RMBS deal structures is designed to provide a level of protection from potential credit losses. In addition, the discounted purchase prices paid on our non-Agency RMBS assets provide additional insulation from credit losses in the event we receive less than 100% of par on such assets. We evaluate credit risk on our non-Agency investments through a comprehensive selection process, which is predominantly focused on quantifying and pricing credit risk. We review our non-Agency RMBS based on quantitative and qualitative analysis of the risk-adjusted returns on such investments. We evaluate each investment's credit risk through our initial

modeling and scenario analysis and through on-going asset surveillance. At purchase, we estimate the portion of the discount we do not expect to recover and factor that into our expected yield and accretion methodology. Nevertheless, unanticipated credit losses could occur, adversely impacting our operating results.

Counterparty exposure and leverage ratio

We monitor counterparty exposure in our broker, banking and lending counterparties on a daily basis. We believe our broker and banking counterparties are well capitalized organizations and we attempt to manage our cash balances across these

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organizations to reduce our exposure to a single counterparty.

In relation to our lending counterparties, we have entered into repurchase agreements with 19 counterparties as of the date of this filing. As of March 31, 2011, we had a debt to equity ratio of 3.8 times. As of March 31, 2011, we had approximately $5.8 million of unpledged Agency securities and $17.7 million of unpledged non-Agency securities and an overall estimated unused borrowing capacity of approximately $15.1 million. If borrowing rates and collateral requirements change in the next three quarters of 2011, we believe we are subject to less earnings volatility than a more levered organization.

Summary of Results of Operations and Financial Condition

Our reported GAAP net income attributable to common stockholders was $22.4 million ($0.49 per diluted share) for the three months ended March 31, 2011 as compared to a GAAP net income attributable to common stockholders of $5.3 million ($0.40 per diluted share) for the three months ended March 31, 2010.

Our Adjusted GAAP earnings for the three months ended March 31, 2011 was $17.9 million ($0.39 per diluted share). Our GAAP results for the three months ended March 31, 2011 included changes in unrealized fair value gains and losses, net of tax, of $4.5 million, on our interest rate swaps and swaptions, utilized to economically hedge interest rate risk associated with these short-term LIBOR-based repurchase agreements and available-for-sale securities for which we have not elected to apply cash flow hedge accounting. As a result, and in order to facilitate comparison to many of our peers, we have included Adjusted GAAP earnings, a non-GAAP measure, which excludes the change in unrealized fair value gains and losses, net of tax, associated with these interest rate swaps and swaptions. A reconciliation between GAAP net income and Adjusted GAAP earnings is provided in the following tables.

On March 2, 2011, we declared a dividend of $0.40 per diluted share. Our GAAP book value per diluted common share was $9.90 at March 31, 2011, an increase from $9.44 book value per diluted common share at December 31, 2010.

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The following table presents the components of our net income for the three months ended March 31, 2011 and 2010:

(in thousands, except share data)	Three Months Ended March 31,	
Income Statement Data:	2011	2010
Interest income:		
Available-for-sale securities	$19,535	$6,153
Trading securities	272	—
Cash and cash equivalents	63	6
Total interest income	19,870	6,159
Interest expense	2,499	518
Net interest income	17,371	5,641
Other income:		
Gain on sale of investment securities, net	1,539	1,197
Gain (loss) on interest rate swap and swaption agreements	1,939	(1,547)
Gain on other derivative instruments	5,347	946
Total other income	8,825	596
Expenses:		
Management fees	1,550	457
Other operating expenses	1,512	987
Total expenses	3,062	1,444
Net income before income taxes	23,134	4,793
Benefit from (provision for) income taxes	(757)	534
Net income attributable to common stockholders	$22,377	$5,327
Basic and diluted earnings per weighted average common share	$0.49	$0.40
Dividends declared per common share	$0.40	$0.36
Basic and diluted weighted average number of shares of common stock	45,612,376	13,401,368

Balance Sheet Data:	March 31, 2011	December 31, 2010
Available-for-sale securities	$2,882,992	$1,354,405
Total assets	$3,662,704	$1,797,432
Repurchase agreements	$2,616,031	$1,169,803
Total stockholders' equity	$685,568	$382,448

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(in thousands, except share data) Reconciliation of net income attributable to common stockholders to Adjusted GAAP Earnings	Three Months Ended March 31,	
	2011	2010
Net income attributable to common stockholders	$22,377	$5,327
Adjustments to GAAP Net Income:		
Unrealized (gain)/loss, net of tax, on interest rate swap and swaptions economically hedging repurchase agreements and available-for-sale securities (1)	(4,502)	745
Adjusted GAAP Earnings	$17,875	$6,072
Weighted average shares outstanding - diluted	45,612,376	13,401,368
Adjusted GAAP Earnings per weighted average share outstanding - diluted	$0.39	$0.45

(1) Amounts include tax expense of $0.1 million for the three months ended March 31, 2011 and tax benefit of $0.4 million for the three months ended March 31, 2010.

Results of Operations
The following analysis focuses on the results generated during the three months ended March 31, 2011 and 2010.
Interest Income and Average Portfolio Yield
For the three months ended March 31, 2011, we recognized $19.5 million of interest income from our Agency and non-Agency RMBS portfolio. Our RMBS portfolio's average amortized cost of securities was approximately $1.7 billion for the three months ended March 31, 2011, resulting in an annualized net yield of approximately 4.7%. For the three months ended March 31, 2010, we recognized $6.2 million of interest income from our Agency and non-Agency RMBS portfolio. Our RMBS portfolio's average amortized cost of securities was approximately $501.1 million for the three months ended March 31, 2010, resulting in an annualized net yield of approximately 4.9%.
For the three months ended March 31, 2011, we recognized $7.8 million of net premium amortization on our Agency RMBS, including our interest-only securities. This resulted in an overall net asset yield of approximately 3.1% on our Agency RMBS. For the three months ended March 31, 2011, we recognized $5.4 million of accretion income from the discounts on our non-Agency portfolio resulting in an overall net yield of approximately 9.7%. For the three months ended March 31, 2010, we recognized $2.5 million of net premium amortization on our Agency RMBS, including our interest-only securities. This resulted in an overall net asset yield of approximately 3.6% on our Agency RMBS. For the three months ended March 31, 2010, we recognized $1.1 million of accretion income from the discounts on our non-Agency portfolio, resulting in an overall net yield of approximately 10.6%. The decrease in gross and net yield for the non-Agency portfolio across comparative periods is due primarily to the deployment of new capital in non-Agency RMBS with lower stated coupons and the overall strengthening in non-Agency RMBS market prices in 2010.
The following table presents the components of the net yield earned by investment type on our RMBS portfolio as a percentage of our average amortized cost of securities (ratios for the periods have been annualized):

