

REDWOOD TRUST INC
Form 10-K/A
February 26, 2010

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

FORM 10-K/A

x

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

For the Fiscal Year Ended: December 31, 2009

OR

o

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

**For the transition period from to
Commission file number 1-13759**

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

68-0329422
(I.R.S. Employer
Identification No.)

**One Belvedere Place, Suite 300
Mill Valley, California 94941**

(Address of Principal Executive Offices) (Zip Code)

(415) 389-7373

(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class:	Name of Exchange on Which Registered:
Common Stock, par value \$0.01 per share	New York Stock Exchange
Securities registered pursuant to Section 12(g) of the Act: None	

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes
o No x

At June 30, 2009, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,095,757,486 based on the closing sale price as reported on the New York Stock Exchange.

The number of shares of the registrant's Common Stock outstanding on February 24, 2010 was 77,743,821.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement to be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of registrant's fiscal year covered by this Annual Report are incorporated by reference into Part III.

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EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A (Amendment No. 1) to the Redwood Trust, Inc. Annual Report on Form 10-K for the year ended December 31, 2009, as filed with the Securities and Exchange Commission on February 25, 2010 (the 2009 Annual Report), is being filed solely for the purpose of correcting the following typographical errors therein that occurred when the document was typeset by our filing agent:

On page F-5, the column that was captioned December 31, 2007 has been corrected to be captioned December 31, 2008 . All of the dollar amounts in that column are unchanged, as they were in fact the dollar amounts at December 31, 2008.

On page F-5, the column that was captioned December 31, 2008 has been corrected to be captioned December 31, 2009 . All of the dollar amounts in that column are unchanged, as they were in fact the dollar amounts at December 31, 2009.

On page F-6, the column that was captioned 2006 has been corrected to be captioned 2007 . All of the dollar amounts in that column are unchanged, as they were in fact the dollar amounts for the year ended December 31, 2007.

On page F-6, the column that was captioned 2007 has been corrected to be captioned 2008 . All of the dollar amounts in that column are unchanged, as they were in fact the dollar amounts for the year ended December 31, 2008.

On page F-6, the column that was captioned 2008 has been corrected to be captioned 2009 . All of the dollar amounts in that column are unchanged, as they were in fact the dollar amounts for the year ended December 31, 2009.

The header on pages F-24 through F-55 has been corrected to refer to December 31, 2009 in place of December 31, 2008 .

This Amendment No.1 represents the refiling of the entire 2009 Annual Report after correction of the above-indicated typographical errors and does not otherwise update any information as originally filed and does not otherwise reflect events occurring after the original filing date of the 2009 Annual Report.

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REDWOOD TRUST, INC.

2009 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS

Introduction

Redwood Trust, Inc., together with its subsidiaries, is a financial institution that seeks to invest in real estate related assets that have the potential to provide attractive cash flows over a long period of time and support our goal of distributing attractive levels of dividends to our stockholders. For tax purposes, we are structured as a real estate investment trust, or REIT. We are able to pass through substantially all of our earnings generated at our REIT to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941. A further description of our business is set forth in Part II, Item 7 of this Annual Report on Form 10-K.

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations, the Consolidated Financial Statements and Notes thereto, and supplementary data, which is included in Part II, Items 7, 7A, and 8 of this Annual Report on Form 10-K.

Our website can be found at www.redwoodtrust.com. We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission (SEC). We also make available, free of charge, access to our Corporate Governance Standards, charters for our Audit Committee, Compensation Committee, and Corporate Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our web site any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code of Ethics). In addition, our web site includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-generally accepted accounting principles (GAAP) and financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. The information on our website is not part of this Annual Report on Form 10-K.

Our Investor Relations Department can be contacted at One Belvedere Place, Suite 300, Mill Valley, CA 94941, Attn: Investor Relations, telephone (866) 269-4976.

Cautionary Statement

This Annual Report on Form 10-K and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions or forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

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Statements regarding the following subjects, among others, are forward-looking by their nature: (i) our competitive position and our ability to compete efficiently in the future; (ii) our future capital needs and our ability to access additional capital if needed; (iii) our future investment strategy and our ability to find attractive investments and future trends relating to our pace of acquiring or selling assets, including, without limitation, statements about the likelihood of, and our participation in, future securitization transactions and our potential future investment activity in the commercial real estate sector; (iv) the future returns we may earn on our investment portfolio; (v) future market and economic conditions, including, without limitation, future conditions in the residential and commercial real estate markets and related financing markets; (vi) our beliefs about the future direction of housing market fundamentals, including, without limitation, home prices, mortgage delinquencies and loan modification programs, inventory of homes for sale, and mortgage interest rates; (vii) our views on the sustainability of government interventions into various financial markets and the possible future effects of the government's withdrawal from such interventions; (viii) the future of the status of Fannie Mae and Freddie Mac, the role of the Federal Housing Administration, and other issues the resolution of which may depend on political factors and actions; (ix) our expectations regarding future credit losses and impairments on our investments (including as compared to our original expectations and credit reserve levels) and our ability to generate attractive returns even if losses increase above current estimates; (x) the drivers of our future earning and future trends in operating expenses; (xi) our board of directors' intention to pay a regular dividend of \$0.25 per share per quarter in 2010; (xii) our anticipation of additional losses for tax accounting purposes; and (xiii) our expectations relating to tax accounting that we may report a taxable loss in 2010 and that we expect any 2010 dividends will be characterized as a return of capital.

Important factors, among others, that may affect our actual results include: general economic trends, the performance of the housing, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; our exposure to adjustable-rate and negative amortization mortgage loans; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies' credit rating methodologies; changes in interest rates; changes in mortgage prepayment rates; the availability of high-quality assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions and the risks we are exposed to in executing securitization transactions; exposure to litigation arising from our involvement in securitization transactions; whether we have sufficient liquid assets to meet short-term needs; our ability to successfully compete and retain or attract key personnel; our ability to adapt our business model and strategies to changing circumstances; changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities; exposure to environmental liabilities and the effects of global climate change; failure to comply with applicable laws and regulations; our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures; changes in accounting principles and tax rules; our ability to maintain our status as a real estate investment trust (REIT) for tax purposes; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; decisions about raising, managing, and distributing capital; and other factors not presently identified.

This Annual Report on Form 10-K may contain statistics and other data that in some cases have been obtained from or compiled from information made available by servicers and other third-party service providers.

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Certifications

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated February 25, 2010, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to this Annual Report on Form 10-K. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on May 20, 2009 that he is unaware of any violations by Redwood Trust, Inc. of the NYSE's corporate governance listing standards in effect as of that date.

Employees

As of December 31, 2009, Redwood employed 68 people.

ITEM 1A. RISK FACTORS

The following is a summary of the risk factors that we believe are most relevant to our business. These are factors which, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. In addition to understanding the key risks described below, investors should understand that it is not possible to predict or identify all risk factors, and consequently, the following is not a complete discussion of all potential risks or uncertainties. We undertake no obligation to update forward-looking statements, whether as a result of new information, future events, or otherwise. Investors are advised, however, to review any further disclosure we make in our reports on Forms 10-Q and 8-K filed with the SEC.

General economic trends and the performance of the housing, mortgage, and broader financial markets may adversely affect our business and the value of, and returns on, real estate-related and other assets we own or may acquire.

The values of, and the cash flows from, the assets we own are affected by developments in the U.S. economy. There is particular uncertainty about the prospects for economic growth as the country exits the recent serious recession. A number of factors influence the potential uncertainty, including, but not limited to, high current unemployment, rising government debt levels, prospective Federal Reserve policy shifts, the withdrawal of government interventions into the financial markets, changing U.S. consumer spending patterns, and changing expectations for inflation and deflation. Income growth and unemployment levels affect borrowers' ability to repay loans underlying our assets, and there is risk that economic activity could be weaker than anticipated as the country exits the recent recession.

Real estate values and the ability to generate returns by owning or taking credit risk on loans secured by real estate are important to our business. We anticipate continued weakness in many residential and commercial real estate markets and related mortgage markets. Still, that weakness could exceed our expectations, harming the value of our assets, earnings, and access to liquidity.

The economic downturn and the significant government interventions into the financial markets and fiscal stimulus spending over the last two years have contributed to significantly increased U.S. budget deficits. This upward pressure on U.S. budget deficits has the potential to put upward pressure on U.S. interest rates, should the major lenders to the U.S. government become alarmed and need additional incentive to fund the U.S. deficit. It is possible we would not fully anticipate such a shift or all the negative consequences of such a shift in the interest rate environment. Thus, higher long term interest rates could adversely affect our overall business, income, and our ability to pay dividends, as

discussed further below under Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility in our earnings.

Since the Fall of 2008, government intervention has been important to support real estate markets, the overall U.S. economy, capital markets, and mortgage markets. We expect the government will gradually withdraw this support. It is possible we will not accurately anticipate the timing of that withdrawal and it is possible we will not fully anticipate all the implications of that withdrawal. If we do not fully and accurately anticipate the implications of the withdrawal of government intervention, it is possible that our earnings, cash flows, dividends, and liquidity will be negatively affected.

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Mortgage markets have received tremendous U.S. government support. In fact, the government's support of mortgage markets through its support of Fannie Mae and Freddie Mac was recently expanded, as the U.S. Treasury chose to backstop these government sponsored enterprises for three years, without limit. This outsized support for these entities may cause Fannie Mae and Freddie Mac to continue to dominate mortgage and securitization activity, inhibiting the return of private mortgage securitization. This has potentially negative consequences to us, since we have traditionally taken an active role in assuming credit risk in the private sector mortgage market, often via securitization.

If the Federal Reserve completes its \$1.25 trillion agency mortgage-backed securities purchase program and discontinues agency mortgage-backed securities acquisitions by March 2010 as planned, there could be significant implications for mortgage-related securities pricing. There is risk to returns we expect on our mortgage-related assets if we do not fully and accurately anticipate the broader implications for mortgage-backed securities pricing.

While market participants expect the Federal Reserve to abandon its low interest rate policy at some point, it is very difficult, if not impossible, to predict the timing or implications of the Federal Reserve's rate hikes. It is possible Redwood will not accurately anticipate the future interest rate environment; our business may be harmed by our inability to accurately anticipate the developments on the interest rate front.

Federal and state legislative and regulatory developments, and the actions of governmental authorities and entities, may adversely affect our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.

As noted above, our business is affected by conditions in the residential and commercial real estate markets and the broader financial markets, as well as by the financial condition and resources of other participants in these markets. These markets and many of the participants in these markets are subject to, or regulated under, various federal and state laws and regulations. In some cases, the government or government sponsored entities directly participate in these markets. In particular, because issues relating to residential real estate and housing finance can be areas of political focus, federal and state governments may be more likely to take actions that affect residential real estate, the markets for financing residential real estate, and the participants in residential real estate-related industries than they would with respect to other industries. As a result of the government's statutory and regulatory oversight of the markets we participate in and the government's direct and indirect participation in these markets, federal and state governmental actions, policies, and directives can have an adverse effect on these markets and on our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future, which effects may be material.

As an example, we believe that Fannie Mae, Freddie Mac, and the Federal Housing Administration accounted for approximately 90% of the financing for new residential mortgage loans in 2009. These entities, in turn, currently receive much of their financing from the U.S. Treasury Department or the Federal Reserve System. As a result, most of the market for housing finance in the U.S. is controlled by the federal government and can be materially affected by decisions of federal policy makers, the President, and Congress, and they may establish or change existing laws, regulations, and policies to respond to political rather than market pressures. If the federal government determines to maintain or expand its current role in the markets for financing residential mortgage loans, it may adversely affect our business due to the difficulty of effectively competing with it. Even if the federal government determines to decrease its role in the markets for financing residential mortgage loans, it may establish regulations for other market participants that have an adverse effect on our ability to effectively participate or compete or which may diminish or eliminate the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.

During the third quarter of 2008, the federal government commenced implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. In addition, certain mortgage lenders and servicers then voluntarily, or as part of settlements with law enforcement authorities, established loan modification programs relating to the mortgages they hold or service. Subsequently, in early 2009, the President announced administration plans aimed at reducing foreclosures through loan modification and refinancing programs. In addition, members of Congress have at times indicated support for additional legislative relief for homeowners, including a proposed amendment of the bankruptcy

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laws to permit the forgiveness of principal on first lien mortgage loans in bankruptcy proceedings. These loan modification programs, as well as future law enforcement and legislative or regulatory actions, including possible amendments to the bankruptcy laws, may adversely affect the value of, and the returns on, the mortgage loans and the related mortgage securities we currently own or may acquire in the future.

The recent credit crisis, financial turmoil, and the economic recession that followed led to a level of federal governmental intervention in the financial markets and into the affairs of particular financial institutions that was unprecedented. These events revealed the extent to which the functioning of financial markets and the ability of particular counterparties to perform can be affected by, and be dependent on, the policies and actions of the government. They also prompted the government to begin offering attractive financing to certain industry participants, through programs such as the Public-Private Investment Program and the Term Asset-Backed Securities Loan Facility, which arguably gave a competitive advantage to firms taking advantages of these programs. These and other types of governmental interventions may not be predictable and may not benefit us and, therefore, could adversely affect our financial position and our ability to compete.

Furthermore, the recent credit crisis and subsequent financial turmoil prompted the President and Congress to develop comprehensive statutory and regulatory proposals for reforming the U.S. financial system. These financial reform plans are expected to be aimed at, among other things, promoting robust supervision and regulation of financial firms, establishing comprehensive supervision of financial markets, protecting consumers and investors from financial abuse, providing the government with additional tools to manage financial crises, and raising international regulatory standards and improving international cooperation, but their scope could be expanded beyond what has been currently proposed. Implementation of all or part of any such financial reform plan, whether through new laws or new regulations, including changes to the manner in which financial institutions, financial products, and financial markets operate and are regulated and any related changes in the accounting standards that govern them, could adversely affect our business and results of operations by subjecting us to regulatory oversight, making it more expensive to conduct our business, reducing or eliminating any competitive advantage we may have, limiting our ability to expand, or could have other adverse effects on us.

Ultimately, there can be no assurance that governmental actions will directly benefit our business or otherwise have a lasting and beneficial impact on the financial markets and, in fact, they may adversely affect us, possibly materially. We cannot predict whether or when such actions may occur or what impact, if any, such actions could have on our business, results of operations, and financial condition.

The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact the value of those assets and investments, our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

Overview of credit risk

We assume credit risk with respect to residential and commercial real estate loans through the ownership of securities backed by residential and commercial real estate loans, collateralized debt obligation (CDO) securities backed by residential and commercial loans and real estate securities, and through residential and commercial real estate loans.

Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; increases in payments required to be made by borrowers; declines in the value of homes; earthquakes, the

The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact

effects of global climate change (including flooding, drought, and severe weather) and other natural events; uninsured property loss; over-leveraging of the borrower; costs of remediation of environmental conditions, such as indoor mold; changes in zoning or building codes and the related costs of compliance; acts of war or terrorism; changes in legal protections for lenders and other changes in law or regulation; and personal events affecting borrowers, such as reduction in income, job loss, divorce, or health problems. If the U.S. economy or the housing market continues to weaken, our credit losses could increase beyond levels that we currently anticipate.

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In addition, rising interest rates may increase the credit risks associated with residential real estate loans. For example, the interest rate is adjustable for most of the loans securitized by securitization entities we have sponsored and for a portion of the loans underlying residential and CDO securities we have acquired from securitizations sponsored by others. Accordingly, when short-term interest rates rise, required monthly payments from homeowners will rise under the terms of these adjustable-rate mortgages, and this may increase borrowers' delinquencies and defaults.

Credit losses on commercial real estate loans can occur for many of the reasons noted above for residential real estate loans. Losses on commercial real estate loans can also occur for other reasons including decreases in the net operating income from the underlying property, which could be adversely affected by a weakened U.S. economy. Moreover, many commercial real estate loans are not fully amortizing and, therefore, the borrower's ability to repay the principal when due may depend upon the ability of the borrower to refinance or sell the property at maturity.

Commercial real estate loans are particularly sensitive to changes in the local economy, so even minor local adverse economic events may adversely affect the performance of commercial real estate assets. Mezzanine loans, distressed assets, and loan participations have concentrated credit, servicing, and other risks. We have in the past directly originated some of our commercial loans and participated in the origination of others, and may do so again in the future. Directly originating, or being a participant in the direct origination of, commercial loans may expose us to credit, legal, and other risks that may be greater than when we acquire loans originated by others.

We may incur losses on commercial real estate loans and securities for reasons not necessarily related to an adverse change in the performance of the property. This includes bankruptcy by the owner of the property, issues regarding the form of ownership of the property, poor property management, origination errors, inaccurate appraisals, fraud, and non-timely actions by servicers. We review the underlying loan files prior to acquiring commercial loans and securities backed by commercial loans, but our review may not uncover these or other issues at that time. By the time these problems become apparent, we may have little or no recourse to the issuer of the securities or seller of the loan and we may incur credit losses as a result.

We may have heightened credit losses associated with certain securities we own.

Within a securitization of residential and commercial real estate loans, various securities are created, each of which has varying degrees of credit risk. We may own the securities with the most concentrated credit risk or the least concentrated credit risk within a securitization, in each case, assuming a certain amount of credit risk associated with the underlying real estate loans.

In general, losses on an asset securing a residential or commercial real estate loan included in a securitization will be borne first by the owner of the property (i.e., the owner will first lose the equity invested in the property) and, thereafter, by mezzanine or preferred equity investors, if any, then by a cash reserve fund or letter of credit, if any, then by the first-loss security holder, and then by holders of more senior securities. In the event the losses incurred upon default on the loan exceed any equity support, reserve fund, letter of credit, and classes of securities junior to those in which we invest (if any), we may not be able to recover all of our investment in the securities we hold. In addition, if the underlying properties have been overvalued by the originating appraiser or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related security, then the first-loss securities may suffer a total loss of principal, followed by losses on the second-loss and then third-loss securities (or other residential and commercial securities which we own).

The nature of the assets underlying some of the securities we hold could increase the credit risk of those securities.

The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact

For certain types of loans underlying our securities the loan rate or borrower payment rate may increase over time, increasing the potential for default. For example, a portion of the securities we acquire, or have an indirect interest in through our investment in the Acacia entities we sponsor, are backed by residential real estate loans that have negative amortization features. The rate at which interest accrues on these loans may change more frequently or to a greater extent than payment adjustments on an adjustable-rate loan, and adjustments of monthly payments may be subject to limitations or may be limited by the borrower's option to

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pay less than the full accrual rate. As a result, the amount of interest accruing on the remaining principal balance of the loans at the applicable adjustable mortgage loan rate may exceed the amount of the monthly payment. This is particularly a risk in a rising interest rate environment. Negative amortization occurs when the resulting excess (of interest owed over interest paid) is added to the unpaid principal balance of the related adjustable mortgage loan. For certain loans that have a negative amortization feature, the required monthly payment is increased after a specified number of months or after a maximum amount of negative amortization has occurred in order to amortize fully the loan by the end of its original term. Other negative amortizing loans limit the amount by which the monthly payment can be increased, which results in a larger final payment at maturity. As a result, negatively amortizing loans have performance characteristics similar to those of balloon loans. Negative amortization may result in increases in delinquencies, loan loss severity, and loan defaults, which may, in turn, result in payment delays and credit losses on our investments. Other types of loans to which we are exposed, such as hybrid loans and teaser-rate adjustable-rate loans, may also have greater credit risk than more traditional amortizing mortgage loans.

We have concentrated credit risk in certain geographical regions and may be disproportionately affected by an economic or housing downturn, natural disaster, terrorist event, global warming, or any other adverse event specific to those regions.

A decline in the economy or difficulties in certain real estate markets, such as a high level of foreclosures in a particular area, are likely to cause a decline in the value of residential and commercial properties. This, in turn, will increase the risk of delinquency, default, and foreclosure on real estate underlying securities and loans we hold with properties in those regions. This may then adversely affect our credit loss experience and other aspects of our business, including our ability to securitize real estate loans and securities.

The occurrence of a natural disaster (such as an earthquake, tornado, hurricane, or a flood), or the effects of global climate change (including flooding, drought, and severe weather), may cause decreases in the value of real estate (including sudden or abrupt changes) and would likely reduce the value of the properties collateralizing the mortgage loans we own or those underlying the securities we own. Since certain natural disasters may not typically be covered by the standard hazard insurance policies maintained by borrowers, the borrowers may have to pay for repairs due to the disasters. Borrowers may not repair their property or may stop paying their mortgage loans under those circumstances, especially if the property is damaged. This would likely cause foreclosures to increase and lead to higher credit losses on our loans or on the pool of mortgage loans underlying the securities in which we provide credit-enhancement.

We have residential credit risk in all states although we do not have more than 1% of our residential loans in any one zip code. However, a significant number of residential and real estate loans that underlie the securities we own are secured by property in California, so we have more credit risk within California than other states. Other states with concentrated residential loan credit risk through our ownership in securities include Florida and New York. We also have commercial credit risk in most states.

To the extent global warming adversely affects certain geographic areas (e.g., coastal regions), our geographic concentration could lead to disproportional reduction in values on underlying properties on loans on which we take credit risk.

We assume credit risk on a variety of residential and commercial mortgage assets through our investments in Acacia entities.

The Acacia entities we sponsor own securities issued by various residential and commercial real estate loan securitization entities. Acacia entities also own CDO securities created and issued by others and these securities

usually have concentrated risks with respect to residential and commercial real estate. Other assets held by Acacia entities include loans, debt instruments, and derivatives. Assets held by Acacia entities are reported as part of our consolidated securities portfolio on our consolidated balance sheets. Generally, we do not control or influence the underwriting, servicing, management, or loss mitigation efforts with respect to the underlying assets in these securities. Some of the securities Acacia entities own are backed by subprime and alt-a residential loans that have substantially higher risk characteristics than prime-residential loans and are expected to have higher rates of delinquency and loss than prime residential loans. Some of these securities were acquired from Sequoia securitization entities that we have sponsored. When the pools of residential or

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commercial loans underlying any of the securitizations in which an Acacia entity owns an interest experience poor credit results, the securities issued by that Acacia entity could have their credit ratings down-graded, could suffer declines in fair value, or could experience principal or interest losses. When any of these events occurs, it likely reduces our long-term returns and near-term cash flows from the Acacia equity securities we have acquired. As a result of poor credit performance and outlook of the underlying securities with the Acacia entities, most of these securities have been downgraded and cash flows to most of our Acacia equity securities and other junior securities have been cut off. We do not currently anticipate sponsoring any new Acacia securitization transactions.

The timing of credit losses can harm our economic returns.

The timing of credit losses can be a material factor in our economic returns from residential and commercial loans and securities. If unanticipated losses occur within the first few years after a loan is originated or a securitization is completed, those losses could have a greater negative impact on our investment returns than unanticipated losses on more seasoned loans or securities. In addition, higher levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of the principal and interest that is due to us under the terms of the securities backed by that pool. This would also lower our economic returns. The timing of credit losses could be affected by the creditworthiness of the borrower, the borrower's willingness and ability to continue to make payments, and new legislation, legal actions, or programs that allow for the modification of loans or ability for borrowers to get relief through bankruptcy or other avenues.

Our efforts to manage credit risks may fail.

We attempt to manage risks of credit losses by continually evaluating our investments for impairment indicators and establishing reserves under GAAP for credit and other risks based upon our assessment of these risks. We cannot establish credit reserves for tax accounting purposes. The amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility, and liquidity issues. If these increased credit losses are greater than we anticipated and we need to increase our credit reserves or in the event that assets that have declined in value are deemed to be other-than-temporarily impaired, our GAAP earnings might be reduced. Increased credit losses may also adversely affect our cash flows, dividend distribution requirements and payments, asset fair values, access to short-term borrowings, and our ability to securitize assets.

Despite our efforts to manage credit risk, there are many aspects of credit risk that we cannot control. Our quality control and loss mitigation operations may not be successful in limiting future delinquencies, defaults, and losses, or they may not be cost effective. Our underwriting reviews may not be effective. The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies and other counterparties.

Loan servicing companies may not cooperate with our loss mitigation efforts or those efforts may be ineffective. Service providers to securitizations, such as trustees, bond insurance providers, and custodians, may not perform in a manner that promotes our interests.

The value of the homes collateralizing residential loans may decline. The value of the commercial properties collateralizing commercial loans may decline. The frequency of default and the loss severity on loans upon default may be greater than we anticipate. Interest-only loans, negative amortization loans, adjustable-rate loans, larger balance loans, reduced documentation loans, subprime loans, alt-a loans, second lien loans, loans in certain locations, and loans that are partially collateralized by non-real estate assets may have increased risks and severity of loss. If loans become real estate owned as a result of foreclosure, we bear the risk of not being able to sell the property and recovering our investment and of being exposed to the risks attendant to the ownership of real property.

The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact

Changes in consumer behavior, bankruptcy laws, tax laws, regulation of the mortgage industry, and other laws may exacerbate loan losses. Future changes in rules that would enable loans owned by a securitization entity to be modified may not be beneficial to our interests if the modifications reduce the interest we earn and increase the eventual severity of a loss. In some states and circumstances, the securitizations in which we invest have recourse as owner of the loan against the borrower's other assets and income in the event of loan default; however, in most cases, the value of the underlying property will be the sole effective source of funds

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for any recoveries. Other changes or actions by judges or legislators regarding mortgage loans and contracts, including the voiding of certain portions of these agreements, may reduce our earnings, impair our ability to mitigate losses, or increase the probability and severity of losses. Any expansion of our loss mitigation efforts as we grow our portfolio will increase our operating costs and the expanded loss mitigation efforts may not reduce our future credit losses.

Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated with those securities. Furthermore, downgrades in the credit ratings of bond insurers or any downgrades in the credit ratings of mortgage insurers could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business and operations.

We generally do not consider credit ratings in assessing our estimates of future cash flows and desirability of our investments (although our assessment of the quality of an investment may prove to be inaccurate and we may incur credit losses in excess of our initial expectations).

We note that the assignment of an investment grade rating to a security by a rating agency does not mean that there is not credit risk associated with the security or that the risk of a credit loss with respect to such security is necessarily remote. However, securities we own do have credit ratings, and to the extent we securitize loans and securities, we will be required to rely on the credit rating agencies to provide ratings on the securities created by these securitization entities.

Rating agencies rate debt securities based upon their assessment of the safety of the receipt of principal and interest payments. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of debt securities and, therefore, the assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to credit ratings based on available data or changes in economic outlook or may otherwise fail to make changes in credit ratings in response to subsequent events, so that our investments may be better or worse than the ratings indicate. Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities. These changes may occur quickly and often. The market's ability to understand and absorb these changes, and the impact to the securitization market in general, are difficult to predict. Such changes may have an impact on the amount of investment-grade and non-investment-grade securities that are created or placed on the market in the future.

Downgrades to the ratings of securities could have an adverse effect on the value of some of our investments and our cash flows from those investments, particularly our equity investments in Acacia entities. The underlying documents of each Acacia securitization entity state that certain average rating levels must be met on the securities held by the entity, and if not met, then cash that would otherwise be distributed to the equity holders or the lower-rated debt holders, would instead be distributed to the more senior debt holders. Our investments in Acacia are primarily in the equity of these securitization entities, and the vast number of downgrades that rating agencies reported have caused most of the Acacia entities to fail this average rating test, which, in turn, has adversely affected our cash flows from our investments in these entities.

Some of the securities held by the Acacia entities as well as some of the securities held by Redwood are insured by bond insurers such as Ambac Financial Group Inc., MBIA Inc., and Financial Guaranty Insurance Co., which are commonly known as monoline insurers. These monoline insurers historically have had AAA credit ratings and this credit rating has been passed on to any bonds that they insure. The high number of recent credit downgrades and other recent market turbulence has revealed that these monoline insurers have greater credit risk exposure than previously realized and the credit ratings of a number of these insurers have been downgraded as a result. Any decline in the credit rating of a monoline insurer generally results in a corresponding decline in the credit ratings of the securities insured by that insurer.

The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact

Some of the loans held by our Sequoia securitization entities, or in which we have an indirect interest through securities we hold through Acacia entities or at Redwood, are insured in part by mortgage insurers. Mortgage insurance protects the lender or other holder of a loan, up to a specified amount, in the event the borrower defaults on the loan. Mortgage insurance generally is required only when the principal amount of the loan at the time of origination is greater than 80% of the value of the property (loan-to-value). Any inability of the mortgage insurers to pay in full the insured portion of the loans that we hold would adversely affect the

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value of the securities we own that are backed by these loans, which could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business.

Changes in prepayment rates of residential real estate loans could reduce our earnings, dividends, cash flows, and access to liquidity.

The economic returns we earn from most of the residential real estate securities and loans we own (directly or indirectly) are affected by the rate of prepayment of the underlying residential real estate loans. Prepayments are unpredictable and adverse changes in the rate of prepayment could reduce our cash flows, earnings, and dividends.

Adverse changes in cash flows would likely reduce an asset's fair value, which could reduce our ability to borrow against that asset and may cause a market valuation adjustment for GAAP purposes, which could reduce our reported earnings. While we estimate prepayment rates to determine the effective yield of our assets and valuations, these estimates are not precise, and prepayment rates do not necessarily change in a predictable manner as a function of interest rate changes. Prepayment rates can change rapidly. As a result, changes can cause volatility in our financial results, affect our ability to securitize assets, affect our ability to fund acquisitions, and have other negative impacts on our ability to grow and generate earnings.

We own a number of securities backed by residential loans that are particularly sensitive to changes in prepayments rates. These securities include interest-only securities (IOs) that we acquire from third parties and from our Sequoia entities. Faster prepayments than we anticipated on the underlying loans backing these IOs will have an adverse effect on our returns on these investments.

Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility, in our earnings.

Changes in interest rates, the interrelationships between various interest rates, and interest rate volatility could have negative effects on our earnings, the fair value of our assets and liabilities, loan prepayment rates, and our access to liquidity. Changes in interest rates can also harm the credit performance of our assets. We generally seek to hedge some but not all interest rate risks. Our hedging may not work effectively, or we may change our hedging strategies or the degree or type of interest rate risk we assume.

A majority of our equity-funded assets have adjustable-rate coupons (coupons that reset within a year and at least once per year thereafter). The cash flows we receive from these assets may vary as a function of interest rates, as may the reported earnings generated by these assets. We may also acquire loans and securities which are generally held as inventory prior to sale to a securitization entity or as a longer term investment. We may fund assets with equity and with floating rate debt and to the extent these assets have fixed or hybrid interest rates (or are adjustable with an adjustment period longer than our short-term debt), an interest rate mismatch would exist and we would earn less (and fair values may decline) if interest rates rise. We may or may not seek to mitigate interest rate mismatches for these assets with a hedging program using interest rate agreements and, to the extent we do use hedging techniques, they may not be successful.

Interest rate changes have diverse and sometimes unpredictable effects on the prepayment rates of residential real estate loans. Changes in prepayment rates can lower the returns we earn from our assets, diminish or delay our cash flows, reduce the fair value of our assets, and decrease our liquidity.

Except with respect to our adjustable-rate assets, higher interest rates generally reduce the fair value of most of our assets. This may affect our earnings results, reduce our ability to re-securitize or sell our assets, or reduce our

Changes in prepayment rates of residential real estate loans could reduce our earnings, dividends, cash flows, and

liquidity. Higher interest rates could reduce the ability of borrowers to make interest payments or to refinance their loans. Higher interest rates could reduce property values and increased credit losses could result. Higher interest rates could reduce mortgage originations, thus reducing our opportunities to acquire new assets.

When short-term interest rates are high relative to long-term interest rates, an increase in adjustable-rate residential loan prepayments may occur, which would likely reduce our returns from owning interest-only securities backed by adjustable-rate residential loans.

When short-term interest rates vary, our premium amortization expense on loans acquired by Sequoia entities prior to July 2004 (which are reported on our consolidated balance sheet), may significantly increase

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or decrease from one quarter to the next. Under the applicable GAAP accounting elections, the amortization expense for the current period is a function of actual and projected prepayments and the current London Interbank Offered Rate (LIBOR) interest rate. During a period when rates change dramatically, the effect that the interest rate has on the amortized amount may become the more significant factor (over prepayments) and may alter the amount of premium amortized thereby creating volatility in our reported income for that period, all other factors being equal.

We have significant investment and reinvestment risks.

New assets we acquire may not generate yields as attractive as yields on our current assets, which would likely result in a decline in our earnings per share over time.

We believe the assets we acquire have the potential to generate attractive economic returns and GAAP yields, although there is the risk that the acquisitions will not perform as expected. Realized cash flow could be significantly lower than expected and mark-to-market returns from new asset acquisitions could be negative, including both new assets that are backed by newly-originated loans, as well as new acquisitions that are backed by more seasoned loans.

In order to maintain our portfolio size and our earnings, we must reinvest in new assets a portion of the cash flows we receive from principal, interest, calls, and sales. We receive monthly payments from many of our assets, consisting of principal and interest. In addition, occasionally some of our residential securities are called (effectively sold). We may also sell assets from time to time as part of our portfolio and capital management strategies. Principal payments, calls, and sales reduce the size of our current portfolio and generate cash for us.

If the assets we acquire in the future earn lower GAAP yields than the assets we currently own, our reported earnings per share will likely decline over time as the older assets are paid down, are called, or are sold. Under the effective yield method of accounting that we use for GAAP accounting purposes for some of our assets, we recognize yields on assets based on our assumptions regarding future cash flows. A portion of the cash flows we receive may be used to reduce our basis in these assets. As a result of these various factors, our basis for GAAP amortization purposes may be lower than their current fair values. Assets with a lower GAAP basis than current fair values generate higher GAAP yields, yields that are not necessarily available on newly acquired assets. Economic conditions, including credit results, prepayment patterns, and interest rate trends in the future are difficult to project with accuracy over the life of the assets we acquire, so there will be volatility in the reported returns over time.

Our growth may be limited if assets are not available or not available at attractive prices.

To reinvest proceeds from principal repayments and deploy capital we raise, we must acquire new assets. If the availability of new assets is limited, we may not be able to acquire assets that will generate attractive returns. Generally, asset supply can be reduced if originations of a particular product are reduced or if there are few sales in the secondary market of seasoned product from existing portfolios. In particular, assets we believe have a favorable risk/reward ratio may not be available for purchase.

We do not originate residential loans; rather, we rely on the origination market to supply the types of loans we wish to credit-enhance. At times, due to heightened credit concerns, strengthened underwriting standards, or concerns about economic growth or housing values, the volume of originations may decrease significantly. In 2008 and 2009, the volume of loan originations was lower than in prior years, and the volume may not return to previous levels in the foreseeable future. This reduced volume may make it difficult for us to acquire loans and securities.

The supply of new non-agency securitized assets available for purchase could continue to be reduced if the economics

or form of the securitization continues to be unattractive. A key factor in the economics of securitization is a highly liquid market for triple-A rated securities. The events beginning in late 2007 and continuing through 2009 revealed that the liquidity of this market may be severely disrupted at times. Fears about credit quality and the changes in credit rating agencies' analyses have dampened the demand for investment grade securities backed by real estate loans and securities, and investor demand in the foreseeable future for these securities may not reach previous levels. Without a robust market for triple-A rated securities, the supply of real estate credit enhancement securities could be significantly diminished. In addition, the risks

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associated with the acquisition of loans for the purpose of securitization may increase significantly and we may choose not to acquire any loans during these periods.

Investments in diverse types of assets and businesses could expose us to new, different, or increased risks.

We have invested in and may in the future invest in a variety of real estate and non-real estate related assets that may not be closely related to our current core business. Additionally, we may enter various securitizations, services, and other operating businesses that may not be closely related to our current business. Any of these actions may expose us to new, different, or increased investment, operational, financial, or management risks. We have made investments in CDO debt and equity securities issued by CDO securitizations other than Acacia entities that own various types of assets, generally real estate related. These CDOs (as well as the Acacia entities) have invested in manufactured housing securities, subprime residential securities, synthetic securities that reference other securities, and other residential securities backed by lower-quality borrowers. They also own a variety of commercial real estate loans and securities, corporate debt issued by REITs that own commercial real estate properties, and other assets that have diverse credit risks. We may invest in equity securities issued by CDOs that own trust preferred securities issued by financial institutions or other types of non-real estate assets. We may invest directly or indirectly in real property. We may invest in non-real estate ABS or corporate debt or equity. We have invested in diverse types of IOs from residential and commercial securitizations sponsored by us or by others. The higher credit and prepayment risks associated with these types of investments may increase our exposure to losses. We may invest in non-U.S. assets that may expose us to currency risks (which we may choose not to hedge) and different types of credit, prepayment, hedging, interest rate, liquidity, legal, and other risks.

We may change our investment strategy or financing plans, which may result in riskier investments and diminished returns.