	Three Months Ended March 31, 2011			Three Months Ended March 31, 2010		
	Agency	Non-Agency	Consolidated	Agency	Non-Agency	Consolidated
Gross Yield/Stated Coupon	5.6%	4.3%	5.3%	6.1%	5.9%	6.0%
	(2.5)%	5.4%	(0.6)%	(2.5)%	4.7%	(1.1)%

Net accretion/amortization of discount/premium												
Net Yield	3.1	%	9.7	%	4.7	%	3.6	%	10.6	%	4.9	%

(1) These yields have not been adjusted for cost of delay and cost to carry purchase premiums.

The following tables provide the components of interest income and net asset yield detail by investment type on our RMBS portfolio:

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	Three Months Ended March 31, 2011				
(dollars in thousands)	Average Amortized Cost	Coupon Interest	Net (Premium Amortization)/ Discount Accretion	Interest Income	Net Asset Yield
Agency	$1,274,928	$17,749	$(7,843)	$9,906	3.1%
Non-Agency	393,387	4,253	5,376	9,629	9.7%
Total	$1,668,315	$22,002	$(2,467)	$19,535	4.7%

	Three Months Ended March 31, 2010				
(dollars in thousands)	Average Amortized Cost	Coupon Interest	Net (Premium Amortization)/ Discount Accretion	Interest Income	Net Asset Yield
Agency	$406,951	$6,181	$ (2,517)	$3,664	3.6%
Non-Agency	94,162	1,388	1,101	2,489	10.6%
Total	$501,113	$7,569	$ (1,416)	$6,153	4.9%

For the three months ended March 31, 2011, we also recognized $0.3 million of interest income associated with our trading U.S. Treasuries, or approximately 0.5% annualized net yield on average amortized cost. We did not hold any U.S. Treasuries for the three months ended March 31, 2010.

Interest Expense and the Cost of Funds

For the three months ended March 31, 2011, we recognized $2.3 million in interest expense on our borrowed funds collateralized by RMBS. For the same three month period, our average outstanding balance under repurchase agreements to fund RMBS was approximately $1.5 billion, an increase from first quarter 2010 due to our offering proceeds and allocation of additional capital to leverage our RMBS portfolio. Our leverage ratio on our RMBS portfolio as of March 31, 2011 combined with low LIBOR rates, resulted in an average cost of funds of 0.6% on an annualized basis. For the three months ended March 31, 2010, we recognized $0.5 million in interest expense on our borrowed funds collateralized by RMBS. For the same three months ended, our average outstanding balance under repurchase agreements to fund RMBS was approximately $428.6 million, resulting in an average cost of funds on our RMBS of 0.5% on an annualized basis.

For the three months ended March 31, 2011, we also recognized $0.2 million of interest expense associated with the financing of our U.S. Treasuries and Agency inverse interest-only derivatives, or an average cost of funds of approximately 0.4% on an annualized basis. The additional funds borrowed during the three months ended March 31, 2011 resulted in an overall debt-to-equity ratio of 3.8:1.0, largely driven by the borrowings to fund the U.S. Treasuries and increased capital allocation to Agency RMBS. We did not hold any U.S. Treasuries for the three months ended March 31, 2010.

Net Interest Income

For the three months ended March 31, 2011, our net interest income on our RMBS AFS portfolio was $17.2 million resulting in a net interest spread of approximately 4.1%. For the three months ended March 31, 2010, our net interest income on our RMBS AFS portfolio was $5.6 million resulting in a net interest spread of approximately 4.4%.

The following table provides the interest income and expense incurred in the three months ended March 31, 2011 and March 31, 2010:

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(dollars in thousands)	Three Months Ended March 31, 2011 Agency	Non-Agency	Total	Three Months Ended March 31, 2010 Agency	Non-Agency	Total
Average available-for-sale securities held (1)	$1,274,928	$393,387	$1,668,315	$406,951	$94,162	$501,113
Total interest income	$9,906	$9,629	$19,535	$3,664	$2,489	$6,153
Yield on average investment securities	3.1 %	9.8 %	4.7 %	3.6 %	10.6 %	4.9 %
Average balance of repurchase agreements	$1,214,210	$260,005	$1,474,215	$392,001	$36,553	$428,554
Total interest expense (2) (3)	$1,044	$1,247	$2,291	$351	$167	$518
Average cost of funds	0.3 %	1.9 %	0.6 %	0.4 %	1.8 %	0.5 %
Net interest income	$8,862	$8,382	$17,244	$3,313	$2,322	$5,635
Net interest rate spread	2.8 %	7.9 %	4.1 %	3.2 %	8.8 %	4.4 %

(1) Excludes change in realized and unrealized gains/(losses).

(2) Cost of funds by investment type is based off the underlying investment type of the RMBS AFS assigned as collateral.

(3) Cost of funds does not include accrual and settlement of interest associated with interest rate swaps. In accordance with GAAP, those costs are included in gain (loss) on interest rate swap and swaption agreements in the consolidated statement of income.

Gain on Investment Securities, Net

For the three months ended March 31, 2011 and 2010, we sold AFS and trading securities for $270.9 and $10.4 million with an amortized cost of $269.8 and $9.2 million, for a net realized gain of $1.1 and $1.2 million, respectively, which included sales of U.S. Treasuries with an amortized cost of $200.0 million for the three months ended March 31, 2011. We do not expect to sell assets on a frequent basis, but may sell assets to reallocate capital into new assets that our management believes might have higher risk-adjusted returns.

During the three months ended March 31, 2011, we recognized unrealized losses on our U.S. Treasury trading securities held as of March 31, 2011 of $0.4 million. We did not hold any U.S. Treasuries classified as trading securities during the three months ended March 31, 2010.

We review each of our securities on a quarterly basis to determine if an OTTI charge would be necessary. For the three months ended March 31, 2011 and 2010, we did not recognize any losses from other-than-temporary impairments.

Gain (loss) on Interest Rate Swap and Swaption Agreements

For the three months ended March 31, 2011 and 2010, we recognized $3.2 million and $0.4 million of expenses for the accrual and/or settlement of the net interest expense associated with the interest rate swaps. The expenses result from paying a fixed interest rate on an average 1.3 billion and 144.4 million notional, respectively, to hedge a portion of our interest rate risk on our short-term repurchase agreements and funding costs and receiving LIBOR interest. During the three months ended March 31, 2011, we terminated four notional interest rate swap and swaption positions of 350.0 million. Upon settlement of the early terminations, we paid $0.4 million in full settlement of our net interest spread liability and $1.3 million in realized gains on the swaps, including any early termination penalty. We elected to terminate the swaps to reduce our cost of financing and align with our investment portfolio.

Also, included in our financial results for the three months ended March 31, 2011 and 2010 was the recognition of a change in unrealized valuation gains of $3.8 million and losses of $1.1 million, respectively, on our interest rate swap

and swaption agreements that were accounted as trading instruments. The increase in the two- and three-year swap rates during the three months ended March 31, 2011 resulted in the overall favorable market value movement over the three month period.

The following table provides the net interest spread and gains and losses associated with our interest rate swap and swaption positions:

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(in thousands)	Three Months Ended March 31,	
	2011	2010
Net interest spread	$(3,152)	$(419)
Early termination gains	1,253	—
Change in unrealized gain on interest rate swap and swaption agreements, at fair value	3,838	(1,129)
Gain (loss) on interest rate swap and swaption agreements	$1,939	$(1,548)

Gain on Other Derivative Instruments

Included in our financial results for the three months ended March 31, 2011 and 2010 was the recognition of $5.3 and $0.9 million of gains on other derivative instruments we hold for purposes of both hedging and non-hedging activities, principally TBAs and inverse interest-only securities. Included within these three months ended March 31, 2011 and 2010 results, we recognized $2.9 million of interest income, net of accretion, and $0.5 million of accretion, net of interest income on inverse interest-only securities on an average amortized cost basis of $53.3 and $0.3 million, respectively. The remainder represented realized and unrealized net gains on other derivative instruments. As these derivative instruments are considered trading instruments, the financial results include both realized and unrealized gains (losses) associated with these instruments.

Expenses

Management Fees

We incurred management fees of $1.6 and $0.5 million for the three months ended March 31, 2011 and 2010, which are payable to PRMC Advisers under our management agreement. The management fee is calculated based on our stockholders' equity.

Other Operating Expenses

For the three months ended March 31, 2011, we recognized $1.5 million of other operating expenses compared to $1.0 million of expenses for the same period in 2010.

The following table provides other operating expenses as a percentage of average equity for the three month periods presented:

(dollars in thousands)	Other Operating Expenses	Other Operating Expenses/Average Equity
	(Ratios for the quarter have been annualized)	
For the Three Months Ended March 31, 2011	$1,512	1.3 %
For the Three Months Ended March 31, 2010	$987	3.2 %

Our other operating expenses as a percentage of average equity for the three months ended March 31, 2011 was 1.3%. The favorable decrease of our operating expense ratio since the first three months of 2010 resulted from the additional capital raised upon completion of our secondary common stock offerings. See Note 12 of the Notes to the Consolidated Financial Statements.

Income Taxes

For the three months ended March 31, 2011, we have recognized $0.8 million of income tax expenses related to both current and deferred income tax losses in our TRS. Our effective tax rate for the three months ended March 31, 2011 was an expense of 3.3%.

For the three months ended March 31, 2011, we have recognized $0.4 million of deferred tax benefit related to unrealized gains on derivative instruments, and $0.1 million of deferred tax expense related to unrealized gains on U.S. Treasuries held in our TRS.

For the three months ended March 31, 2011, we have recognized current federal tax benefit of $0.3 million due to realized gains and losses on U.S. Treasuries and derivative instruments.
We currently intend to distribute 100% of our REIT taxable income and comply with all requirements to continue to qualify as a REIT, and therefore we have not recognized any further federal or state tax provisions.

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Financial Condition

Available-for-Sale Securities, at Fair Value

Agency RMBS

Our Agency RMBS portfolio is comprised of adjustable rate and fixed rate mortgage-backed securities backed by single-family and multi-family mortgage loans. All of our principal and interest Agency RMBS were Fannie Mae or Freddie Mac mortgage pass-through certificates or collateralized mortgage obligations that carry an implied “AAA” rating, or Ginnie Mae mortgage pass-through certificates, which are backed by the guarantee of the U.S. Government. The majority of these securities consist of whole pools in which we own all of the investment interests in the securities.

The table below summarizes certain characteristics of our Agency available-for-sale securities at March 31, 2011:

	March 31, 2011							
(dollars in thousands, except purchase price)	Principal/Current Face	Net (Discount)/ Premium	Amortized Cost	Unrealized Gain	Unrealized Loss	Carrying Value	Weighted Average Coupon Rate	Weighted Average Purchase Price
Principal and interest securities:								
Fixed	$1,946,198	$42,834	$1,989,032	$7,152	$(7,141)	$1,989,043	4.22 %	$102.53
Hybrid/ARM	248,662	13,405	262,067	2,484	(83)	264,468	4.44 %	$105.97
Total P&I Securities	2,194,860	56,239	2,251,099	9,636	(7,224)	2,253,511	4.25 %	$102.93
Interest-only securities								
Fixed	607,243	(519,473)	87,770	5,260	(1,806)	91,224	5.23 %	$15.76
Fixed Other (1)	193,579	(180,524)	13,055	285	(87)	13,253	1.37 %	$7.04
Total	$2,995,682	$(643,758)	$2,351,924	$15,181	$(9,117)	$2,357,988		

(1) Fixed Other represent weighted-average coupon interest-only securities that are not generally used for our interest-rate risk management purposes. These securities pay variable coupon interest based on the weighted average of the fixed rates of the underlying loans of the security, less the weighted average rates of the applicable issued principal and interest securities.