We may change our investment strategy or financing plans at any time, which could result in our making investments that are different from, and possibly riskier than, the investments we have previously made or described. A change in our investment strategy or financing plans may increase our exposure to interest rate and default risk and real estate market fluctuations. A decision to employ additional leverage could increase the risk inherent in our investment strategy. Furthermore, a change in our investment strategy could result in our making investments in new asset categories or in different proportions among asset categories than we previously have. For example, we could in the future determine to invest a greater proportion of our assets in securities backed by subprime residential mortgage loans. These changes could result in our making riskier investments, which could ultimately have an adverse effect on our financial returns. Alternatively, we could determine to change our investment strategy or financing plans to be more risk averse, resulting in potentially lower returns, which could also have an adverse effect on our financial returns.

We may allocate investment opportunities between us and investment funds or accounts we manage.

One of our long-term business strategies is to build an asset management business through our wholly-owned subsidiary, Redwood Asset Management, and as part of this strategy we may sponsor additional limited partnerships that Redwood Asset Management will advise. We believe that this strategy will allow us to expand our investment platform by attracting third party limited partnership investors. It will also enable us to generate revenue by charging management and performance fees for managing the investments of those limited partnerships, which may make investments in the same types of assets in which we invest. In addition, Redwood Asset Management may provide investment advice with respect to separately managed accounts that also invest in the same types of assets in which we invest. As a result, we may allocate investment opportunities, in whole or in part, to limited partnerships that we sponsor or separate accounts that we manage, which may reduce the availability of assets for Redwood to invest in.

We have significant investment and reinvestment risks.

The performance of the assets we own and the investments we make will vary and may not meet our expectations, which may reduce our earnings and cash flows. In addition, the cash flows from, market values of, and earnings from securities and loans we own are variable.

We actively manage the risks associated with acquiring, holding, and managing real estate loans and securities. No amount of risk management or mitigation, however, can change the variable nature of the cash flows, fair values of, and financial results generated by these loans and securities. Changes in the credit

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performance or the prepayments on these real estate loans and the loans underlying these securities and changes in interest rates impact the cash flows on these securities, and the impact could be significant for our securities with concentrated risks. Changes in cash flows lead to changes in our return on investment and also to potential variability in reported income. The revenue recognized on most of our assets is based on an estimate of the yield over the remaining life of the asset. Thus, changes in our estimates of expected cash flow from an asset will result in changes in our reported earnings on that asset in the current reporting period. We may be forced to recognize adverse changes in expected future cash flows as a current expense, further adding to earnings volatility.

For other assets, our revenue and income are based on changes in the fair value of the asset. As market conditions, liquidity, perceptions, supply, demand, and the fundamentals of each asset change, the fair values can vary widely, causing volatility in our reported earnings. Fair values for illiquid assets can be difficult to ascertain accurately, which may also lead to volatility and uncertainty of earnings.

Changes in the fair values of our assets, liabilities, and derivatives can have various negative effects on us, including reduced earnings, increased earnings volatility, and volatility in our book value.

Fair values for our assets, liabilities, and derivatives can be volatile. The fair values can change rapidly and significantly and changes can result from changes in interest rates, perceived risk, supply, demand, and actual and projected cash flows and prepayments and credit performance. Fair values for illiquid assets can be difficult to estimate, which may lead to volatility and uncertainty of earnings.

A decrease in fair value may not necessarily be the result of deterioration in future cash flows. For GAAP purposes, we mark-to-market some, but not all, of our consolidated assets and liabilities on our consolidated balance sheet. In addition, valuation adjustments on certain consolidated assets and many of our derivatives are reflected in our consolidated statement of income. As a result, assets that are funded with certain liabilities and interest-rates matched with certain liabilities and hedges may have differing mark-to-market treatment than the liability or hedge. If we sell an asset that has not been marked to market through our consolidated statement of income at a reduced market price relative to its cost basis, our reported earnings will be reduced.

A decrease in the fair value of the securities we own may result in a reduction in our book value due to the accounting standards we are required to apply. Reporting a low book value could have adverse effects even if that book value is not indicative of the actual value of our net investments in assets and securitization entities. The adverse effects include the inability to meet or agree upon covenants with counterparties, to enter into derivative contracts, or a reduction in the market price of our common stock.

There will be differences between the value of our investments in certain securitization entities (e.g., Sequoia and Acacia entities) under GAAP presentation and the economic value of our investments in these entities, and they could be significant. Discrepancies arise as a result of market dynamics, the limitations of the measurement techniques required by GAAP, and the consolidation accounting principles under GAAP.

Our calculations of the fair value of the securities we own or consolidate are based upon assumptions that are inherently subjective and involve a high degree of management judgment.

We report our securities at fair value on our consolidated balance sheets. In computing the fair values for illiquid securities, such as the securities we own or consolidate and for which there are few, if any, observable third-party trades, we make a number of market-based assumptions, including assumptions regarding future interest rates, prepayment rates, discount rates, credit loss rates, and the timing of credit losses. These assumptions are inherently subjective and involve a high degree of management judgment. Use of different assumptions could materially affect

The performance of the assets we own and the investments we make will vary and may not meet our expectations,

our fair value calculations and our results of operations and financial condition.

Although we rely on our internal calculations to compute the fair value of securities we own, we also request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. Recent market disruptions have resulted in fewer third-party generated data points for us to consider in connection with our estimates of the fair value of our securities than were available to us in the past.

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Investments we make, hedging transactions that we enter into, and the manner in which we finance our investments and operations expose us to various risks such as, among other things, liquidity risk, risks associated with the use of leverage, market risks, and counterparty risk.

Many of our investments have limited liquidity.

Some, and, at times, a majority, of the residential, commercial, and CDO securities we acquire are generally illiquid—that is, there are not a significant pool of potential investors that are likely to invest in these, or similar, securities and loans. In turbulent markets, it is likely that the securities we own may become even less liquid. As a result, we may not be able to sell certain assets at opportune times or at attractive prices or we may incur significant losses upon sale of these assets, should we determine to sell them.

As a result of the limited liquidity of the types of securities we acquire and our securitization entities issue, there may be little trading information available to verify the values at which we report these assets and liabilities on our financial statements. This makes the estimates of fair value reflected in our financial statements more assumption-based, and our reported earnings and book values may not reflect the values we ultimately realize from our portfolio.

We sometimes utilize short-term financial leverage and this could expose us to increased risks.

We have invested in the past and may invest in the future in securities and loans financed with various types of short-term debt. By incurring this leverage we can generate attractive returns on our equity invested in these assets. However, as a result of the leverage, we could also incur significant losses if our borrowing costs increase relative to the earnings on our assets and hedges. Financing facilities may also force us to sell assets under adverse market conditions to meet lenders' margin calls in the event of a decrease in the fair values of the assets pledged as collateral. Liquidation of the collateral could create negative tax consequences and raise REIT qualification issues.

Although we typically seek a variety of financing facilities from several counterparties, there can be no assurance that we would be able to establish short-term financing facilities or renew them when they mature. The failure to renew facilities could force us to sell assets in adverse market conditions. Liquidity in debt markets, including repo and commercial paper, can be withdrawn suddenly, making it difficult or expensive to renew short-term borrowings as they mature.

To the extent the use of short-term financial leverage is or was to become critical to our business, the inability to access financial leverage through warehouse and repurchase facilities, credit facilities, commercial paper, or other forms of debt financing may inhibit our ability to execute our business plan, and our inability to access funding could have a material adverse effect on our results of operations, financial condition, and business.

Our ability to fund our business or our investment strategy may depend upon our securing warehouse, repurchase, credit, commercial paper, and other forms of debt financing (or leverage) on acceptable terms. For example, pending the securitization of a pool of mortgage loans we may fund the acquisition of mortgage loans through borrowings from warehouse, repurchase, and credit facilities, and commercial paper issuances. We can provide no assurance that we would be successful in establishing sufficient warehouse, repurchase, credit facilities, or in issuing commercial paper. In addition, because warehouse, repurchase, and credit facilities, and commercial paper are short-term in nature, the lenders may decline to renew them upon maturity or expiration, making it more difficult for us to secure continued financing. During certain periods of the credit cycle such as has been in effect recently, lenders may curtail

their willingness to provide financing. To the extent our business or investment strategy calls for us to access leverage through borrowing funds and counterparties are unable or unwilling to lend to us, then our business and results of operations will be adversely affected. Furthermore, to the extent we do employ leverage, and subsequently default or are unable to renew the facilities when they mature, we may suffer adverse consequences. In addition, it is possible that lenders who provide us with committed financing could experience changes in their ability to advance funds to us, independent of our performance or the performance of our investments, in which case funds we had planned to be able to access may not be available to us.

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Hedging activities may reduce long-term earnings, may fail to reduce earnings volatility, and may fail to protect our capital in difficult economic environments.

We attempt to hedge certain interest rate risks (and, to a lesser extent, prepayment risks) by balancing the characteristics of our assets and associated liabilities with respect to those risks and entering into various interest rate agreements. The number and scope of the interest rate agreements we utilize may vary significantly over time. We generally attempt to enter into interest rate agreements that provide an appropriate and efficient method for hedging the desired risk.

Hedging against interest rate risks using interest rate agreements and other instruments usually has the effect over time of lowering long-term earnings. To the extent that we hedge, it is usually to protect us from some of the effects of short-term interest rate volatility, to lower short-term earnings volatility, to stabilize liability costs or fair values, to stabilize our economic returns from or meet rating agency requirements with respect to a securitization transaction, or to stabilize the future cost of anticipated issuance of securities by a securitization entity. Hedging may not achieve its desired goals. Pipeline hedging for loan purchase commitments may not be effective due to loan fallout or other reasons. Using interest rate agreements as a hedge may increase short-term earnings volatility, especially if we do not elect certain accounting treatments for our hedges. Reductions in fair values of interest rate agreements may not be offset by increases in fair values of the assets or liabilities being hedged. Conversely, increases in fair values of interest rate agreements may not fully offset declines in fair values of assets or liabilities being hedged. Changes in fair values of interest rate agreements may require us to pledge significant amounts of collateral or cash.

We also may hedge by taking short, forward, or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. We may take both long and short positions in credit derivative transactions linked to real estate assets. These derivatives may have additional risks to us, such as special liquidity, basis risks, and counterparty risks.

Our quarterly earnings may be subject to fluctuations from period to period as a result of the accounting treatment for certain derivatives or for assets or liabilities that do not necessarily match those used for derivatives, or as a result of our failure to meet the requirements necessary to obtain specific hedge accounting treatment for certain derivatives.

We may enter into derivative contracts that expose us to contingent liabilities and those contingent liabilities may not appear on our balance sheet. We may invest in synthetic securities, credit default swaps, and other credit derivatives, which expose us to additional risks.

We may enter into derivative contracts that could require us to make cash payments in certain circumstances. Potential payment obligations would be contingent liabilities and may not appear on our balance sheet. Our ability to satisfy these contingent liabilities depends on the liquidity of our assets and our access to capital and cash. The need to fund these contingent liabilities could adversely impact our financial condition.

We may invest in synthetic securities, credit default swaps, and other credit derivatives that reference other real estate securities or indices. These investments may present risks in excess of those resulting from the referenced security or index. These investments are typically a contractual relationship with a counterparty and not an acquisition of a referenced security or other asset. In these types of investments, we have no right directly to enforce compliance with the terms of the referenced security or other assets and we have no voting or other consensual rights of ownership with respect to the referenced security or other assets. In the event of insolvency of a counterparty, we will be treated as a general creditor of the counterparty and will have no claim of title with respect to the referenced security.

The markets for these types of investments have, in some cases, only existed for a few years and may not be liquid. Many of these investments incorporate pay as you go credit events which have been introduced into the market fairly

Investments we make, hedging transactions that we enter into, and the manner in which we finance our investments

recently. For example, the terms of credit default swaps are still evolving and may change significantly, which could make it more difficult to assign such an instrument or determine the loss pursuant to the underlying agreement. In a credit default swap, the party wishing to buy protection will pay a premium. When interest rates change, the spreads change, or the prevailing credit premiums on credit default swaps change, the amount of the termination payment due could change by a substantial

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amount. In an illiquid market, the determination of this change could be difficult to ascertain and, as a result, we may not achieve the desired benefit of entering into this contractual relationship.

To date, we have entered into a limited number of these agreements. We may over time increase our exposure to these types of investments as the market for them grows and during times when acquiring other real estate loans and securities may be difficult. We may find credit default swaps and other forms of synthetic securities to be a more efficient method of providing credit-enhancement on specific pools of real estate loans. We will attempt to manage the risks associated with these investments including counterparty risks, but our efforts may prove to be insufficient in enabling us to generate the returns anticipated.

Our results could be adversely affected by counterparty credit risk.

We have credit risks that are generally related to the counterparties with which we do business. There is a risk that counterparties will fail to perform under their contractual arrangements with us and this risk is usually more pronounced during an economic downturn. Counterparties may seek to eliminate credit exposure by entering into offsetting, or back-to-back, hedging transactions, and the ability of a counterparty to settle a synthetic transaction may be dependent on whether the counterparties to the back-to-back transactions perform their delivery obligations. Those risks of non-performance may differ materially from the risks entailed in exchange-traded transactions, which generally are backed by clearing organization guarantees, daily mark-to-market and settlement of positions, and segregations and minimum capital requirements applicable to intermediaries. Transactions entered into directly between parties generally do not benefit from those protections, and expose the parties to the risk of counterparty default. Furthermore, there may be practical and timing problems associated with enforcing our rights to assets in the case of an insolvency of a counterparty.

In the event a counterparty to our short-term borrowings becomes insolvent, we may fail to recover the full value of our pledged collateral, thus reducing our earnings and liquidity. In the event a counterparty to our interest rate agreements, credit default swaps, or other derivatives becomes insolvent or interprets our agreements with it in a manner unfavorable to us, our ability to realize benefits from the hedge transaction may be diminished, any cash or collateral we pledged to the counterparty may be unrecoverable, and we may be forced to unwind these agreements at a loss. In the event that one of our servicers becomes insolvent or fails to perform, loan delinquencies and credit losses may increase and we may not receive the funds to which we are entitled. We attempt to diversify our counterparty exposure and (except with respect to loan representations and warranties) attempt to limit our counterparty exposure to counterparties with investment-grade credit ratings; however, we may not always be able to do so. Our counterparty risk management strategy may prove ineffective and, accordingly, our earnings and cash flows could be adversely affected.

Through certain of our wholly-owned subsidiaries, we have in the past engaged in securitization transactions relating to residential mortgage loans and other types of assets. In the future we plan to continue to engage in securitization transactions relating to residential mortgage loans and may also engage in other types of securitization transactions or similar transactions. In addition, we invest in mortgage-backed securities issued in securitization transactions sponsored by other companies. These types of transactions and investments expose us to various potentially material risks.

Engaging in securitization transactions and other similar transactions may require us to incur short-term debt, either on a recourse or non-recourse basis, to finance the accumulation of loans or other assets prior to securitization. This type of debt may not be available to us, including in circumstances where a line of credit had previously been committed to us. In addition, the terms of any available debt may be unfavorable to us or impose restrictive covenants that could limit our business and operations or the violation of which could lead to losses and inhibit our ability to borrow in the future. We expect to pledge assets we acquire to secure the short-term debt we incur. To the extent this debt is recourse to us, if the fair value of the assets pledged as collateral declines, we would be required to increase the amount of collateral pledged to secure the debt or to repay all or a portion of the debt. Furthermore, if we are unable to complete the securitization of these types of assets, we would likely need to sell the assets on unfavorable terms instead of completing the planned securitization, which typically would result in a loss. In addition, when we acquire assets for a securitization, we make assumptions about the cash flows that will be generated from those assets.

Widening ABS interest rate spreads, rising ABS yields, incorrect estimation of rating agency securitization requirements, poor hedging

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practices or results, changes in applicable law and regulations, and other factors could result in a securitization execution that is less favorable to us than initially assumed, which would typically result in a loss.

Prior to acquiring assets for securitization transactions or making other investments, we may undertake due diligence efforts with respect to various aspects of the investment. When conducting due diligence, we rely on resources and data available to us, which may be limited, and may rely on investigations by third parties. To the extent we conduct due diligence on investments, our due diligence effort may not reveal matters which could lead to investment losses. If we do not conduct adequate due diligence, or the scope of our due diligence is limited, we may incur investment losses.

When engaging in securitization transactions, we typically make representations and warranties to the securitization entities that purchase loans or other assets from us regarding, among other things, certain characteristics of those assets. If our representations and warranties are inaccurate with respect to any asset, we may be obligated to repurchase that asset, which may result in a loss. We generally obtain representations and warranties that parallel those we provide to the securitization entities from the parties from whom we acquired the loans or other assets. However, if those representations and warranties do not parallel the representations and warranties we make, or if the representations and warranties made to us are not enforceable or if we cannot collect damages for a breach (e.g., due to the financial condition of the party that made the representation or warranty to us), we may incur losses.

Loans and other assets that are held by securitization entities are serviced by third-party loan servicers. Should a servicer experience financial difficulties, it may not be able to perform these obligations or these obligations may be limited in nature, including any obligation to advance payments of amounts due from delinquent loan obligors. For example, typically a servicer's obligation to make advances on behalf of a delinquent loan obligor is limited to the extent that it does not expect to recover the advances from the ultimate disposition of the collateral pledged to secure the loan. In addition, as with any external service provider, we are subject to the risks associated with inadequate or untimely services for other reasons such as errors, miscalculations, or other reasons. In the current economic environment, many servicers are experiencing higher volumes of delinquent loans than they have in the past and, as a result, there is a risk that their operational infrastructures cannot properly process this increased volume. To the extent a third party loan servicer fails to fully perform its obligations, ABS that we hold as investments may experience losses and securitizations that we have sponsored may experience poor performance, which could harm our ability to engage in future securitization transactions. We also rely on corporate trustees to act on behalf of us and other holders of ABS in enforcing our rights as security holders. Under the terms of most ABS we hold, we do not have the right to directly enforce remedies against the issuer of the security, but instead must rely on a trustee to act on behalf of us and other security holders. Should a trustee not be required to take action under the terms of the securities, or fail to take action, we could experience losses.

Our past and future securitization activities or other past and future business activities could expose us to litigation, which may adversely affect our business and results of operations.

Through certain of our wholly-owned subsidiaries we have in the past engaged in securitization transactions relating to residential mortgage loans and other types of assets. In the future we plan to continue to engage in securitization transactions relating to residential mortgage loans and may also engage in other types of securitization transactions or similar transactions. Our Sequoia securitization entities issue ABS backed by residential mortgage loans held by these Sequoia entities. Our Acacia securitization entities issue ABS backed by securities and other assets held by these Acacia entities. As a result of declining property values, increasing defaults, and other factors, the cash flows from the loans held by the Sequoia entities and the securities and other assets held by the Acacia entities may be insufficient to

Our past and future securitization activities or other past and future business activities could expose us to litigation, 30

repay in full the principal amount of ABS issued by these securitization entities. We are not directly liable for any of the ABS issued by these entities. Nonetheless, third parties who hold the ABS issued by these entities may try to hold us liable for any losses they experience, including through claims under federal and state securities laws. For example, as discussed below in Part I, Item 3 of this Annual Report on Form 10-K, on December 23, 2009, the Federal Home Loan Bank of Seattle filed a claim in Superior Court for the State of Washington against us, our subsidiary, Sequoia Residential Funding, Inc., Morgan Stanley & Co., and Morgan Stanley Capital, Inc. The complaint relates in part to residential mortgage-backed securities, or RMBS, that were issued by a Sequoia securitization entity and alleges that, at the time of issuance, we, Sequoia Residential

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Funding, and the underwriters made various misstatements and omissions about these RMBS in violation of Washington state law. Defending a lawsuit can consume significant resources and may divert management's attention from our operations. To the extent we are unsuccessful in our defense of any lawsuit, we could suffer losses, which could be material.

Our cash balances and cash flows may be insufficient relative to our cash needs.

We need cash to meet our interest expense payments, working capital, minimum REIT dividend distribution requirements, and other needs. We may also need cash to repay any recourse short-term borrowings in the event the fair values of our assets that serve as collateral for that debt decline, the terms of short-term debt become less attractive, or for other reasons. In addition, we may need to use cash to post margin calls on various derivative instruments we enter into as the value of these derivatives change.

Our sources of cash flow are primarily the principal and interest payments on the loans and securities we own. In addition, we may generate cash flow from the sales or calls of assets, issuing debt, or raising equity. Our sources of cash may not be sufficient to satisfy our cash needs. Cash flows from principal repayments could be reduced if prepayments slow or if credit quality deteriorates. Cash flows from most of our investments in CDOs (including investments in Acacia entities) have been disrupted due to credit rating agencies downgrading securities owned by the securitization entity below certain average rating tests. For some of our assets, cash flows are locked-out and we receive less than our pro-rata share of principal payment cash flows in the early years of the investment. For some loans, borrowers have the option to make payments that are less than they would if those loans were fully amortizing over their terms.

Our minimum dividend distribution requirements could exceed our cash flows if our income as calculated for tax purposes significantly exceeds our net cash flows. This could occur when taxable income (including non-cash income such as discount amortization and interest accrued on negative amortizing loans) exceeds cash flows received. In the event that our liquidity needs exceed our access to liquidity, we may need to sell assets at an inopportune time, thus reducing our earnings. In an adverse cash flow situation, we may not be able to sell assets effectively, and our REIT status or our solvency could be threatened.

We are subject to competition and we may not compete successfully.

We are subject to competition in seeking investments and in engaging in securitization transactions. Our competitors include other mortgage REITs, Fannie Mae, Freddie Mac, banks, broker-dealers, insurance companies, and other financial institutions, as well as investment funds and other investors in real estate-related assets. In addition, other companies may be formed that will compete with us. Some of our competitors have greater resources than us and we may not be able to compete successfully with them. Furthermore, competition for investments and in engaging in securitization transactions may lead to a decrease in the opportunities and returns available to us.

Currently there are significant competitive threats to our business from governmental actions and initiatives that have already been undertaken or which may be undertaken in the future. Increases in competition from governmental actions and initiatives could have a material adverse effect on us. For example, Fannie Mae and Freddie Mac are, among other things, engaged in the business of acquiring loans and engaging in securitizations transactions. Until 2008, competition from Fannie Mae and Freddie Mac was limited to some extent due to the fact that they were statutorily prohibited from purchasing loans for single unit residences in the continental United States with a principal amount in excess of \$417,000, while much of our business had historically focused on acquiring residential loans with

a principal amount in excess of \$417,000. In February 2008, Congress passed an economic stimulus package that temporarily increased the size of certain loans these entities could purchase to up to \$729,750, if the loans were made to secure real estate purchases in certain high-cost areas, and these increases have been extended through at least 2010. In addition, in September 2008, Fannie Mae and Freddie Mac were placed into conservatorship and have become, in effect, instruments of the U.S. federal government. To the extent that laws or regulations limiting the business activities of Fannie Mae and Freddie Mac are changed, including any increases to, or extensions of, these loan size limits, the competition from these two governmental entities could increase. In addition, to the extent that property values decline while these loan size limits remain the same, it may have the same effect as an increase in this limit, as a greater percentage of loans would likely be within the size limit. Any

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increase in the loan size limit, or in the overall percentage of loans that are within the limit, allows Fannie Mae and Freddie Mac to compete against us to a greater extent than they had been able to compete previously and our business could be adversely affected. The status of Fannie Mae and Freddie Mac as government-sponsored enterprises, combined with their size, cost of funding, and other factors, make them significant competitors.

Our future success depends on our ability to attract and retain key personnel.

Our future success depends on the continued service and availability of skilled personnel, including members of our executive management team. There can be no assurance that we will be able to attract and retain key personnel.

Our business model and business strategies, and the actions we take (or fail to take) to implement them and adapt them to changing circumstances involve risk and may not be successful. Continued disruption in the mortgage securitization market may adversely affect our earnings and growth.

Due to the recent credit crisis and downturn in the U.S. housing markets and the economy, the mortgage industry and the related capital markets are undergoing significant changes, including due to the significant governmental interventions in these areas and changes to the laws and regulations that govern the banking and mortgage finance industry. Our methods of, and model for, doing business and financing our investments are changing and if we fail to develop, enhance, and implement strategies to adapt to changing conditions in the mortgage industry and capital markets, our financial condition and earnings may be adversely affected. Furthermore, changes we make to our business to respond to changing circumstances may expose us to new or different risks than we were previously exposed to and we may not effectively identify or manage those risks.

Similarly, the competitive landscape that we operate in, and the products and investments for which we compete, are also affected by changing conditions which can take the form of trends or sudden changes in our industry, regulatory environment, changes in the role of government sponsored entities, changes in the role of credit rating agencies or their rating criteria or process, or the U.S. economy more generally. If we do not effectively respond to these changes, or if our strategies to respond to these changes are not successful, our ability to effectively compete in the marketplace may be negatively impacted, which would likely result in our financial condition and earnings being adversely affected.

We have historically depended upon the issuance of mortgage-backed securities by the securitization entities we sponsor as a funding source for our business. However, due to recent market conditions, we have not engaged in additional mortgage securitization transactions since 2007. We do not know when, or if, market conditions will allow us to restart our securitization business and the continued disruption of this market may adversely affect our earnings and growth. If mortgage securitization activity does resume among market participants other than government sponsored entities, we do not know if it will be on terms and conditions that will permit us to participate or be favorable to us. Even if conditions are favorable to us, we may not be able to return to the volume of securitization activity we previously conducted.

Initiating new business activities or significantly expanding existing business activities may expose us to new risks and will increase our cost of doing business.

Initiating new business activities or significantly expanding existing business activities are two ways to grow our business and respond to changing circumstances in our industry, however, they may expose us to new risks. Furthermore our efforts may not succeed, and any revenues we earn from new or expanded business initiatives may not be sufficient to offset the initial and ongoing costs of these ventures, which would result in a loss. For example, we have a subsidiary, Redwood Asset Management, Inc., that engages in the investment advisory business. Redwood Asset Management historically was the collateral manager for the Acacia securitization entities we have sponsored, but in 2008 Redwood Asset Management expanded its business by forming and advising the Redwood Opportunity Fund, LP. Following this expansion of its activities, Redwood Asset Management registered with the SEC as an investment advisor and became subject to compliance with the laws and regulations governing SEC-registered investment advisors. Existing and new asset management activities may increase our exposure to litigation, fiduciary responsibilities, conflicts of

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interest arising from Redwood's investment activities and the activities of the entities we manage, and other risks. We cannot be certain that we will be able to manage these risks and compliance requirements effectively. Similarly efforts we are making to significantly expand our investing activity in commercial real-estate related assets and to develop new methods for acquiring residential real estate-related investment assets may expose us to new risks, may not succeed, and may not generate sufficient revenue to offset our related costs.

In connection with initiating new business activities or expanding existing business activities, or for other business reasons, we may create new subsidiaries. Generally, these subsidiaries would be wholly-owned by Redwood. The creation of those subsidiaries may increase our administrative costs and expose us to other legal and reporting obligations, including, for example because they may be incorporated in states other than Maryland or may be established in a foreign jurisdiction. Any new subsidiary we create may be designated as a taxable subsidiary. Taxable subsidiaries are wholly-owned subsidiaries of a REIT that pay corporate income tax on the income they generate. That is, a taxable subsidiary is not able to deduct its dividends paid to its parent in determining its taxable income, and any dividends paid to the parent are generally recognized as income at the parent level.

We may change our policies, procedures, practices, product lines, leverage, hedging strategies, or internal risk-adjusted capital guidelines in ways that may increase our risk exposure.

We may alter our policies, procedures, practices, product lines, leverage, internal risk-adjusted capital guidelines, and other aspects of our business. We may enter into new businesses, relationships, or partnerships or pursue acquisitions of other companies or a variety of different types of assets. These changes may increase the nature or magnitude of the risks to which we are exposed.

The purchase of residential mortgage loans in the secondary market may, in some circumstances, require us to obtain various state licenses. Similarly, certain commercial real estate lending activities that we may engage in may also require us to obtain various state licenses. There is no assurance we will be able to obtain or maintain those licenses and we may fail to comply with various state and federal laws and regulations relating to these activities.

While we are not required to obtain licenses to purchase mortgage-backed securities, the purchase of residential mortgage loans in the secondary market may, in some circumstances, require us to obtain various state licenses. Similarly, certain commercial real estate lending activities that we may engage in would also require us to obtain various state licenses. As a result, we could be delayed in conducting certain business if we were first required to obtain a state license. There is no assurance that we will be able to obtain all of the licenses we need or that we would not experience significant delays in obtaining these licenses. Furthermore, once any licenses were issued we would be required to comply with various information reporting and other regulatory requirements to maintain those licenses, and there is no assurance that we would be able to satisfy those requirements on an ongoing basis. Our failure to obtain or maintain required licenses may restrict our business and investment options and could harm our business and expose us to penalties.

With respect to mortgage loans we own, or which we have purchased and subsequently sold, we may be subject to liability for potential violations of predatory lending laws or similar laws, which could adversely impact our results of operations, financial condition, and business.

Various federal, state, and local laws have been enacted that are designed to discourage predatory lending practices. For example, the federal Home Ownership and Equity Protection Act of 1994 (HOEPA) prohibits inclusion of certain provisions in residential mortgage loans that have mortgage rates or origination costs in excess of prescribed levels and requires that borrowers be given certain disclosures prior to origination. Some states have enacted, or may enact, similar laws or regulations, which in some cases impose restrictions and requirements greater than those in HOEPA. In addition, under the anti-predatory lending laws of some states, the origination of certain residential mortgage loans, including loans that are not classified as high cost loans under applicable law, must satisfy a net tangible benefits test with respect to the borrower. This test may be highly subjective and open to interpretation. As a result, a court may determine that a residential mortgage loan did not meet the test even if the originator reasonably believed that the test had been satisfied. Failure of residential mortgage loan originators or servicers to comply with these laws, could subject us, as an assignee

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or purchaser of these loans, to monetary penalties and could result in rescission of the affected residential mortgage loans, which could adversely impact our results of operations, financial condition, and business.

We may be exposed to environmental liabilities with respect to properties to which we take title, which could adversely affect our results of operations, financial condition, and business.

In the course of our business, we may take title to real estate. If we do take title, we could be subject to environmental liabilities with respect to the property, including liability to a governmental entity or third parties for property damage, personal injury, investigation, and clean-up costs. In addition, we may be required to investigate or clean up hazardous or toxic substances, or chemical releases, at a property. The costs associated with investigation or remediation activities could be substantial. If we ever become subject to significant environmental liabilities, our results of operations, financial condition, and business could be materially and adversely affected.

Our risk management efforts may not effectively mitigate the risks we seek to manage.

We could incur substantial losses and our business operations could be disrupted if we are unable to effectively identify, manage, monitor, and mitigate financial risks, such as credit risk, interest rate risk, prepayment risk, liquidity risk, and other market-related risks, as well as operational risks related to our business, assets, and liabilities. Our risk management policies, procedures, and techniques may not be sufficient to identify all of the risks we are exposed to, mitigate the risks we have identified, or to identify additional risks to which we may become subject in the future.

Our technology infrastructure and systems are important and any significant disruption could have an adverse effect on our business.

In order to analyze, acquire, and manage our investments and manage the operations and risks associated with our business, assets, and liabilities, we rely upon computer hardware and software systems. Some of these systems are located at our office and some are maintained by third party vendors. Any significant interruption in the availability or functionality of these systems could have an adverse effect on our operations. Steps we have taken to provide for the security of our systems and data may not effectively prevent others from obtaining improper access to our systems data. Improper access could expose us to risks of data loss, litigation, and liabilities to third parties, and otherwise disrupt our operations.

Our business could be adversely affected if we have deficiencies in our disclosure controls and procedures or internal controls over financial reporting.

The design and effectiveness of our disclosure controls and procedures and internal controls over financial reporting may not prevent all errors, misstatements, or misrepresentations. While management continues to review the effectiveness of our disclosure controls and procedures and internal controls over financial reporting, there can be no assurance that our disclosure controls and procedures or internal controls over financial reporting will be effective in accomplishing all control objectives all of the time. Deficiencies, particularly material weaknesses, in internal controls over financial reporting which may occur in the future could result in misstatements of our results of operations, restatements of our financial statements, a decline in our stock price, or otherwise materially and adversely affect our

We may be exposed to environmental liabilities with respect to properties to which we take title, which could adversely

business, reputation, results of operation, financial condition, or liquidity.

Our financial results are determined and reported in accordance with accounting principles (and related conventions and interpretations) and are based on estimates and assumptions made in accordance with those principles, conventions and interpretations. Furthermore, the amount of dividends we distribute is largely driven by the determination of our income in accordance with tax accounting principles rather than generally accepted accounting principles, or GAAP. There are risks inherent in the application of these accounting principles to our business and in the differences between tax and GAAP accounting principles.

Our reported GAAP financial results differ from the taxable income results that drive our dividend distribution requirements and, therefore, our GAAP results may not be an accurate indicator of future taxable income and dividend distributions.

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Generally, the cumulative income we report on an asset will be the same for GAAP and tax purposes, although the timing of this recognition over the life of the asset could be materially different. Furthermore, there are certain permanent differences in the recognition of certain expenses under the respective accounting principles applied for GAAP and tax, and these differences could be material. Thus, the amount of GAAP earnings reported in any given period may not be indicative of future dividend distributions. A further explanation of differences between our GAAP and taxable income is presented in Management's Discussion and Analysis, which is set forth in Part II, Item 7 of this Annual Report on Form 10-K.

Our minimum dividend distribution requirements are determined under the REIT tax laws and are based on our taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. Note that our Board of Directors may also decide to distribute more than is required based on these determinations.

Since inception, we have distributed over \$1.1 billion in dividends and this exceeds our retained GAAP earnings of \$0.4 billion. One should not expect that our retained GAAP earnings will equal cumulative distributions as the Board of Directors' dividend distribution decisions, permanent differences in GAAP and tax accounting, and even temporary differences will result in material differences in these balances.

Over time, accounting principles, conventions, rules, and interpretations may change, which could affect our reported GAAP and taxable earnings, and stockholders' equity.

Accounting rules for the various aspects of our business change from time to time. Changes in GAAP, or the accepted interpretation of these accounting principles, can affect our reported income, earnings, and stockholders' equity. In addition, changes in tax accounting rules or the interpretations thereof could affect our taxable income and our dividend distribution requirements.

Redwood has elected to be a Real Estate Investment Trust (REIT) and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and operations, and exposes us to additional risks.

Failure to qualify as a REIT would adversely affect our income and dividend distributions and could adversely affect the value of our common stock.

We believe that we have met all requirements for qualification as a REIT for federal income tax purposes for all tax years since 1994 and we intend to continue to operate so as to qualify as a REIT in the future. However, many of the requirements for qualification as a REIT are highly technical and complex and require an analysis of particular facts and an application of the legal requirements to those facts in situations where there is only limited judicial and administrative guidance. Thus, no assurance can be given that the Internal Revenue Service or a court would agree with our conclusion that we have qualified as a REIT or that future changes in our factual situation or the law will allow us to remain qualified as a REIT. Furthermore, in an environment where assets are subject to rapid changes in value, previous planning for compliance with REIT qualification rules may be disrupted. If we failed to qualify as a REIT for federal income tax purposes and did not meet the requirements for statutory relief, we would be subject to federal income tax at regular corporate rates on all of our income and we could possibly be disqualified as a REIT for four years thereafter. If we were to become subject to federal income tax, we might not have at that time the liquid assets to pay the taxes due, which could result in our needing to liquidate assets at unattractive prices. Failure to qualify as a REIT would adversely affect our dividend distributions and could adversely affect the value of our common stock.

Our financial results are determined and reported in accordance with accounting principles (and related conventions)

Maintaining REIT status and avoiding the generation of excess exclusion income may reduce our flexibility and could limit our ability to pursue certain opportunities. Failure to appropriately structure our business and the transactions we enter into to comply with laws and regulations applicable to REITs could have adverse consequences.

To maintain REIT status, we must follow certain rules and meet certain tests. In doing so, our flexibility to manage our operations may be reduced. For instance:

If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a dealer, and thus subject to 100% prohibited transaction taxes or other entity-level taxes on income from such transactions.

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Compliance with the REIT income and asset rules may limit the type or extent of financing or hedging that we can undertake.

Our ability to own non-real estate related assets and earn non-real estate related income is limited. Our ability to own equity interests in other entities is limited. If we fail to comply with these limits, we may be forced to liquidate attractive assets on short notice on unfavorable terms in order to maintain our REIT status.

Our ability to invest in taxable subsidiaries is limited under the REIT rules. Maintaining compliance with this limit could require us to constrain the growth of our taxable REIT subsidiaries in the future.