Our three-month average constant prepayment rate, or CPR, experienced by Agency RMBS owned by us as of March 31, 2011, on an annualized basis, was 6.3%.

The following table summarizes the number of months until the next re-set for our floating or adjustable rate Agency RMBS mortgage portfolio at March 31, 2011:

(in thousands)	Carrying Value
0-12 months	$209,133
13-36 months	20,157
37-60 months	6,910
Greater than 60 months	28,268
Total	$264,468

Non-Agency RMBS

Our non-Agency RMBS portfolio is comprised of senior and mezzanine tranches of mortgage-backed securities. The following table provides investment information on our non-Agency RMBS as of March 31, 2011:

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(in thousands)	As of March 31, 2011 Principal/Current Face	Accretable Purchase Discount	Credit Reserve Purchase Discount	Amortized Cost	Unrealized Gain	Unrealized Loss	Carrying Value
Senior	$706,164	$(123,348)	$(175,366)	$407,450	$21,287	$(2,242)	$426,495
Mezzanine	184,746	(34,763)	(58,099)	91,884	8,354	(1,729)	98,509
Total	$890,910	$(158,111)	$(233,465)	$499,334	$29,641	$(3,971)	$525,004

The following tables present certain information detailed by investment type and their respective underlying loan characteristics for our senior and mezzanine non-Agency RMBS, excluding our non-Agency interest-only portfolio, at March 31, 2011:

Non-Agency Principal and Interest (P&I) RMBS Characteristics	At March 31, 2011 Senior Bonds	Mezzanine Bonds	Total P&I Bonds
Carrying Value (in thousands)	$426,109	$98,509	$524,618
% of Non-Agency Portfolio	81.2%	18.8%	100.0%
Average Price	$62.77	$58.30	$61.91
Average Coupon	3.0%	1.6%	2.7%
Average Fixed Coupon	5.7%	5.9%	5.7%
Average Floating Coupon	2.1%	0.9%	1.1%
Average Hybrid Coupon	4.7%	5.3%	4.8%
Collateral Attributes			
Avg Loan Age (months)	59	72	61
Avg Original Loan-to-Value	80.5%	80.1%	80.4%
Avg Original FICO [1]	670	661	668
Current Performance			
60+ day delinquencies	41.3%	29.5%	39.0%
Average Credit Enhancement [2]	23.6%	25.6%	23.9%
3-Month CPR [3]	3.2%	3.8%	3.4%

(1) FICO represents a mortgage industry accepted credit score of a borrower, which was developed by Fair Isaac Corporation.

(2) Average credit enhancement remaining on our non-Agency RMBS portfolio, which is the average amount of protection available to absorb future credit losses due to defaults on the underlying collateral.

(3) 3-Month CPR is reflective of the prepayment speed on the underlying securitization; however, it does not necessarily indicate the proceeds received on our investment tranche. Proceeds received for each security are dependent on the position of the individual security within the structure of each deal.

Non-Agency RMBS Characteristics (dollars in thousands)	March 31, 2011 Senior Bonds		Mezzanine Bonds		Total Bonds	
Loan Type	Carrying Value	% of Senior Bonds	Carrying Value	% of Mezzanine Bonds	Carrying Value	% of Non-Agency Portfolio
Prime	$14,218	3.3%	$3,101	3.2%	$17,319	3.3%
Alt-A	76,011	17.8%	9,178	9.3%	85,189	16.2%

POA	146,647	34.4	%	22,574	22.9	%	169,221	32.3	%
Subprime	189,233	44.5	%	63,656	64.6	%	252,889	48.2	%
	$426,109	100.0	%	$98,509	100.0	%	$524,618	100.0	%

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Non-Agency RMBS Characteristics	March 31, 2011					
(dollars in thousands)	Senior Bonds		Mezzanine Bonds		Total Bonds	
Coupon Type	Carrying Value	% of Senior Bonds	Carrying Value	% of Mezzanine Bonds	Carrying Value	% of Non-Agency Portfolio
Fixed Rate	$96,489	22.6 %	$14,154	14.4 %	$110,643	21.1 %
Hybrid or Floating	329,620	77.4 %	84,355	85.6 %	413,975	78.9 %
	$426,109	100.0 %	$98,509	100.0 %	$524,618	100.0 %

Non-Agency RMBS Characteristics	March 31, 2011					
(dollars in thousands)	Senior Bonds		Mezzanine Bonds		Total Bonds	
Loan Origination Year	Carrying Value	% of Senior Bonds	Carrying Value	% of Mezzanine Bonds	Carrying Value	% of Non-Agency Portfolio
2006+	$308,390	72.4 %	$19,073	19.4 %	$327,463	62.4 %
2002-2005	115,893	27.2 %	79,109	80.3 %	195,002	37.2 %
Pre-2002	1,826	0.4 %	327	0.3 %	2,153	0.4 %
	$426,109	100.0 %	$98,509	100.0 %	$524,618	100.0 %

Repurchase Agreements

Our borrowings consist entirely of repurchase agreements collateralized by our pledge of AFS and trading securities, derivative instruments and certain cash balances. Substantially all of our Agency RMBS are currently pledged as collateral, and the majority of our non-Agency RMBS has been pledged. As of March 31, 2011, our debt-to-equity ratio was 3.8:1.0. Our debt-to-equity ratio includes the debt collateralized by our U.S. Treasuries and Agency derivatives. Our debt-to-equity ratio for RMBS and Agency derivatives only was 3.4:1.0. We believe our debt-to-equity ratio provides unused borrowing capacity and, thus, improves our liquidity and the strength of our balance sheet.

As of March 31, 2011, the term to maturity of our borrowings ranged from four days to over six months. The weighted average original term to maturity of our borrowings collateralized by RMBS was 81 days at March 31, 2011. At March 31, 2011, the weighted average cost of funds for all our repurchase agreements was 0.54%.

(dollars in thousands)	March 31, 2011		December 31, 2010	
Collateral Type	Amount Outstanding	Weighted Average	Amount Outstanding	Weighted Average
U.S. Treasuries	$298,875	0.22 %	$198,750	0.28 %
Agency RMBS	1,929,297	0.33 %	745,861	0.37 %
Non-Agency RMBS	326,306	2.02 %	201,976	2.05 %
Agency derivatives	61,553	0.90 %	23,216	1.07 %
Total	$2,616,031	0.54 %	$1,169,803	0.66 %

As of March 31, 2011, our amounts outstanding under repurchase agreements includes $70.8 million of borrowings under the 364-day repurchase facility with Wells Fargo. The facility provides an aggregate maximum borrowing capacity of $75 million and it is set to mature on August 3, 2011, unless extended pursuant to its terms. The facility is collateralized by non-Agency RMBS and its weighted average borrowing rate as of March 31, 2011 was 1.95%.

Equity

As of March 31, 2011, our stockholders' equity was $685.6 million and our diluted book value per share was $9.90. As of December 31, 2010, our stockholders' equity was $382.4 million and our diluted book value per share was $9.44.

The following table provides details of our changes in stockholders' equity from December 31, 2010 to March 31, 2011:

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(dollars in thousands, except per share amounts)	Book Value	Book Value Per Diluted Share [2]
Stockholders' equity at December 31, 2010	$382,448	$9.44
GAAP net income:		
Core Earnings, net of tax of $0.2 million [1]	14,767	0.21
Realized gains and losses, net of tax	1,887	0.03
Unrealized mark-to-market gains and losses, net of tax	5,723	0.08
Other comprehensive income, net of tax	9,115	0.13
Dividend declaration	(16,200)	(0.23)
Net proceeds from common stock issuance	287,766	0.24
Other	62	—
Stockholders' equity at March 31, 2011	$685,568	$9.90

(1) Core Earnings is a non-GAAP measure that we define as net income, excluding impairment losses, gains or losses on sales of securities and termination of interest rate swaps, unrealized gains or losses on trading securities, interest rate swaps and swaptions, certain gains or losses on other derivative instruments and non-recurring business combination expenses. As defined, Core Earnings includes interest income associated with our inverse interest-only securities ("Agency derivatives") and premium income on credit default swaps. Core Earnings is provided for purposes of comparability to other peer issuers.

(2) Diluted shares outstanding at end of period are used as the denominator in book value per share calculation.

Liquidity and Capital Resources

Our liquidity and capital resources are managed and forecast on a daily basis to ensure that we have sufficient liquidity to absorb market events that could negatively impact collateral valuations and result in margin calls and to ensure that we have the flexibility to manage our portfolio to take advantage of market opportunities.

Our principal sources of cash consist of borrowings under repurchase agreements, payments of principal and interest we receive on our RMBS portfolio, cash generated from our operating results, and proceeds from capital market transactions. We typically use cash to repay principal and interest on our repurchase agreements, to purchase RMBS, to make dividend payments on our capital stock, and to fund our operations.

To the extent that we raise additional equity capital through capital market transactions, we anticipate using cash proceeds from such transactions to purchase additional RMBS and for other general corporate purposes. There can be no assurance, however, that we will be able to raise additional equity capital at any particular time or on any particular terms.

As of March 31, 2011, we held $302.3 million in cash and cash equivalents and $21.5 million in due from counterparties available to support our operations, $3.0 billion of AFS and derivative assets held at fair value, and $2.6 billion of outstanding debt in the form of repurchase agreements (excludes $338.1 million in payables due to broker counterparties for unsettled security purchases). As of March 31, 2011, our debt-to-equity ratio was 3.8:1.0. During the three months ended March 31, 2011, our debt-to-equity ratio increased from 3.1:1.0 to 3.8:1.0, including monies borrowed to finance our investment in U.S. Treasuries. The debt-to-equity ratio funding our RMBS and Agency derivatives increased from 2.5:1:0 to 3.4:1.0 as we completed the investment of our offering proceeds and allocated additional capital to a more leveraged Agency RMBS strategy. We believe the debt-to-equity ratio funding our RMBS and Agency derivatives is the most meaningful leverage measure as U.S. Treasuries are viewed to be highly liquid in nature.

As of March 31, 2011, we had approximately $5.8 million of unpledged Agency securities and $17.7 million of unpledged non-Agency securities and an overall estimated unused borrowing capacity of approximately $15.1 million. On a daily basis, we monitor and forecast our available, or excess, liquidity. Additionally, we frequently perform

shock analyses against various market events to monitor the adequacy of our excess liquidity. If borrowing rates and collateral requirements change in the next three quarters of 2011, we believe we are subject to less earnings volatility than a more leveraged organization.

We have not experienced any restrictions to our funding sources in 2011 and generally witnessed an increasing amount of available liquidity in the RMBS marketplace. We expect ongoing sources of financing to be primarily repurchase agreements and similar financing arrangements. We plan to finance our assets with a moderate amount of leverage, the level of which may vary based upon the particular characteristics of our portfolio and market conditions. We may deploy, on a debt-to-equity basis, up to ten times leverage on our Agency RMBS assets. We also deploy some leverage on our non-Agency RMBS assets utilizing repurchase agreements as the source of financing.