Meeting minimum REIT dividend distribution requirements could reduce our liquidity. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.

A REIT is limited in its ability to earn income that is treated as compensation for services. Federal legislation has been proposed that would characterize taxable income earned in the form of a carried interest in an investment fund as compensation for services. If this legislation is enacted and does not contain a carve out for carried interests earned by REITs, we may need to restructure the way we invest in funds that we sponsor, including by having all or a portion of any carried interests held by our taxable affiliates and subject to taxation as compensation for services.

The rules we must follow and the tests we must satisfy to maintain our REIT status may change, or the interpretation of these rules and tests by the Internal Revenue Service may change. In circumstances where the application of these rules and tests to our business is not clear, we may have to interpret them and their application to us. We seek the advice of outside tax advisors in arriving at these interpretations, but our interpretations may prove to be wrong, which could have adverse consequences.

In addition, historically, our stated goal has been to not generate excess inclusion income that would be taxable as unrelated business taxable income (UBTI) to our tax-exempt stockholders. Achieving this goal has limited, and may continue to limit, our flexibility in pursuing certain transactions or has resulted in, and may continue to result in, our having to pursue these transactions through a taxable subsidiary, which reduces the net returns on these transactions by the associated tax liabilities. Despite our efforts to do so, we may not be able to avoid creating or distributing UBTI to our stockholders.

Changes in tax rules could adversely affect REITs and could adversely affect the value of our common stock.

The requirements for maintaining REIT status or the taxation of REITs could change in a manner adverse to our operations. Rules regarding the taxation of dividends are enacted from time to time and future legislative or regulatory changes may limit the tax benefits accorded to REITs, either of which may reduce some of a REIT's competitive edge relative to non-REIT corporations. For example, federal legislation enacted in 2003 generally reduced the maximum federal tax rate for dividends payable to domestic stockholders that are individuals, trusts, and estates to 15% (through 2010), however, this legislation did not, as a general matter, reduce tax rates on dividends paid by REITs. Any future adverse changes could negatively affect our business and reduce the value of our common stock.

Our decisions about raising, managing, and distributing our capital may adversely affect our business and results of operations. Furthermore, our growth may be limited if we are not able to raise additional capital.

As a REIT we are required to distribute at least 90% of our REIT taxable income. Thus, we do not generally have the ability to retain earnings and we rely on our ability to raise capital to grow. We may raise capital through the issuance of new shares of our common stock, either through our direct stock purchase and dividend reinvestment plan or through secondary offerings. We may also raise capital by issuing other types of securities, such as preferred stock or convertible subordinated notes, or by taking on short-term or long-term debt. We have less than 25 million additional

Our decisions about raising, managing, and distributing our capital may adversely affect our business and results of

shares authorized for issuance under our charter, which will limit the amount of capital we can raise through issuances of common stock unless we seek and receive

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approval from our stockholders to increase the authorized number of our shares in our charter. Also, certain stock change of ownership tests, which could impact our future use of tax losses, may limit our ability to raise significant amounts of equity capital.

In addition, we may not be able to raise capital at times when we see opportunities to employ capital. Many of the same factors that could make the pricing for investments in real estate loans and securities attractive, such as the availability of assets from distressed owners who need to liquidate them and thus may accept reduced prices, and uncertainty about credit risk, housing, and the economy, may make it difficult for us to convince investors to provide us with additional capital. There may be other reasons we are not able to raise capital and, as a result, may not be able to finance growth in our portfolios. If we are unable to raise capital and expand our portfolio of investments, our growth may be limited, we may have to forgo attractive investment opportunities, and our operating expenses may increase significantly relative to our capital base.

To the extent we have capital that is available for investment, we have broad discretion over how to invest that capital and you will be relying on the judgment of our management regarding its use. To the extent we invest capital in our business or in portfolio assets, we may not be successful in yielding favorable returns.

Conducting our business in a manner so that we are exempt from registration under and compliance with the Investment Company Act of 1940 may reduce our flexibility and could limit our ability to pursue certain opportunities. At the same time, failure to continue to qualify for exemption from the Investment Company Act could adversely affect us.

Under the Investment Company Act of 1940, as amended, an investment company is required to register with the SEC and is subject to extensive restrictive and potentially adverse regulations relating to, among other things, operating methods, management, capital structure, dividends, and transactions with affiliates. However, companies primarily engaged in the business of acquiring mortgages and other liens on and interests in real estate are exempt from the requirements of the Investment Company Act. We believe that we have conducted our business so that we are exempt from the Investment Company Act, however, in order to continue to do so we must, among other things, maintain at least 55% of our assets in certain qualifying real estate assets (the 55% Requirement) and are also required to maintain an additional 25% of our assets in such qualifying real estate assets or certain other types of real estate-related assets (the 25% Requirement). Rapid changes in the values of assets we own, however, can disrupt prior efforts to conduct our business to meet these requirements. Our efforts to comply with the 55% Requirement and the 25% Requirement may reduce our flexibility and could limit our ability to pursue certain opportunities.

If we failed to meet the 55% Requirement and the 25% Requirement, we could, among other things, be required either (i) to change the manner in which we conduct our operations to avoid being required to register as an investment company or (ii) to register as an investment company, either of which could adversely affect us by, among other things, requiring us to dispose of certain assets or to change the structure of our business in ways that we may not believe to be in the best interests of Redwood. Legislative or regulatory changes relating to the Investment Company Act or which affect our efforts to comply with the 55% Requirement and the 25% Requirement could also result in these or other adverse effects on us.

If we were deemed an unregistered investment company, we could be subject to monetary penalties and injunctive relief and we could be unable to enforce contracts with third parties and third parties could seek to obtain rescission of transactions undertaken during the period we were deemed an unregistered investment company, unless the court

found that under the circumstances, enforcement (or denial of rescission) would produce a more equitable result than no enforcement (or grant of rescission) and would not be inconsistent with the Investment Company Act.

Provisions in our charter and bylaws and provisions of Maryland law may limit a change in control or deter a takeover that might otherwise result in a premium price being paid to our stockholders for their shares in Redwood.

In order to maintain our qualifications as a REIT, not more than 50% in value of our outstanding capital stock may be owned, actually or constructively, by five or fewer individuals (defined in the Internal Revenue Code to include certain entities). In order to protect us against risk of losing our status as a REIT due to concentration of ownership among our stockholders, our charter generally prohibits any single stockholder, or

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any group of affiliated stockholders, from beneficially owning more than 9.8% of the outstanding shares of any class of our stock, unless our board of directors waives or modifies this ownership limit. This limitation may have the effect of precluding an acquisition of control of us by a third party without the consent of our board of directors. As of January 31, 2009, our board of directors has granted a waiver to one institutional shareholder to own shares in excess of this 9.8% limit, which waiver is subject to certain terms and conditions including the execution of a voting agreement. This voting agreement applies to the shares owned in excess of 9.8% and states that the excess shares shall be voted on matters in the same proportion as all other shares are voted (exclusive of the 9.8% block voted by the party to the voting agreement.) Our board of directors may amend this existing waiver to permit additional share ownership or may grant waivers to additional stockholders at any time.

Certain other provisions contained in our charter and bylaws and in the Maryland General Corporation Law (MGCL) may have the effect of discouraging a third-party from making an acquisition proposal for us and may therefore inhibit a change in control. For example, our charter includes provisions granting our board of directors the authority to issue preferred stock from time to time and to establish the terms, preferences and rights of the preferred stock without the approval of our stockholders. In addition, provisions in our charter and the MGCL restrict our stockholders' ability to remove directors and fill vacancies on our board of directors and restrict unsolicited share acquisitions. Our charter provides that our board of directors is divided into three classes serving staggered terms of office of three years each, and thus at least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of our directors. These provisions and others may deter offers to acquire our stock or large blocks of our stock upon terms attractive to our stockholders, thereby limiting the opportunity for stockholders to receive a premium for their shares over then-prevailing market prices.

The ability to take action against our directors and officers is limited by our charter and bylaws and provisions of Maryland law and we may (or, in some cases, are obligated to) indemnify our current and former directors and officers against certain losses relating to their service to us.

Our charter limits the liability of our directors and officers to us and to shareholders for money damages to the fullest extent permitted by Maryland law. In addition, our charter authorizes our board of directors to indemnify our officers and directors (and those of our subsidiaries or affiliates) for losses relating to their service to us to the full extent required or permitted by Maryland law. Our bylaws require us to indemnify our officers and directors (and those of our subsidiaries and affiliates) to the maximum extent permitted by Maryland law, in the defense of any proceeding to which he or she is made, or threatened to be made, a party because of his or her service to us. In addition, we have entered into, and may in the future enter into, indemnification agreements with our directors and certain of our officers and the directors and certain of the officers of certain of our subsidiaries and affiliates which obligate us to indemnify them against certain losses relating to their service to us and the related costs of defense.

Investing in our common stock may involve a high degree of risk. Investors in our common stock may experience losses, volatility, and poor liquidity, and we may reduce our dividends in a variety of circumstances.

An investment in our common stock may involve a high degree of risk, particularly when compared to other types of investments. Risks related to the economy, the financial markets, our industry, our investing activity, our other business activities, our financial results, the amount of dividends we distribute, the manner in which we conduct our business, and the way we have structured and limited our operations could result in a reduction in, or the elimination of, the value of our common stock. The level of risk associated with an investment in our common stock may not be

suitable for the risk tolerance of many investors. Investors may experience volatile returns and material losses. In addition, the trading volume of our common stock (*i.e.*, its liquidity) may be insufficient to allow investors to sell their common stock when they want to or at a price they consider reasonable.

Our earnings, cash flows, book value, and dividends can be volatile and difficult to predict. Investors in our common stock should not rely on our estimates, projections, or predictions, or on management's beliefs about future events. In particular, the sustainability of our earnings and our cash flows will depend on numerous factors, including our level of investment activity, the returns we earn, the amount and timing of

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credit losses, prepayments, the expense of running our business, and other factors, including risk factors described herein. As a consequence, although we seek to pay a regular common stock dividend rate that is sustainable, we may reduce our regular dividend rate, or stop paying dividends, in the future for a variety of reasons. We may not provide public warnings of dividend reductions prior to their occurrence. Although we have paid special dividends in the past, we did not pay a special dividend in 2008 or 2009 and may not do so in the future. Changes to the amount of dividends we distribute may result in a reduction in the value of our common stock.

A limited number of institutional shareholders own a significant percentage of our common stock, which could have adverse consequences to other holders of our common stock.

As of December 31, 2009, we believe that three institutional shareholders each owned in excess of 5% of our outstanding common stock and that, overall, 25 institutional shareholders owned, in the aggregate, approximately 60% of our outstanding common stock. Furthermore, one or more of these investors or other investors could significantly increase their ownership of our common stock. Significant ownership stakes held by these individual institutions or other investors could have adverse consequences for other stockholders because each of these stockholders will have a significant influence over the outcome of matters submitted to a vote of our stockholders, including the election of our directors and transactions involving a change in control. In addition, should any of these significant shareholders determine to liquidate all or a significant portion of their holdings of our common stock, it could have an adverse effect on the market price of our common stock.

Although under our charter stockholders are generally precluded from beneficially owning more than 9.8% of our outstanding common stock, we have granted a limited waiver of this restriction to one institutional shareholder. Under the terms of that waiver, for so long as George E. Bull, III remains as our chief executive officer or as a member of our Board of Directors, the number of shares of our common stock that institutional shareholder beneficially owns in excess of 9.8% of our outstanding common stock will be voted on all matters in the same proportion as the votes cast on such matters by all stockholders, excluding, in each case, the votes cast by that institutional shareholder. As a result, if Mr. Bull ceased to serve as our chief executive officer and ceased to serve as a member of our Board of Directors, that institutional shareholder would be able to vote all shares it beneficially owned, potentially increasing its ability to influence the outcome of matters submitted to a vote of our stockholders. We may amend this agreement or enter into other agreements with other shareholders in the future, in each case in a manner which may allow for increases in the concentration of the ownership of our common stock held by one or more stockholders.

Future sales of our common stock by us or by our officers and directors may have adverse consequences for investors.

We may issue additional shares of common stock in subsequent public offerings or private placements. In addition, we may issue additional shares of common stock to participants in our direct stock purchase and dividend reinvestment plan and to our directors, officers, and employees under our employee stock purchase plan and our incentive plan, including upon the exercise of, or in respect of, distributions on equity awards previously granted thereunder. We are not required to offer any such shares to existing stockholders on a preemptive basis. Therefore, it may not be possible for existing stockholders to participate in future share issuances, which may dilute existing stockholders' interests in us. In addition, if market participants buy shares in issuances by us in the future, it may reduce or eliminate any purchases of our common stock they might otherwise make in the open market, which in turn could have the effect of reducing the volume of shares of our common stock traded in the marketplace, which could have the effect of reducing the market price and liquidity of our common stock.

A limited number of institutional shareholders own a significant percentage of our common stock, which could have

Our current directors and executive officers beneficially own, in the aggregate, approximately 2% of our common stock. Sales of shares of our common stock by certain of these individuals are required to be publicly reported and are tracked by many market participants as a factor in making their own investment decisions. As a result, future sales by these individuals could negatively affect the market price of our common stock.

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There is a risk that you may not receive dividend distributions or that dividend distributions may decrease over time. Changes in the dividend distributions we pay may adversely affect the market price of our common stock.

Our dividend distributions are driven by a variety of factors, including our minimum dividend distribution requirements under the REIT tax laws and our REIT taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. We generally intend to distribute to our stockholders at least 90% of our REIT taxable income, although our reported financial results for GAAP purposes may differ materially from our REIT taxable income.

For 2009, we reduced our regular dividend to a rate of \$0.25 per share per quarter and in November 2009 our Board of Directors announced its intention to continue to pay regular dividends during 2010 at rate of \$0.25 per share per quarter. Our ability to pay a dividend of \$0.25 per share per quarter in 2010 may be adversely affected by a number of factors, including the risk factors described herein. These same factors may affect our ability to pay other future dividends. In addition, to the extent we determine that future dividends would represent a return of capital to investors, rather than the distribution of income, we may determine to discontinue dividend payments until such time that dividends would again represent a distribution of income. Any reduction or elimination of our payment of dividend distributions would not only reduce the amount of dividends you would receive as a holder of our common stock, but could also have the effect of reducing the market price of our common stock.

The market price of our common stock could be negatively affected by various factors, including broad market fluctuations.

The market price of our common stock may be negatively affected by various factors, which change from time to time. Some of these factors are:

Our actual or anticipated financial condition, performance, and prospects and those of our competitors.

The market for similar securities issued by other REITs and other competitors of ours.

Changes in recommendations or in estimated financial results published by securities analysts who provide research to the marketplace on us, our competitors, or our industry.

General economic and financial market conditions, including, among other things, actual and projected interest rates, prepayments, and credit performance and the markets for the types of assets we hold or invest in.

Proposals to significantly change the manner in which financial markets, financial institutions, and related industries, or financial products are regulated under applicable law, or the enactment of such proposals into law or regulation.

Other events or circumstances which undermine confidence in the financial markets or otherwise have a broad impact on financial markets, such as the sudden instability or collapse of large financial institutions or other significant corporations (whether due to fraud or other factors), terrorist attacks, natural or man-made disasters, or threatened or actual armed conflicts.

Furthermore, these fluctuations do not always relate directly to the financial performance of the companies whose stock prices may be affected. As a result of these and other factors, investors who own our common stock could experience a decrease in the value of their investment, including decreases unrelated to our financial results or prospects.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Redwood has two leases for its principal executive and administrative offices located at One Belvedere Place, Mill Valley, California 94941. One lease expires in 2013 and the second lease expires in 2018. The 2010 rent obligation for these leases is \$1.7 million. Additionally, Redwood also has one lease for administrative offices at 245 Park Ave., 24th Floor, New York, NY 10167, which expires in 2010. The 2010 rent obligation for this lease is \$0.1 million.

ITEM 3. LEGAL PROCEEDINGS

On December 23, 2009, the Federal Home Loan Bank of Seattle filed a claim in Superior Court for the State of Washington against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc., Morgan Stanley & Co., and Morgan Stanley Capital, Inc. The complaint relates in part to residential mortgage-backed securities, or RMBS, that were issued by a securitization trust with respect to which Sequoia Residential Funding, Inc. was the depositor. Those RMBS were sold to the Federal Home Loan Bank of Seattle in September 2005 by the underwriters of those RMBS, which included Morgan Stanley and Banc of America Securities. The RMBS purchased by the Federal Home Loan Bank of Seattle have a coupon rate of LIBOR plus 0.22% and represent the super senior interest in the pool 1 mortgage loans included in the Sequoia Mortgage Trust 2005-4 securitization (CUSIP No. 81744FHV2).

The Federal Home Loan Bank of Seattle alleges that, at the time of issuance, Redwood Trust, Sequoia Residential Funding, and the underwriters made various misstatements and omissions about these RMBS in violation of Washington state law. The Federal Home Loan Bank of Seattle seeks, under Washington law, to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys' fees and costs. We believe that the Federal Home Loan Bank of Seattle's claims are without merit and intend to defend the action vigorously.

The RMBS purchased by the Federal Home Loan Bank of Seattle, as well as the loans in pool 1 of the Sequoia Mortgage Trust 2005-4 securitization, have not experienced principal losses to date. Since the time of issuance, all interest on these RMBS has been paid in full when due, and, as of December 31, 2009, approximately \$101 million of the \$133.5 million original principal amount has been repaid in accordance with the terms of these securities. In addition, as of December 31, 2009, only 3 of the loans in pool 1 were 60 or more days delinquent or in bankruptcy (representing approximately 11% of the remaining principal amount in that pool), and subordinated tranches of securities issued by the securitization trust are available to absorb the first 21% of any principal losses experienced by the loans remaining in pool 1 as of December 31, 2009. Based on the characteristics of the residential mortgage loans in pool 1 and the credit support provided to these super senior RMBS from subordinated tranches, we currently expect that all remaining principal and interest payments that will become due in the future on the RMBS purchased by the Federal Home Loan Bank of Seattle will be paid in full when due.

The outcome of this matter cannot be determined at this time, and the results cannot be predicted with certainty. There can be no assurance that this matter will not have a material adverse effect on the Company's results of operations in any future period, and any loss and expense related to this litigation could have a material adverse impact on the Company's consolidated statements of financial condition, operations, and cash flows. The Company may in the future become involved in additional litigation in the ordinary course of its business, including litigation that could be

The market price of our common stock could be negatively affected by various factors, including broad market fluctu

material to the Company's business.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of our fiscal year ended December 31, 2009.