We have master repurchase agreements in place with 19 counterparties and continue to evaluate further counterparties

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to manage and reduce counterparty risk. Under our repurchase agreements, we are required to pledge additional assets as collateral to our counterparties (lenders) when the estimated fair value of the existing pledged collateral under such agreements declines and such lenders, through a margin call, demand additional collateral. Lenders generally make margin calls because of a perceived decline in the value of our assets collateralizing the repurchase agreements. This may occur following the monthly principal reduction of assets due to scheduled amortization and prepayments on the underlying mortgages, or may be caused by changes in market interest rates, a perceived decline in the market value of the investments and other market factors. To cover a margin call, we may pledge additional securities or cash. At maturity, any cash on deposit as collateral is generally applied against the repurchase agreement balance, thereby reducing the amount borrowed. Should the value of our assets suddenly decrease, significant margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

For the three months ended March 31, 2011, we have continued to maintain our repurchase agreement with Wells Fargo Bank, National Association, or Wells Fargo. The repurchase agreement serves as a repurchase facility used from time to time to finance certain of our non-Agency securities held in our RMBS portfolio with Wells Fargo pursuant to its terms. The Wells Fargo repurchase agreement provides for a 364-day term with an aggregate maximum borrowing capacity of $75 million and it is set to mature on August 3, 2011, unless extended pursuant to its terms. Once an RMBS is financed by Wells Fargo in accordance with the repurchase agreement, the financing is committed for the duration of the facility subject to similar pledged collateral and margin requirements as a standard repurchase agreement discussed above. As part of the repurchase agreement, we are subject to certain financial covenants, which we monitor and comply with on a daily basis. The extended duration of the facility and its terms provide an additional source to manage our liquidity and interest rate risk.

We have guaranteed the obligations of our subsidiary, Two Harbors Asset I, under the Wells Fargo Repurchase Agreements. As a result, we are subject to the following financial covenants, as further detailed by the Guaranty Agreement:

(a) On any date, the ratio of our Total Indebtedness to our Tangible Net Worth, on a consolidated basis, shall not be greater than 6.00 to 1.00. As of March 31, 2011, our calculated ratio, as defined, was 3.9 to 1.00.

(b) On any date, the Guarantor's Liquidity, on a consolidated basis, shall not be less than $15.0 million. As of March 31, 2011, our liquidity, as defined, was $158.7 million.

(c) On any date, the Guarantor's Tangible Net Worth, on a consolidated basis, shall not be less than $150.0 million. As of March 31, 2011, our tangible net worth, as defined, was $685.6 million.

We also serve as guarantor for a number of additional ISDA and repurchase agreements entered into by our subsidiaries in the normal course of business. The covenants noted above are considered the most restrictive of all covenant terms under these agreements. We intend to continue to operate in a manner which complies with all guarantor requirements.

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

(in thousands)	March 31, 2011	December 31, 2010
Available-for-sale securities, at fair value	$2,521,201	$1,090,598
Trading securities, at fair value	299,262	199,523
Cash and cash equivalents	15,000	14,467
Restricted cash	22,624	11,634
Due from counterparties	11,381	10,508
Derivative assets, at fair value	80,895	30,534
Total	$2,950,363	$1,357,264

Although we generally intend to hold our target assets as long-term investments, we may sell certain of our investment securities in order to manage our interest rate risk and liquidity needs, to meet other operating objectives and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities, if any. Because many of our investment securities are financed with repurchase agreements and may be financed with credit facilities (including term loans and revolving facilities), a significant portion of the proceeds from sales of our investment securities (if any), prepayments and scheduled amortization are used to repay balances under these financing sources. The following table provides the maturities of our repurchase agreements as of March 31, 2011 and December 31, 2010:

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(in thousands)	March 31, 2011	December 31, 2010
Within 30 days	$592,883	$197,286
30 to 59 days	322,605	211,556
60 to 89 days	431,301	117,621
90 to 119 days	560,029	152,433
Over 120 days (1)	410,338	292,157
Open maturity (2)	298,875	198,750
Total	$2,616,031	$1,169,803

(1) Over 120 days includes the amounts outstanding under the Wells Fargo 364-day borrowing facility.

(2) 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.

For the three months ended March 31, 2011, our unrestricted cash balance increased from $163.9 million to $302.3 million. The cash movements can be summarized by the following:

- Cash flows from operating activities. For the three months ended March 31, 2011, operating activities increased our cash balances by approximately $13.1 million, primarily driven by our strong interest yield and financial results for the year.
- Cash flows from investing activities. For the three months ended March 31, 2011, investing activities reduced our cash balances by approximately $1.6 billion. The reduction was driven by the increase in our RMBS portfolio as we deployed capital from our common stock offerings. Included in this change is an increase in due to counterparties represented by purchased RMBS to be settled in the second quarter of 2011.
- Cash flows from financing activities. For the three months ended March 31, 2011, financing activities increased our cash balance by approximately $1.7 billion, resulting from the net borrowings under repurchase agreements to fund our AFS portfolio as well as net proceeds of $287.8 million obtained from our common stock offering.

Inflation

Substantially all of our assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact our performance far more than does inflation. Our financial statements are prepared in accordance with GAAP and dividends are based upon net ordinary income and capital gains as calculated for tax purposes; in each case, our results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair value without considering inflation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We seek to manage our risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market value while providing an opportunity to stockholders to realize attractive risk-adjusted returns through ownership of our capital stock. Although we do not seek to avoid risk completely, we believe that risk can be quantified from historical experience and we seek to manage our risk levels in order to earn sufficient compensation to justify the risks we undertake and to maintain capital levels consistent with taking such risks.

To reduce the risks to our portfolio, we employ portfolio-wide and security-specific risk measurement and management processes in our daily operations. PRCM Advisers' risk management tools include software and services licensed or purchased from third parties, in addition to proprietary software and analytical methods developed by Pine River. There can be no guarantee that these tools will protect us from market risks.

Interest Rate Risk

Interest rates are highly sensitive to many factors, including fiscal and monetary policies and domestic and international economic and political considerations, as well as other factors beyond our control. We are subject to interest rate risk in connection with our assets and related financing obligations. Subject to maintaining our qualification as a REIT, we engage in a variety of interest rate management techniques that seek to mitigate the influence of interest rate changes on the values of our assets.

We utilize U.S. Treasuries as well as derivative financial instruments, currently limited to interest rate swaps, swaptions, TBAs, and to a certain extent inverse interest-only securities, as of March 31, 2011, to hedge the interest rate risk associated with our portfolio. We seek to hedge interest rate risk with respect to both the fixed income nature of our

assets and the financing of our portfolio. In hedging interest rates with respect to our fixed income assets, we seek to reduce the risk of losses on the value of our investments that may result from changes in interest rates in the broader markets. In utilizing interest rate hedges with respect to our financing, we seek to improve risk-adjusted returns and, where possible, to obtain a favorable spread between the yield on our assets and the cost of our financing. We rely on PRCM Advisers' expertise to manage these risks on our behalf. We implement part of our hedging strategy through Capitol, our TRS, which is subject to U.S. federal, state and, if applicable, local income tax.

Interest Rate Effect on Net Interest Income

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our leveraged fixed-rate RMBS will remain static. Moreover, interest rates may rise at a faster pace than the yields earned on our leveraged adjustable-rate and hybrid RMBS. Both of these factors could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our target assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

Our hedging techniques are partly based on assumed levels of prepayments of our target assets. If prepayments are slower or faster than assumed, the life of the investment will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

We acquire adjustable-rate and hybrid RMBS. These are assets in which some of the underlying mortgages are typically subject to periodic and lifetime interest rate caps and floors, which may limit the amount by which the security's interest yield may change during any given period. However, our borrowing costs pursuant to our financing agreements are not subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation, while the interest-rate yields on our adjustable-rate and hybrid RMBS could effectively be limited by caps. This issue will be magnified to the extent we acquire adjustable-rate and hybrid RMBS that are not based on mortgages that are fully indexed. In addition, adjustable-rate and hybrid RMBS may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. If this happens, we could receive less cash income on such assets than we would need to pay for interest costs on our related borrowings. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would harm our financial condition, cash flows and results of operations.

Interest Rate Mismatch Risk

We fund the majority of our adjustable-rate and hybrid Agency RMBS assets with borrowings that are based on LIBOR, while the interest rates on these assets may be indexed to other index rates, such as the one-year Constant Maturity Treasury index, or CMT, the Monthly Treasury Average index, or MTA, or the 11th District Cost of Funds Index, or COFI. Accordingly, any increase in LIBOR relative to these indices may result in an increase in our borrowing costs that is not matched by a corresponding increase in the interest earnings on these assets. Any such interest rate index mismatch could adversely affect our profitability, which may negatively impact distributions to our stockholders. To mitigate interest rate mismatches, we utilize the hedging strategies discussed above.

The following table provides the indices of our variable rate assets as of March 31, 2011, based on total carrying value of bonds (dollars in thousands).

	As of March 31, 2011				
Index Type	Floating	Hybrid [1]	Total	Index Percentage	
CMT	$—	$194,078	$194,078	29	%

LIBOR	380,999	67,798	448,797	66	%
Other [2]	18,048	17,906	35,954	5	%
Total	$399,047	$279,782	$678,829	100	%

(1) Hybrid amounts reflect those assets with greater than 12 months to reset.
(2) Other - includes COFI, MTA and other indices.
Our analysis of risks is based on PRCM Advisers and its affiliates' experience, estimates, models and assumptions.

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These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of decisions by PRCM Advisers may produce results that differ significantly from the estimates and assumptions used in our models.
We use a variety of recognized industry models, as well as proprietary models, to perform sensitivity analyses which are derived from primary assumptions for prepayment rates, discount rates and credit losses. The primary assumption used in this model is implied market volatility of interest rates. The information presented in the following interest sensitivity table projects the potential impact of sudden parallel changes in interest rates on our financial results and financial condition over the next 12 months, based on our interest sensitive financial instruments at March 31, 2011. All changes in value are measured as the change from the March 31, 2011 financial position. All projected changes in annualized net interest income are measured as the change from the projected annualized net interest income based off current performance returns.

	Changes in Interest Rates							
(dollars in thousands)	-100 bps		-50 bps		+50 bps		+100 bps	
Change in value of financial position:								
Available-for-sale securities, at fair value	$60,370		$33,809		$(39,381	)	$(81,684	)
As a % of March 31, 2011 equity	8.8	%	4.9	%	(5.7	)%	(11.9	)%
Trading securities, at fair value	$4,218		$2,769		$(2,757	)	$(5,472	)
As a % of March 31, 2011 equity	0.6	%	0.4	%	(0.4	)%	(0.8	)%
Derivatives, at fair value, net	$(62,584	)	$(33,126	)	$33,787		$68,353	
As a % of March 31, 2011 equity	(9.1	)%	(4.8	)%	4.9	%	10.0	%
Repurchase Agreements	$(1,163	)	$(1,163	)	$2,423		$4,846	
As a % of March 31, 2011 equity	(0.2	)%	(0.2	)%	0.4	%	0.7	%
Total Net Assets	$841		$2,289		$(5,928	)	$(13,957	)
As a % of March 31, 2011 total assets	—	%	0.1	%	(0.2	)%	(0.4	)%
As a % of March 31, 2011 equity	0.1	%	0.3	%	(0.8	)%	(2.0	)%
	-100 bps		-50 bps		+50 bps		+100 bps	
Change in annualized net interest income:	$528		$528		$(1,463	)	$(2,925	)
% change in net interest income	0.4	%	0.4	%	(1.2	)%	(2.4	)%

The AFS securities, at fair value, included in the interest rate sensitivity table “change in value of financial position” were limited to Agency RMBS. Due to our non-Agency RMBS's significantly discounted prices and underlying credit risks, we believe our non-Agency RMBS's valuation is inherently de-sensitized to changes in interest rates. As such, we cannot project the impact to these financial instruments and have excluded these RMBS from the interest rate sensitivity analysis. These non-Agency RMBS have been included in the “change in annualized net interest income” analysis.
Certain assumptions have been made in connection with the calculation of the information set forth in the foregoing interest rate sensitivity table and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at March 31, 2011. The analysis presented utilizes assumptions and estimates based on management's judgment and experience. Furthermore, while we generally expect to retain such assets and the associated interest rate risk to maturity, future purchases and sales of assets could materially change our interest rate risk profile.
The interest rate sensitivity table quantifies the potential changes in net interest income and portfolio value, which includes the value of swaps and our other derivatives, should interest rates immediately change. The interest rate sensitivity table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and

falling 50 and 100 basis points. The cash flows associated with the portfolio of RMBS for each rate change are calculated based on assumptions, including prepayment speeds, yield on future acquisitions, slope of the yield curve, and size of the portfolio. Assumptions made on the interest rate sensitive liabilities, which are assumed to relate to repurchase agreements, including anticipated interest rates, collateral requirements as a percent of the repurchase agreement, amount and term of borrowing.