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RELATED STOCKHOLDER MATTERS, AND ISSUER
PURCHASES OF EQUITY SECURITIES**

Our common stock is listed and traded on the NYSE under the symbol RWT. As of February 24, 2010, our common stock was held by approximately 1,228 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 24,985. As of February 24, 2010, there were 77,743,821 shares of common stock outstanding.

The closing high and low sales prices of shares of our common stock, as reported by the Bloomberg Financial Markets service, and the cash dividends declared on our common stock for each full quarterly period during 2009 and 2008 were as follows:

	Stock Prices		Common Dividends Declared			
	High	Low	Record Date	Payable Date	Per Share	Dividend Type
Year Ended December 31, 2009						
Fourth Quarter	\$ 15.94	\$ 13.40	12/31/2009	1/21/2010	\$ 0.25	Regular
Third Quarter	\$ 18.48	\$ 14.25	9/30/2009	10/21/2009	\$ 0.25	Regular
Second Quarter	\$ 18.54	\$ 13.84	6/30/2009	7/21/2009	\$ 0.25	Regular
First Quarter	\$ 17.80	\$ 10.76	3/31/2009	4/21/2009	\$ 0.25	Regular
Year Ended December 31, 2008						
Fourth Quarter	\$ 21.52	\$ 9.78	12/31/2008	1/21/2009	\$ 0.75	Regular
Third Quarter	\$ 27.70	\$ 17.93	9/30/2008	10/21/2008	\$ 0.75	Regular
Second Quarter	\$ 41.00	\$ 22.79	6/30/2008	7/21/2008	\$ 0.75	Regular
First Quarter	\$ 45.63	\$ 28.49	3/31/2008	4/21/2008	\$ 0.75	Regular

All dividend distributions are made with the authorization of the board of directors at its discretion and will depend on such items as our REIT taxable earnings, financial condition, maintenance of REIT status, and other factors that the board of directors may deem relevant from time to time. The holders of our common stock share proportionally on a per share basis in all declared dividends on common stock. We intend to distribute to our stockholders as dividends at least 90% of our REIT taxable income. For 2009, we estimate a taxable loss and, as a result, 2009 our dividends are characterized as a return of capital.

We announced a new stock repurchase plan on November 5, 2007 for the repurchase of up to a total of 5,000,000 shares. This plan replaces all previous share repurchase plans and has no expiration date. The following table contains information on the shares of our common stock that we purchased during the year ended December 31, 2009.

Total Number of Shares Purchased	Average Price per Share Paid	Total Number of Shares Purchased as Part of	Maximum Number (or Approximate Dollar Value) of
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				Publicly Announced Plans or Programs	Shares that May Yet be Purchased Under the Plans or Programs
January 1, 2009	January 31, 2009	2,642	(1) \$ 14.91		4,658,344
February 1, 2009	February 28, 2009	1,149	(2)		4,658,344
March 1, 2009	June 30, 2009				4,658,344
July 1, 2009	July 30, 2009	121	(3) 14.76		4,658,344
August 1, 2009	August 31, 2009	1,074	(4) 4.57	273	4,658,071
September 1, 2009	September 30, 2009	268	(5)		4,658,071
October 1, 2009	October 30, 2009	645	(6) 5.84		4,658,071
November 1, 2009	December 31, 2009				4,658,071
Total		5,899	\$ 5.84	273	4,658,071

(1) The 2,642 shares repurchased in January 2009 represent shares reacquired to satisfy tax withholding requirements on the vesting of stock awards.

(2) The 1,149 shares repurchased in February 2009 were reacquired at no cost upon forfeiture of unvested stock options.

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(3) The 121 shares repurchased during July 2009 represent shares reacquired to satisfy tax withholding requirements on the vesting of restricted shares.

(4) Of the 1,074 shares repurchased in August 2009, (i) 273 shares were repurchased for a price of \$17.99 per share as part of an effort to repurchase fractional shares held by participants in our dividend reinvestment plan who held less than one share and (ii) 801 shares were reacquired at no cost upon forfeiture of unvested restricted stock.

(5) The 268 shares repurchased in September 2009 were reacquired at no cost upon forfeiture of unvested restricted stock.

(6) Of the 645 shares repurchased in October 2009, (i) 243 represent shares reacquired to satisfy tax withholding requirements on the vesting of stock awards, and (ii) 402 represent shares reacquired at no cost upon forfeiture of unvested stock awards.

The following table provides information, as of December 31, 2009, with respect to compensation plans under which equity securities of the registrant are authorized for issuance.

Plan Category	Plan Name	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance ⁽³⁾
Equity compensation plan approved by security holders	2002 Incentive Plan	2,208,399 ⁽¹⁾	\$50.2469 ⁽²⁾	783,911
Equity compensation plan approved by security holders	2002 Employee Stock Purchase Plan			107,521
Total		2,208,399 ⁽¹⁾	\$50.2469 ⁽²⁾	891,432

(1) As of December 31, 2009, 1,708,326 shares of common stock may be issued pursuant to outstanding deferred stock units and 500,073 shares of common stock may be issued pursuant to outstanding options to purchase common stock.

(2) As of December 31, 2009, the weighted-average exercise price of outstanding options to purchase common stock was \$50.25. Under our 2002 Incentive Plan no exercise price is applicable to deferred stock units.

(3) Number of securities remaining available for future issuance does not reflect the awards made under the 2002 Incentive Plan since December 31, 2009 and does not include issuance of shares of common stock under the 2002 Employee Stock Purchase Plan since December 31, 2009.

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The following graph presents a total return comparison of our common stock, over the last five years, to the S&P Composite-500 Stock Index and the National Association of Real Estate Investment Trusts, Inc. (NAREIT) Mortgage REIT index. The total returns reflect stock price appreciation and the reinvestment of dividends for our common stock and for each of the comparative indices. The information has been obtained from sources believed to be reliable; but neither its accuracy nor its completeness is guaranteed. The total return performance shown on the graph is not necessarily indicative of future performance of our common stock.

Five Year Total Return Comparison December 31, 2004 through December 31, 2009

	2004	2005	2006	2007	2008	2009
Redwood Trust, Inc	100.00	75.29	118.16	79.76	39.69	41.07
S&P Composite-500 Index	100.00	104.91	121.48	128.15	80.74	102.11
NAREIT Mortgage REIT Index	100.00	69.13	80.40	46.69	32.03	40.71

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The following selected financial data for 2009, 2008, 2007, 2006, and 2005 is qualified in its entirety by, and should be read in conjunction with, the more detailed information contained in the Consolidated Financial Statements and Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K and in our Annual Reports on Form 10-K for each of the years ended December 31, 2008, 2007, 2006 and 2005. Certain amounts for prior periods have been reclassified to conform to the 2009 presentation.

(In Thousands, Except Per Share Data)	2009	2008	2007	2006	2005
Selected Statement of Operations Data:					
Interest income	\$287,877	\$567,545	\$868,348	\$884,801	\$961,766
Interest expense	(132,003)	(416,669)	(651,762)	(701,704)	(757,270)
Net interest income	155,874	150,876	216,586	183,097	204,496
(Provision for) reversal of loan losses	(49,573)	(55,111)	(12,808)	359	431
Market valuation adjustments, net	(87,628)	(492,902)	(1,261,449)	(12,586)	(5,031)
Net interest income (loss) after provision and market valuation adjustments	18,673	(397,137)	(1,057,671)	170,870	199,896
Operating expenses	(46,995)	(60,906)	(58,555)	(55,925)	(48,382)
Realized gains, net	63,166	8,511	12,781	22,557	65,879
Benefit from (provision for) income taxes	4,268	3,210	(5,192)	(9,970)	(17,521)
Net income (loss)	39,112	(446,322)	(1,108,637)	127,532	199,872
Less: Net loss attributable to noncontrolling interest	(83)	(1,936)			
Net Income (Loss) Attributable to Redwood Trust, Inc.	\$39,195	\$(444,386)	\$(1,108,637)	\$127,532	\$199,872
Average common shares basic	68,458,009	33,022,622	27,928,234	25,718,435	24,637,016
Earnings (loss) per share basic	\$0.56	\$(13.46)	\$(39.70)	\$4.96	\$8.11
Average common shares diluted	68,990,891	33,022,622	27,928,234	26,313,826	25,121,467
Earnings (loss) per share diluted	\$0.55	\$(13.46)	\$(39.70)	\$4.85	\$7.96
Regular dividends declared per common share	\$1.00	\$3.00	\$3.00	\$2.80	\$2.80
Special dividends declared per common share	\$	\$	\$2.00	\$3.00	\$3.00
Total dividends declared per common share	\$1.00	\$3.00	\$5.00	\$5.80	\$5.80
Selected Balance Sheet Data:					
Earning assets	\$5,090,188	\$5,436,184	\$9,695,240	\$12,752,890	\$16,529,286
Total assets	\$5,252,650	\$5,581,749	\$9,938,472	\$13,030,473	\$16,776,960
Short-term debt	\$	\$	\$7,561	\$1,856,208	\$169,707

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Asset-backed securities issued	\$3,942,529	\$4,855,058	\$10,329,279	\$9,979,224	\$15,585,277
Long-term debt	\$140,000	\$150,000	\$150,000	\$100,000	
Total liabilities	\$4,263,559	\$5,257,286	\$10,656,751	\$12,027,783	\$15,842,000
Noncontrolling interest	\$17,370	\$22,611	\$	\$	\$
Total stockholders equity (deficit)	\$971,721	\$301,852	\$(718,279)	\$1,002,690	\$934,960
Number of common shares outstanding	77,737,130	33,470,557	32,385,073	26,733,460	25,132,625
Book value per common share	\$12.50	\$9.02	\$(22.18)	\$37.51	\$37.20
Other Selected Data:					
Average assets	\$5,310,825	\$8,026,050	\$12,177,451	\$14,123,151	\$21,797,922
Average debt and ABS issued outstanding	\$4,461,745	\$7,386,690	\$11,322,898	\$12,996,244	\$20,710,057
Average stockholders equity	\$729,032	\$556,354	\$723,807	\$988,495	\$970,269
Net income/average stockholders equity	5.4	% (79.9)%	(153.2)%	12.9	% 20.6 %

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Our Business

Redwood is a financial institution focused on investing in, financing, and managing residential and commercial real estate loans and securities. Our primary source of income consists of interest we earn from our real estate investments less the expenses we incur on our borrowed funds and other liabilities. Our real estate investments primarily include investments in residential and commercial loans and securities, an investment in a private fund that we sponsor Redwood Opportunity Fund, LP (the Fund) and investments in the securitization entities that we sponsor Sequoia entities and Acacia entities (which we may collectively refer to as Sequoia and Acacia, respectively). For financial reporting purposes, we are generally required to consolidate these entities' assets, liabilities, and any noncontrolling interests. We also have investment exposure to real estate-related credit risk through investments in financial instruments other than loans and securities.

A long-term focus of ours is to invest in mortgage-backed securities that have concentrated structural credit risk. We refer to these securities as subordinate securities as they are generally the first securities to incur credit losses within a securitization structure. More recently, we have been actively investing in senior mortgage-backed securities, which have less concentrated credit risk and are generally the first securities to receive cash flows within a securitization structure.

The Fund and securitization entities that we sponsor also invest in real estate assets. Assets held at the Fund include senior securities backed by non-prime residential and collateralized debt obligations (CDO) collateral, which were funded through the sale of limited partnership interests to us and to third party investors. The offer and sale of these interests were privately placed and were not registered under the federal securities laws in reliance on an exemption from registration. Assets held at the Sequoia entities primarily include residential real estate loans, which are funded through the issuance of ABS to us and to third party investors. Assets held at the Acacia entities primarily include real estate securities, and some loans and other mortgage related investments, which are funded through the issuance of ABS and equity to us and to third party investors.

We assume a range of risks when investing and the level of risk is influenced by the manner in which we finance our purchases of, and derive income from, our investments. Our investments in senior and subordinate securities are financed with equity and long-term debt, although we may use short-term debt financing to acquire securities and loans or for other purposes from time to time. Our investments in the Fund and consolidated securitization entities are financed with equity and long-term debt. Our capital at risk is limited to our investment in each entity as they are independent of Redwood and of each other and the assets and liabilities are not owned by and are not obligations of Redwood.

Recent Developments

All in all, we feel reasonably good about our operational and financial performance over the quarter and year ended December 31, 2009. It was a challenging year not only for Redwood but also for almost all mortgage industry participants, some of whom did not survive. In early 2009 we were in the midst of a multifaceted economic downturn, the worst since the Great Depression, and we expressed confidence that our strong balance sheet and other factors would enable us to prosper in that environment and build our franchise in the months and years ahead. Redwood not only survived, but capitalized on excellent investment opportunities that enabled us to increase our book value and

earnings, and end the year with good momentum going into 2010.

We made this happen by completing two successful common stock offerings during a period of great uncertainty earlier in the year. Amidst the panic and fear of systemic collapse, we indicated that we were excited by residential mortgage-backed securities (RMBS) valuations that offered us the chance to make investments in senior residential securities at attractive rates of return.

We were able to invest a substantial amount in these types of investment opportunities early in the year when prices in deeply discounted residential securities were most attractive. Our initial capital raise attracted many competitors to the market, which, combined with unprecedented government intervention into the

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financial markets to restore liquidity and confidence, drove asset prices substantially higher, particularly in the second half of the year. Looking back, we feel we made the right call, made it early, and took advantage of an investment opportunity that continues to work out well for our shareholders.

We ended 2009 in a better financial position than we began, with a stronger balance sheet, more liquidity, no short-term recourse debt, and a considerably larger investment portfolio, and well positioned to take advantage of new investment opportunities. Prices for senior RMBS moved up sharply and steadily from March through December 2009. Contributing factors included a massive shift in liquidity toward fixed income investments, a collapse of risk premiums, and the re-introduction of leverage to enhance yields. Senior RMBS prices continued to rally early in 2010 driven by steady inflows into bond funds as shown in the following chart.

Senior RMBS Prices

Source: JPMorgan Chase

With RMBS prices elevated and yields generally less attractive, our investment pace has slowed from \$246 million in the third quarter of 2009 to \$68 million in the fourth quarter of 2009, and to \$74 million in the first quarter through February 15, 2010. While we are long-term investors at our core, we have taken the rally in prices as an opportunity to cull through our portfolio to sell certain securities. In fact, we sold \$58 million of RMBS in the fourth quarter and \$103 million in the first quarter through February 15, 2010. All first quarter sales were at prices above our year-end marks.

We are acutely aware that we need to put our excess cash to work at appropriate risk and return levels. However, our approach to investing remains the same. Managing our capital and identifying opportunities is an ongoing process rooted in fundamental analysis of cash flow. We continue to believe that patience (both on your part and ours) will ultimately be rewarded. As we said at the end of the third quarter of 2009, and as we have all observed in recent years, it is far more important to get it right than to do it fast and we have a plan for how to get it right. In our view, the world of investing is still a dangerous place and our mortgage capital markets professionals as capable and experienced as any in the business are well positioned to capitalize on market moving events as they arise.

Residential Sector

As the U.S. economy exits the Great Recession, there is much uncertainty about the potential pace of expansion. The economy appears to have benefited more in the past few quarters from inventory accumulation and government stimulus than from other more sustainable contributors to growth. Concerns about future growth stem partly from the risk of higher rates when the Federal Reserve ends its 0% rate policy and the soaring U.S. budget deficit, which is now projected to be \$1.6 trillion, or 10.6% of gross domestic product, for fiscal 2010.

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The expected end of the Federal Reserve's agency MBS purchase program could reverse recent gains in home affordability by pushing mortgage rates higher. Many are speculating that mortgage rates could rise by 25 to 75 basis points in 2010. Also, the unemployment rate remains stubbornly high at 9.7%, with few economists projecting material improvement this year. The prospect of lingering high unemployment remains a concern for housing as the unemployed, underemployed, and those worried about becoming unemployed will be less inclined to buy a house.

And, as is all-too-painfully obvious, high unemployment continues to fuel record defaults and foreclosures.

Perhaps the most disturbing challenge facing housing is the enormous backlog of unsold homes—including those explicitly listed for sale and those not listed but waiting in the shadows. This shadow inventory is fueled by lenders who are delaying the listing of foreclosed properties to avoid significant further write-downs, as well as homeowners trying to hang on until a recovery takes hold. We believe that excess housing supply is prolonging the instability in home prices.

Fannie Mae and Freddie Mac remain in conservatorship, with no blueprints for their future and no clear exit strategy for the government. To date, taxpayers have injected about \$111 billion into these companies and the Treasury Department has committed unlimited financial support for the next three years. Because they are no longer viable businesses, Fannie Mae and Freddie Mac have become tools for implementing the government's goal of supporting housing and helping three-to-four million homeowners avoid foreclosure by refinancing high loan-to-value mortgages and implementing loan modifications. The Federal Housing Administration (FHA) is another instrument of the government that is focused on keeping housing affordable, but it is operating below its required minimum capital level and may ultimately need direct support from the Treasury Department. Combined, these three entities are currently supporting over 90% of the \$11 trillion mortgage market and have on- and off-balance sheet obligations of over \$6 trillion, which is staggering, particularly when compared to the \$7.5 trillion national debt.

The current path for Fannie Mae, Freddie Mac, and the FHA is clearly not sustainable over the long run. Reform is inevitable, it is just a question of when. Unfortunately, our best guess is that this issue will not be addressed until at least 2011, as health care and financial regulatory reform remain on center stage in 2010. If there is anything encouraging to be taken away from this, it is that when we meet with many of the key folks in Washington who are grappling with this situation, they resoundingly agree that the government needs private market participants to step up, and that is exactly what we are working to do.

After being frozen shut, there is progress with re-starting the private residential mortgage securitization market. Private mortgage securitization still makes monumental financial sense, as banks and taxpayers need relief from the massive burden of financing nearly all of the loans in America. Private institutional investors such as mutual funds with trillions of dollars are ready to provide funding for housing. Securitization will bring their money to the table as the majority of institutional investors are required to invest in mortgage securities and not whole loans. To that end, major banks, AAA-investors, the credit rating agencies, the government, industry groups and, of course, Redwood are motivated and taking action to make private securitization a reality.

We have been working with institutional investors to restore their confidence in the securitization process, with a special focus on the private capital providers that invest in AAA-rated RMBS. These buyers typically fund 90% or more of a residential loan and thus drive the math that makes securitization work as a financing vehicle. Not surprisingly, the process has centered on the basic fundamentals—it starts with high quality prime jumbo loans (based on sound underwriting and with meaningful borrower down payments), transparency in disclosures, appropriate credit subordination levels, and enforceable representations and warranties. To that end, we were engaged throughout 2009 and continue to be actively involved in various discussions with policy makers and regulators to improve the mortgage securitization process in ways that rebuild investor confidence and attract private capital. For example, there is a critical need to separate origination risk (the risk that a loan is not what it is represented to be) from credit risk.

Redwood's business model is to invest in and manage credit risk, so we and other private investors want protection from origination risk as we re-enter the market. We are also working closely with credit rating agencies to model a safer and more straightforward securitization structure that will promote investor and public confidence in a time of higher scrutiny and uncertainty.

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If the credit markets remain stable, our best guess is that securitizations may return during the first half of 2010, although it will take longer for a sustainable securitization market to develop. But we are not over the finish line yet.

For securitization to return, a few hurdles still remain. First, some further tightening of AAA credit spreads is necessary. It will be problematic if volatility and uncertainty creep back into the fixed income markets and AAA credit spreads widen. Second, the rating agencies are still working out the kinks in their revised processes for establishing subordination levels and evaluating originators. It would also be problematic if rating agency subordination levels come out so high that they would render a securitization uneconomic. Third, the definition of skin-in-the-game (i.e., how much risk must be retained by loan originators or securitization sponsors) needs to be set. Currently, there are three proposals emanating from the House, the Senate, and the FDIC. We certainly agree with the concept, but not with any of the proposals, as they are fixated on absolute percentages, rather than on ownership requirements proportionate to the risk inherent in the underlying collateral.

Commercial Sector

Last quarter we announced new commercial leadership and the expansion of our commercial real estate platform. Over the last quarter we continued to strengthen our internal resources by adding two new managing directors to the team. The commercial team now includes six investment professionals who have an average of over 20 years of experience in sourcing, originating, and evaluating credit for commercial mortgage investments. Collectively, our commercial group has been responsible for transacting more than \$50 billion in commercial mortgage investments over the course of their careers. The deep experience of our team will serve us well in both sourcing appropriate investments and avoiding unnecessary risks.

Looking forward, we expect the commercial sector to face significant challenges for several years but also provide selected opportunities. There are substantial debt maturities occurring over the next few years and limited capital available from traditional sources to refinance these obligations. With declining property valuations and more conservative underwriting, a significant funding gap is developing between maturing loan balances and the amount that traditional first mortgage lenders are willing to advance. This gap is creating opportunities for Redwood to invest in junior positions alongside leading insurance companies and banks as we focus on building an origination platform and portfolio of attractive high-quality, long-term, stabilized subordinate debt and mezzanine investments that are well suited to our balance sheet structure. What matters most to us is whether commercial valuations, loan underwriting, and structures, reflect our outlook in which case they could offer attractive opportunities to investors like Redwood who carefully target their borrowers, properties, and lending partners.

Outlook

We believe that Redwood has built a business that could not only survive the turmoil of 2007 through 2009, but also enters 2010 well positioned to capitalize on future opportunities. We start 2010 from strength with ample liquidity and a strong balance sheet. At a time of significant market uncertainty and in anticipation of the eventual return of private residential mortgage securitization, we could not be happier with our competitive position. We have been hard at work with our business partners over the past several months on initiatives related to our core business of credit enhancing prime jumbo mortgage loans. In addition, we now have the right team in place in the commercial sector to put capital to work in a highly capital constrained market by investing in loans on attractive properties located in good markets made to high-quality borrowers.

We also believe we have the right corporate structure to compete efficiently, while many of our competitors are faced with the likelihood of increased regulation and restrictions on their business activities. We have the capital, and we believe we have the means, if needed, to access additional capital, to fund investment opportunities as they arise.

Further, our business operations are not subject to bank regulations, enabling us to freely execute on a wide range of opportunities. Equally important, these competitive advantages give Redwood a seat at the table with potential partners as we pursue investment opportunities going forward. It may take us a few quarters, but we believe we will find attractive opportunities in our residential and commercial businesses to fully invest our excess cash.

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Summary of Results of Operations, Financial Condition, Capital Resources and Liquidity

Our reported GAAP net income was \$40 million (\$0.51 per share) for the fourth quarter of 2009, as compared to a GAAP net loss of \$116 million (\$3.46 per share) for the fourth quarter of 2008. Our GAAP book value per common share was \$12.50 at December 31, 2009, a 39% increase from \$9.02 at December 31, 2008. We declared a regular dividend of \$0.25 per share for the fourth quarter of 2009 and \$0.75 per share for the fourth quarter of 2008.

The following table presents the components of our GAAP net income (loss) for the quarters and years ended December 31, 2009 and 2008.

Table 1 Net Income

(In Thousands, Except Share Data)	Quarter Ended December 31,		Year Ended December 31,	
	2009	2008	2009	2008
Interest income	\$61,796	\$123,288	\$287,877	\$567,545
Interest expense	(20,573)	(99,708)	(132,003)	(416,669)
Net interest income	41,223	23,580	155,874	150,876
Provision for loan losses	(8,997)	(18,659)	(49,573)	(55,111)
Market valuation adjustments, net	(4,190)	(111,331)	(87,628)	(492,902)
Net interest income (loss) after provision and market valuation adjustments	28,036	(106,410)	18,673	(397,137)
Operating expenses	(10,835)	(13,452)	(46,995)	(60,906)
Realized gains, net	19,618	5,823	63,166	8,511
Benefit from (provision for) income taxes	3,613	(3,913)	4,268	3,210
Less: Net income (loss) attributable to noncontrolling interest	144	(2,366)	(83)	(1,936)
Net Income (Loss)	\$40,288	\$(115,586)	\$39,195	\$(444,386)
Diluted weighted average common shares outstanding	78,101,232	33,366,389	68,990,891	33,022,622
Net earnings (loss) per share	\$0.51	\$(3.46)	\$0.55	\$(13.46)

Net interest income was \$41 million for the fourth quarter of 2009 as compared to \$24 million for the fourth quarter of 2008, an increase of \$17 million. The increase was primarily due to higher average balances of residential senior securities held at Redwood that were funded with equity. Net interest income after provision and market valuation adjustments was \$28 million for the fourth quarter of 2009 as compared to a loss of \$106 million for the fourth quarter of 2008, an increase of \$134 million. This increase was primarily due to lower negative market valuation adjustments (MVA) at Redwood due to fewer impairment charges on securities and a \$10 million decrease in the provision for loan losses at Sequoia due to lower balances of residential loans.

Operating expenses were \$11 million for the fourth quarter of 2009 as compared to \$13 million for the fourth quarter of 2008, a decrease of \$2 million. This decrease was primarily due to a reduction in headcount and fewer legal and consulting expenses, partially offset by an increase in variable compensation expense. Operating expenses could increase in subsequent periods as we focus on new business development activities.

Realized gains, net, were \$20 million for the fourth quarter of 2009 as compared to \$6 million for the fourth quarter of

2008, an increase of \$14 million, as ongoing portfolio management activities resulted in a greater number of security sales and related gains.

The Results of Operations section of this Management's Discussion and Analysis contains a further analysis of the components of net income.

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Taxable Income and Dividends

Our estimated total taxable loss was \$34 million (\$0.44 per share) for the fourth quarter of 2009 as compared to taxable loss of \$13 million (\$0.39 per share) for the fourth quarter of 2008, an increase of \$21 million. Our estimated REIT taxable loss was \$26 million (\$0.33 per share) for the fourth quarter of 2009 as compared to REIT taxable loss of \$13 million (\$0.39 per share) for the fourth quarter of 2008, an increase of \$13 million. The increase in the REIT taxable loss was primarily due to an increase in realized credit losses on subordinate securities. Realized credit losses for the fourth quarters of 2009 and 2008 were \$54 million and \$40 million, or \$0.70 and \$1.18 per share, respectively.

Our REIT taxable income is that portion of our total taxable income that we earn at Redwood and its qualifying REIT subsidiaries and determines the minimum amount of dividends we must distribute to shareholders in order to maintain our tax status as a REIT. We paid \$1.00 per share in regular dividends in 2009 and announced that these dividends are characterized for tax purposes as a return of capital given our estimated taxable loss at the REIT for the 2009 tax year.

There was no undistributed REIT taxable income at December 31, 2009. On November 16, 2009, our board of directors announced its intention to pay a regular dividend of \$0.25 per share per quarter in 2010.

Depending on the timing of credit losses, we may incur a taxable loss in 2010 for tax purposes. In any case, we currently do not expect to generate sufficient taxable income in 2010 to offset our net operating losses. Thus, we expect that any 2010 dividends will be characterized as a return of capital and, as such, would not be taxable to shareholders.

Differences exist in the accounting for GAAP and tax that can lead to a significant variance in the amount and timing of when income and losses are recognized under these two measures and therefore when we may recognize taxable income and be required to distribute income as dividends to shareholders. Reconciliations of GAAP and tax income are shown in our Results of Operations section of Management's Discussion & Analysis under the sub-heading Results of Operations - Estimated Taxable (Loss) Income .

Components of Book Value

The Financial Condition, Liquidity, and Capital Resources section of this Management's Discussion and Analysis contains a detailed discussion and analysis of the components of GAAP book value at December 31, 2009. The following supplemental non-GAAP components of book value addresses our assets and liabilities as reported under GAAP and as estimated by us using fair values for our investments. We show our investments in the Fund, and the Sequoia and Acacia entities as separate line items to highlight our ownership interests, as the assets and liabilities of these entities that we consolidate for financial reporting purposes are legally not ours.

Our non-GAAP estimated economic value is calculated using estimated bid-side asset values (which take into account available bid-side marks) and estimated offer-side values (which take into account available offer-side marks) for our financial liabilities, as required to determine fair value under GAAP. This method of calculating economic value more closely represents liquidation value and does not represent the higher amount we would have to pay to replace our existing assets or the higher amount we would have to pay to redeem our liabilities. For additional information to consider when reviewing the following table, see the section titled Factors Affecting Management's Estimate of Economic Value following this disclosure.

TABLE OF CONTENTS**Table 2 Book Value and Non-GAAP Economic Value at December 31, 2009**

(In Millions, Except Per Share Data)	GAAP Book Value	Adjustments	Estimate of Non-GAAP Economic Value
Cash and cash equivalents	\$ 243	\$	\$ 243
Real estate securities at Redwood			
Residential	771		771
Commercial	9		9
CDO	1		1
Total real estate securities at Redwood	781		781
Investments in the Fund	22		22
Investments in Sequoia	72	(29)	43
Investments in Acacia	3		3
Total cash, securities, and investments	1,121		1,092
Long-term debt	(140)	71	(69)
Other assets/liabilities, net	(9)		(9)
Stockholders' Equity	\$ 972		\$ 1,014
Book Value Per Share	\$ 12.50		\$ 13.03

During the fourth quarter, our GAAP book value increased by \$0.82 per share to \$12.50. The increase resulted from \$0.50 per share of positive market valuation adjustments and \$0.57 per share from earnings before market valuation adjustments, less \$0.25 per share of dividends. Our estimate of non-GAAP economic value increased by \$0.75 per share, to \$13.03. The increase resulted from \$1.14 per share from net cash flows and net positive market valuation adjustments on our securities and investments and long-term debt, less \$0.14 per share of cash operating and interest expense and \$0.25 per share of dividends. Non-GAAP economic value is determined by calculating the fair value of our investments in consolidated entities directly as opposed to deriving their reported GAAP values by netting their consolidated assets and liabilities. In calculating our estimate of non-GAAP economic value, we also value our long-term debt at its estimated fair value rather than its amortized cost basis as reported for GAAP.

Factors Affecting Management's Estimate of Non-GAAP Economic Value

In reviewing our estimate of non-GAAP economic value, there are a number of important factors and limitations to consider. The estimated economic value of our stockholders' equity is calculated as of a particular point in time based on our existing assets and liabilities or, in certain cases, our estimate of economic value of our existing assets and liabilities, and does not incorporate other factors that may have a significant impact on that value, most notably the impact of future business activities and cash flows. As a result, the estimated economic value of our stockholders' equity does not necessarily represent an estimate of our net realizable value, liquidation value, or our market value as a whole. Amounts we ultimately realize from the disposition of assets or settlement of liabilities may vary significantly from the estimated economic values of those assets and liabilities. Because temporary changes in market conditions can substantially affect our estimate of the economic value of our stockholders' equity, we do not believe that short-term fluctuations in the economic value of our assets and liabilities are necessarily representative of the effectiveness of our investment strategy or the long-term underlying value of our business. When quoted market prices or observable market data are not available to estimate fair value, we rely on Level 3 inputs. Because assets and liabilities classified as Level 3 are generally based on unobservable inputs, the process of calculating economic value is generally subjective and involves a high degree of management judgment and assumptions. These assumptions may

have a significant effect on our estimates of economic value, and the use of different assumptions as well as changes in market conditions could have a material effect on our results of operations or financial condition.

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Cash, Securities, and Investments at Redwood

We have categorized our securities portfolio at December 31, 2009, by acquisition date in the pie chart below to highlight that 92% of the economic value of our cash, securities, and investments are currently held in cash or in recently acquired securities. Our future earnings will be primarily driven by the performance of these recent investments along with how we deploy our existing cash and future cash flows.

**Cash, Securities, and Investments at Redwood
December 31, 2009
(\$ in millions)**

* Estimate of non-GAAP economic value; see Table 2 for explanation and reconciliation.

At February 15, 2010, our cash and cash equivalents had increased since the end of the fourth quarter to \$270 million. Our cash is primarily invested in U.S. Treasury Bills.

In 2010, through February 15, 2010, we acquired \$17 million in prime residential senior securities, \$3 million in prime residential subordinate securities and \$54 million in non-prime residential senior securities and sold \$10 million of prime residential senior securities, \$44 million of residential re-REMIC securities and \$49 million of non-prime residential senior securities.

Real Estate Securities at Redwood

The following table presents the components of fair value (which equals GAAP carrying value) for real estate securities at Redwood at December 31, 2009. We categorize our securities portfolio by priority of cash flows – senior, re-REMIC, and subordinate – and, for residential, by quality of underlying loans – prime and non-prime.

TABLE OF CONTENTS**Table 3 Securities at Redwood by Vintage, as a Percentage of Total Securities**

December 31, 2009 (In Millions)	2004 & Earlier	2005	2006 - 2008	Total	% of Total Securities	
Residential						
Senior						
Prime	\$ 14	\$ 248	\$ 67	\$ 329	42	%
Non-prime	118	183	14	315	40	%
Total Senior	132	431	81	644	82	%
Re-REMIC prime	4	13	89	106	14	%
Subordinate						
Prime	14	3	2	19	3	%
Non-prime	1	1		2		%
Total Subordinate	15	4	2	21	3	%
Total Residential	151	448	172	771	99	%
Commercial	7	2		9	1	%
CDO		1		1		%
Total Securities at Redwood	\$ 158	\$ 451	\$ 172	\$ 781	100	%

The following table details the net increase in the fair value of securities at Redwood during the three months ended December 31, 2009 and 2008.

Table 4 Real Estate Securities Activity at Redwood

(In Millions)	Quarter Ended December 31,	
	2009	2008
Beginning fair value	\$ 751	\$ 229
Acquisitions	68	50
Sales	(46)	(1)
Effect of principal payments	(25)	(3)
Change in fair value, net	33	(84)
Ending Fair Value	\$ 781	\$ 191

During the fourth quarter of 2009, we acquired \$68 million of residential securities. We also sold residential securities with a basis of \$46 million and realized gains of \$20 million. We continue to manage our portfolio and may sell additional assets as conditions merit.

Principal payments reduced the fair value of our securities by \$25 million during the fourth quarter of 2009 compared to \$3 million in 2008. The increase in principal payments primarily reflects the increase in size of our portfolio.

Unscheduled prepayments on our securities were generally consistent with recent prior quarters.

We estimate that the change in fair value of our securities due to market price adjustments was an increase of \$33 million during the fourth quarter of 2009. This increase was primarily due to increased demand for residential senior and re-REMIC securities.

Investments in the Fund, Sequoia and Acacia

The GAAP reported value of our investments in the Fund, Sequoia entities, and Acacia entities totaled \$97 million, or 9% of our securities and investments at December 31, 2009. The fair value (which equals GAAP carrying value) of our investment in the Fund was \$22 million. The Fund is primarily invested in non-prime residential securities and is managed by a subsidiary of Redwood. Our investment represents a 52% interest in the Fund.

The GAAP carrying value of our investments in Sequoia entities was \$72 million and the fair value was \$43 million. The \$43 million of economic value consists of \$41 million of interest-only securities (IOs) and \$2 million of senior and subordinate securities, and is calculated using the same valuation process that we follow to fair value our other real estate securities. These IOs earn the spread between the coupon rate on

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the \$2.4 billion notional amount of underlying adjustable rate mortgage (ARM) loans and the cost of funds (indexed to one-month LIBOR) on the ABS issued within each respective securitization entity. Returns on these investments increase when prepayments slow and decrease when prepayments speed up.

The GAAP carrying value and fair value of our investments in Acacia entities was \$3 million. These investments consist of equity interests and securities in the Acacia entities we sponsor, which have minimal value, as well as the value of future management fees we expect to receive from Acacia entities, which we discounted at a 45% rate.

Capital Resources and Liquidity

Throughout 2009, we maintained our strong balance sheet and liquidity. We ended 2009 with total capital of \$1.1 billion, which consists of \$972 million of common equity and \$140 million of 30-year long-term debt due in 2037. We had no short-term debt at December 31, 2009. We use our capital to invest in earning assets, fund our operations, fund working capital, and meet lender capital requirements with respect to collateralized borrowings, if any. Through our internal risk-adjusted capital policy, we allocate capital for our earning assets to meet liquidity needs that may arise. Currently, we have allocated risk-capital equal to 100% of the fair value of our investments. The amount of remaining capital that exceeds our risk-adjusted capital guidelines is excess capital that can be invested to support business growth. Excess capital generally equals our cash balance less pending investment settlements and other internal capital allocations we have established for the prudent operations of our company. Our excess capital at December 31, 2009 was \$237 million and at February 15, 2010 was \$256 million. Given the amount of our excess capital, it seems unlikely we would seek additional capital in the near term. If circumstances should change, we would likely look first at our own balance sheet for sources of cash before considering other options.