The change in annualized net interest income does not include any benefit or detriment from faster or slower prepayment rates on our Agency premium bonds, non-Agency discount bonds, and instruments that represent the interest payments (but not the principal) on a pool of mortgages, or interest-only bonds. We anticipate that faster prepayment speeds in lower interest rate scenarios will generate lower realized yields on Agency premium and interest-only bonds and

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higher realized yields on non-Agency discount bonds. Similarly, we anticipate that slower prepayment speeds in higher interest rate scenarios will generate higher realized yields on Agency premium and interest-only bonds and lower realized yields on non-Agency discount bonds. Although we have sought to construct the portfolio to limit the effect of changes in prepayment speeds, there can be no assurance this will actually occur, and the realized yield of the portfolio may be significantly different than we anticipate in changing interest rate scenarios.

Given the low interest rates at March 31, 2011, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Because of this floor, we anticipate that any hypothetical interest rate shock decrease would have a limited positive impact on our funding costs; however, because prepayments speeds are unaffected by this floor, we expect that any increase in our prepayment speeds (occurring as a result of any interest rate decrease or otherwise) could result in an acceleration of our premium amortization on Agency and interest-only bonds purchased at a premium, and accretion of discount on our non-Agency bonds purchased at a discount. As a result, because this floor limits the positive impact of any interest rate decrease on our funding costs, hypothetical interest rate decreases could cause the fair value of our financial instruments and our net interest income to decline.

The information set forth in the interest rate sensitivity table and all related disclosures constitutes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act. Actual results could differ significantly from those estimated in the foregoing interest rate sensitivity table.

Prepayment Risk

Prepayment risk is the risk that principal will be repaid at a different rate than anticipated. As we receive prepayments of principal on our assets, premiums paid on such assets will be amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the assets. Conversely, discounts on such assets are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the assets.

Normally, we believe that we will be able to reinvest proceeds from scheduled principal payments and prepayments at acceptable yields; however, no assurances can be given that, should significant prepayments occur, market conditions would be such that acceptable investments could be identified and the proceeds timely reinvested.

Market Risk

Market Value Risk. Our AFS securities are reflected at their estimated fair value, with the difference between amortized cost and estimated fair value reflected in accumulated other comprehensive income. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, we would expect the fair value of these securities to decrease; conversely, in a decreasing interest rate environment, we would expect the fair value of these securities to increase. As market volatility increases or liquidity decreases, the fair value of our assets may be adversely impacted.

Real estate risk. RMBS and residential property values are subject to volatility and may be affected adversely by a number of factors, including national, regional and local economic conditions; local real estate conditions (such as an oversupply of housing); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. Decreases in property values reduce the value of the collateral for mortgage loans and the potential proceeds available to borrowers to repay the loans, which could cause us to suffer losses on our non-Agency RMBS investments.

Liquidity Risk

Our liquidity risk is principally associated with our financing of long-maturity assets with short-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities fall within the guidelines established by our operating policies, maturities are not required to be, nor are they, matched.

Should the value of our assets pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. Additionally, if one or more of our repurchase agreement counterparties chose not to provide on-going funding, our ability to finance would decline or

exist at possibly less advantageous terms. As such, we cannot assure that we will always be able to roll over our repurchase agreements. See Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources" in this Quarterly Report on Form 10-Q for further information about our liquidity and capital resource management.

Credit Risk

We believe that our investment strategy will generally keep our risk of credit losses low to moderate. However, we retain the risk of potential credit losses on all of the loans underlying our non-Agency RMBS. With respect to our non-Agency RMBS that are senior in the credit structure, credit support contained in RMBS deal structures provide a level of protection from losses. We seek to manage the remaining credit risk through our pre-acquisition due diligence process, and

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by factoring assumed credit losses into the purchase prices we pay for non-Agency RMBS. In addition, with respect to any particular target asset, PRCM Advisers' investment team evaluates relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral. We may at times in the future enter into credit default swaps or other derivative instruments in an attempt to manage our credit risk. Nevertheless, unanticipated credit losses could adversely affect our operating results.

Item 4. Controls and Procedures

A review and evaluation was performed by our management, including our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) and 15d-15(e) under the 1934 Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, were effective. Notwithstanding the foregoing, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in our periodic reports.

There have been no changes in our internal control over financial reporting that occurred during the three months ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

As of the date of this filing, we are not party to any litigation or legal proceedings, or to the best of our knowledge, any threatened litigation or legal proceedings, which, in our opinion, individually or in the aggregate, would have a material adverse effect on our results of operations or financial condition.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A - Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2010, or the Form 10-K. The materialization of any risks and uncertainties identified in our Forward Looking Statements contained in this report together with those previously disclosed in the Form 10-K or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations, and cash flows. See Item 2, “Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward Looking Statements” in this Quarterly Report on Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. [Removed and Reserved]

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

Exhibits - The exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as a part of this report. Such Index is incorporated herein by reference.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

			TWO HARBORS INVESTMENT CORP.
Dated:	May 5, 2011	By:	/s/ Thomas Siering
			Thomas Siering
			Chief Executive Officer, President and Director (principal executive officer)
Dated:	May 5, 2011	By:	/s/ Jeffrey Stolt
			Jeffery Stolt
			Chief Financial Officer and Treasurer (principal accounting and financial officer)

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Exhibit Number	Exhibit Index
31.1	Certification of Chief Executive Officer, pursuant to Rule 13a-14 and 15d-14 of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer, pursuant to Rule 13a-14 and 15d-14 of the Securities Exchange Act of 1934.
32.1	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.