At December 31, 2009, we had \$243 million in cash and cash equivalents, or \$3.12 per share. At December 31, 2009, most of our cash and cash equivalents were invested in U.S. Treasury Bills. Our quarterly sources and uses of our cash is one of the financial metrics on which we focus. Therefore, as a supplement to the Consolidated Statement of Cash Flows included in this Annual Report on Form 10-K, we show in the table below (i) the beginning cash balances at December 31, 2009 and September 30, 2009 (which are GAAP amounts), (ii) the ending cash balances at December 31, 2009 and September 30, 2009 (which are GAAP amounts), and (iii) the components of sources and uses of cash organized in a manner consistent with the way management analyzes them. The presentation of our sources and uses of cash for these quarters is derived by aggregating and netting all items within our GAAP Consolidated Statement of Cash Flows that were attributable to the quarters.

Redwood is focused on generating long-term investment cash flow. Beginning in the first quarter of 2008, we began discussing the detailed quarterly components of our sources and uses of cash to supplement our other GAAP financial statement disclosures. We knew that a cash analysis of this type had limitations, but felt at the time that non-cash mark-to-market adjustments and the consolidation of securitization entities made it difficult for readers to measure our economic performance solely by reading our GAAP income statement. In recent quarters, the impact of mark-to-market charges has declined, both by virtue of changes in the mix of our securities portfolio and by the adoption of recent accounting principles, and we believe re-emphasizing more GAAP income centric performance metrics is appropriate, however, we continue to provide supplemental cash flow information to enhance the understanding of our operating results.

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In the fourth quarter, cash flow continued to be strong and in line with our expectations. Our business cash flows exceeded dividend distributions and proceeds from sales generally offset our use of cash for acquisitions. We had a net inflow of cash and ended the year with \$243 million in cash.

The decline in business cash flow from the third to the fourth quarter was due to reduced principal balances on securities held in our portfolio and slightly slower prepayments. Although prepayments slowed this quarter, prepayments on loans underlying our securities were generally faster than we expected at acquisition (which, since we bought these securities at discounts, is a positive).

The sources and uses of cash in the table below are derived from our GAAP Consolidated Statement of Cash Flow for the fourth and third quarters of 2009 by aggregating and netting all items in a manner consistent with the way management analyzes them. This table excludes the gross cash flow generated by our Sequoia and Acacia securitization entities and the Fund (cash flow that is not available to Redwood), but does include the cash flow distributed to Redwood as a result of our investments in these entities. The beginning and ending cash balances presented in the table below are GAAP amounts.

Table 5 Redwood Sources and Uses of Cash

(In Millions)	Quarter Ended	
	December 31, 2009	September 30, 2009
Beginning Cash Balance	\$ 217	\$ 337
Business cash flow		
Cash flow from securities and investments	68	78
Asset management fees	1	1
Cash operating expenses	(11)	(10)
Interest expense on long-term debt	(1)	(1)
Total business cash flow	57	68
Other sources and uses		
Proceeds from asset sales	66	74
Changes in working capital	(9)	6
Acquisitions	(68)	(246)
Repurchase of long-term debt		(3)
Dividends	(20)	(19)
Net other uses	(31)	(188)
Net sources (uses) of cash	26	(120)
Ending Cash Balance	\$ 243	\$ 217

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The table below presents the source of our cash flow from securities and investments for the quarters ended December 31, 2009 and September 30, 2009.

Table 6 Cash Flow from Securities and Investments

(In Millions)	Quarter Ended	
	December 31, 2009	September 30, 2009
Securities at Redwood		
Residential senior	\$ 41	\$ 45
Residential re-REMIC	4	3
Residential subordinate	10	14
Commercial and CDO	1	3
Total Cash Flow from Securities at Redwood	56	65
Investments in the Fund	2	2
Investments in Sequoia entities	10	11
Investments in Acacia entities		
Total Cash Flow from Securities and Investments	\$ 68	\$ 78

Fourth quarter cash flow from securities and investments included \$29 million of coupon interest and \$39 million of principal payments, compared to \$32 million of coupon interest and \$46 million of principal payments in the third quarter.

We evaluate cash flow performance over the life of an investment. Interim quarter to-quarter analysis has limitations and readers should use caution in drawing conclusions from quarterly cash flow data. In particular, we note:

Cash flow from securities and investments can be volatile from quarter to quarter depending on the level of invested capital, the timing of credit losses, and changes in prepayments and interest rates.

The timing of acquisitions and sales will have an impact on quarterly cash flow.

Given the nature of our investments (senior and subordinated securities acquired at deep discounts and IOs) it is difficult to draw conclusions in any one period about what portion of our cash flow represents income and what represents a return of capital. It is only at the end of an asset's life that we can accurately determine what portion of the cumulative cash received (whether principal or interest) was income and what was a return of capital.

Many of our investments may generate cash flow in a quarter that is not necessarily reflective of the long-term economic yield we will earn on the investments. For example, we acquired re-REMIC support securities at what we believe to be attractive yields, although, due to their terms, these securities are locked out of receiving any principal payments for years. Because of the deferred receipt of principal payments (which is modeled into our acquisition assumptions), formulating any conclusions on the value or performance of these securities by looking solely at the quarterly cash flow may not be appropriate.

TABLE OF CONTENTS**Results of Operations**

The tables below present the results of Redwood, the Fund, and Securitization Entities and supplements our consolidated GAAP results for the years ended December 31, 2009 and 2008. Securitization entities include Sequoia and Acacia entities that have been consolidated for financial reporting purposes.

Table 7 Consolidating Income Statements

(In Thousands)	Year Ended December 31, 2009				
	Redwood Parent Only	The Fund	Securitization Entities	Intercompany Adjustments	Redwood Consolidated
Interest income	\$97,871	\$ 8,400	\$ 183,197	\$ (1,591)	\$ 287,877
Management fees	3,248			(3,248)	
Interest expense	(5,785)		(129,690)	3,472	(132,003)
Net interest income	95,334	8,400	53,507	(1,367)	155,874
Provision for loan losses			(49,573)		(49,573)
Market valuation adjustments, net	(68,466)	(6,772)	(12,390)		(87,628)
Net interest income (loss) after provision and market valuation adjustments	26,868	1,628	(8,456)	(1,367)	18,673
Operating expenses	(46,480)	(1,676)	(206)	1,367	(46,995)
Realized gains, net	44,506	(129)	18,789		63,166
Loss from the Fund	(94)			94	
Income from Securitization Entities	10,127			(10,127)	
Noncontrolling interest		83			83
Net income (loss) before provision for taxes	34,927	(94)	10,127	(10,033)	34,927
Benefit from income taxes	4,268				4,268
Net Income (Loss)	\$39,195	\$ (94)	\$ 10,127	\$ (10,033)	\$ 39,195

(In Thousands)	Year Ended December 31, 2008				
	Redwood Parent Only	The Fund	Securitization Entities	Intercompany Adjustments	Redwood Consolidated
Interest income	\$97,688	\$ 10,413	\$ 459,444	\$ -	\$ 567,545
Management fees	5,390			(5,390)	
Interest expense	(9,593)		(411,278)	4,202	(416,669)
Net interest income	93,485	10,413	48,166	(1,188)	150,876
Provision for loan losses			(55,111)		(55,111)
Market valuation adjustments, net	(390,007)	(14,930)	(87,965)		(492,902)
Net interest (loss) income after provision and market valuation adjustments	(296,522)	(4,517)	(94,910)	(1,188)	(397,137)
Operating expenses	(60,622)	(1,378)	(94)	1,188	(60,906)
Realized gains, net	984	1,831	5,696		8,511

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Loss from the Fund	(2,128)			2,128	
Loss from Securitization Entities	(89,308)			89,308	
Noncontrolling interest		1,936			1,936
Net (loss) income before provision for taxes	(447,596)	(2,128)	(89,308)	91,436	(447,596)
Benefit from income taxes	3,210				3,210
Net (Loss) Income	\$(444,386)	\$(2,128)	\$(89,308)	\$ 91,436	\$(444,386)

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The following table presents the net interest income (loss) after market valuation adjustments (MVA) at Redwood for the years ended December 31, 2009 and 2008.

Table 8 Net Interest Loss after Provision and MVA at Redwood

(Dollars in Thousands)	Year Ended December 31, 2009			2008		
	Total Interest Income/ (Expense)	Average Amortized Cost	Yield	Total Interest Income/ (Expense)	Average Amortized Cost	Yield
Interest Income						
Real estate loans	\$200	\$2,662	7.51 %	\$300	\$3,671	7.55 %
Trading securities	6,179	4,878	126.67 %	7,512	11,364	32.17 %
Available-for-sale securities	91,276	510,534	17.88 %	85,324	355,161	25.23 %
Cash and cash equivalents	216	244,192	0.09 %	4,552	158,164	2.36 %
Total Interest Income	97,871			97,688		
Management fees	3,248			5,390		
Interest Expense						
Short-term debt				(318)	7,825	(3.63)%
Long-term debt	(5,785)	142,906	(4.05)%	(9,275)	146,705	(6.33)%
Total Interest Expense	(5,785)			(9,593)		
Net Interest Income	95,334			93,485		
Market valuation adjustments, net	(68,466)			(390,007)		
Net Interest Income (Loss) After MVA at Redwood	\$26,868			\$(296,522)		

Net interest income after MVA at Redwood was \$27 million for 2009, as compared to negative \$297 million for 2008, a difference of \$324 million. The difference was primarily due to a significant decline in negative market valuation adjustments during 2009 due to lower impairment charges on subordinate securities. Additionally, interest income from senior residential securities acquired during 2009 more than offset declining interest income from subordinate securities acquired in prior periods, resulting in similar interest income. Interest expense declined due to lower benchmark LIBOR rates on our long-term debt, as well as the retirement of \$10 million of long-term debt during 2009.

Analysis of Interest Income at Redwood

Interest income at Redwood was \$98 million for both 2009 and 2008. Increases in balances were offset by lower interest rates and yields. The following table details how interest income changed as a result of changes in average investment balances (volume) and changes in interest yields (rate).

Table 9 Interest Income at Redwood Volume and Rate Changes

(In Thousands)	Change in Interest Income Years Ended December 31, 2009 vs. December 31, 2008		
	Volume	Rate	Total Change
Real estate loans	\$ (99)	\$ (1)	\$ (100)
Trading securities	(5,943)	4,610	(1,333)
Available-for-sale securities	43,488	(37,536)	5,952
Cash and cash equivalents	1,215	(5,551)	(4,336)
Total Interest Income	\$ 38,661	\$ (38,478)	\$ 183

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We classify most senior, Re-REMIC, and subordinate securities as available-for-sale (AFS) securities under GAAP. The following table presents the components of the interest income we earned on AFS securities for the years ended December 31, 2009 and 2008.

Table 10 Interest Income AFS Securities at Redwood

Year Ended December 31, 2009					Yield as a Result of ⁽¹⁾				
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income		
Senior Residential	\$25,830	\$27,683	\$53,513	\$394,056	6.55 %	7.03 %	13.58 %		
Re-REMIC Residential Subordinate	8,816	(2,192)	6,624	42,862	20.57 %	(5.11)%	15.46 %		
Residential Commercial CDO	24,937	452	25,389	50,492	49.39 %	0.90 %	50.29 %		
	12,174	(6,650)	5,524	23,114	52.67 %	(28.77)%	23.90 %		
	250	(25)	225	11	2,272.73 %	(227.27)%	2,045.46 %		
Total Subordinate	37,361	(6,223)	31,138	73,617	50.75 %	(8.45)%	42.30 %		
Total AFS Securities	\$72,007	\$19,268	\$91,275	\$510,535	14.10 %	3.77 %	17.87 %		

Year Ended December 31, 2008					Yield as a Result of ⁽¹⁾				
(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount (Premium) Amortization	Total Interest Income		
Senior Residential Subordinate	\$3,003	\$3,308	\$6,311	\$64,268	4.67 %	5.15 %	9.82 %		
Residential Commercial CDO	39,538	27,509	67,047	160,348	24.66 %	17.16 %	41.82 %		
	23,707	(12,392)	11,315	112,892	21.00 %	(10.98)%	10.02 %		
	651		651	665	97.87 %		97.87 %		
Total Subordinate	63,896	15,117	79,013	273,905	23.33 %	5.52 %	28.85 %		
Total AFS Securities	\$66,899	\$18,425	\$85,324	\$338,173	19.78 %	5.45 %	25.23 %		

Cash flow from many of our subordinate securities can be volatile and in certain cases (e.g., when the fair values of (1) certain securities are close to zero) any interest income earned can result in unusually high reported yields that are not sustainable, and not necessarily meaningful.

Analysis of Interest Expense at Redwood

Interest expense at Redwood was \$6 million for 2009, as compared to \$10 million for 2008, a decline of \$4 million, primarily as a result of lower short-term interest rates, as well as lower average debt balances as a result of the extinguishment of \$10 million of long-term debt during 2009. The following table details how interest expense at Redwood changed as a result of changes in average debt balances (volume) and interest yields (rate).

Table 11 Interest Expense at Redwood Volume and Rate Changes

Change in Interest Expense
 Years Ended December 31, 2009 vs.
 December 31, 2008

(In Thousands)	Volume	Rate	Total Change
Short-term debt	\$ (318)	\$	\$ (318)
Long-term debt	(233)	(3,257)	(3,490)
Total Interest Expense	\$ (551)	\$ (3,257)	\$ (3,808)

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The following table shows the impact of market valuation adjustments on our consolidated statements of income (loss) for the years ended December 31, 2009 and 2008.

Table 12 Impact of Market Valuation Adjustments at Redwood

(In Millions)	Year Ended December 31,	
	2009	2008
Market valuation adjustments, net		
Fair value assets and liabilities	\$ (2)	\$ (31)
Impairment on AFS securities	(66)	(359)
Total Market Valuation Adjustments, Net	\$ (68)	\$ (390)

At Redwood, we classify most securities as AFS and report unrealized gains and losses, and other-than-temporary impairments (OTTI) related to non-credit factors, as a component of stockholders' equity in our consolidated balance sheet. OTTI related to credit factors, and market valuation changes on derivatives and trading securities, are recorded through our income statement.

For 2009, we recognized an aggregate \$85 million of OTTI at Redwood. Of this amount, \$66 million was related to credit factors and recognized in our consolidated statement of income, and the remaining \$19 million was recognized as a reduction in stockholders' equity. OTTI for 2008 totaled \$359 million. Unrealized gains and OTTI related to non-credit factors totaled \$174 million for 2009 and \$56 million for 2008.

In the second quarter of 2009, we adopted new accounting guidance for OTTI. As part of this adoption, we were required to evaluate \$431 million of OTTI that was previously expensed through our consolidated statements of income (loss). After evaluating this OTTI, we determined that \$58 million, net of tax, was related to non-credit factors and \$373 million was related to credit factors. The \$58 million was reclassified to accumulated other comprehensive income (loss) (OCI), effectively increasing retained earnings and decreasing accumulated comprehensive income (loss) to result in zero net impact to our reported stockholders' equity and minority interest.

Operating Expenses

The following table presents the components of operating expenses for the years ended December 31, 2009 and 2008.

Table 13 Operating Expenses

(In Thousands)	Year Ended December 31,	
	2009	2008
Fixed compensation expense	\$ 14,526	\$ 18,228
Variable compensation expense	7,470	2,385
Equity compensation expense	6,105	12,264
Severance expense	486	1,814
Total compensation expense	28,587	34,691
Systems	7,012	9,005
Office costs	7,047	7,028

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Accounting and legal	2,904	8,013
Other operating expenses	1,445	2,169
Total Operating Expenses	\$ 46,995	\$ 60,906

Operating expenses were \$47 million for the year ended December 31, 2009, as compared to \$61 million for the year ended December 31, 2008, a decline of \$14 million. The decline was due to a \$6 million decrease in total compensation expense, a \$5 million decrease in legal and accounting expenses, and a \$3 million decrease in systems and other operating expenses.

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The \$6 million decrease in total compensation expense was attributable to decreases in: (i) fixed compensation expense of \$4 million, which was primarily attributable to lower headcount throughout 2009 as compared to 2008, (ii) equity compensation expense of \$6 million, which was primarily attributable to a lower balance of unrecognized equity compensation cost at the beginning of 2009 as compared to the beginning of 2008 and the amortization of these costs over 2009 and 2008, respectively, and (iii) severance expense of \$1 million, which was primarily attributable to a fewer number of headcount reductions in 2009 as compared to 2008. These decreases were offset by a \$5.1 million increase in variable compensation expense, which is further discussed below.

Our variable compensation expense generally consists of two components: Company performance bonuses, which are generally determined based on a Company performance bonus formula established at the beginning of each year, and individual performance bonuses, which are generally determined based on an employee's achievement of pre-established individual goals. The \$5.1 million increase in variable compensation expense from 2008 to 2009, was primarily attributable to the accrual of an aggregate of \$5.6 million in 2009 Company performance bonuses, as compared to 2008, when the Company paid an aggregate of \$0.2 million in Company performance bonuses. In 2009, individual performance bonuses were, in the aggregate, \$0.3 million lower than in 2008, primarily due to lower headcount in 2009 than in 2008.

The 2009 Company performance bonuses were determined in the context of strong Company performance during the year. During 2009 the Company reported positive annual net income for the first time since 2006, earning \$39 million and resulting in a return-on-equity of 5.38%. In addition, during 2009, the Company's book value per share increased by 39% and management's estimate of economic value per share, a non-GAAP measure of performance, increased by 17%, in each case while the Company continued to pay a dividend of \$0.25 per share per quarter. See Table 2 Book Value above for a description of this non-GAAP measure and a reconciliation to GAAP book value per share. In addition, during 2009 the Company successfully executed several other significant business, financial, and operational initiatives, including successfully executing two public offerings of common stock to raise net proceeds of approximately \$521 million and generating a substantial return on the investment of those net proceeds.

Because the 2009 application of, and change in, certain GAAP income recognition rules for other-than-temporary impairments were inconsistent with certain GAAP assumptions that underlay the early 2009 establishment of the Company performance bonus formula, two one-time adjustments were made to the formula after the end of 2009 as follows:

First, the formula was adjusted to eliminate the impact of \$24 million of losses the Company was required to record through its income statement during 2009 that reflected the other-than-temporary impairments of certain securities whose declines in market value occurred during 2008 and had previously reduced the Company's GAAP book value as of December 31, 2008.

Second, the formula was adjusted to take into account the Company's mandatory adoption in April 2009 of the FASB's ASC 320-10-65-1 (ASC 320), formerly Financial Statement Position 115-2. ASC 320 changed the GAAP income recognition rules for other-than-temporary impairments and required a one-time 2009 adjustment to the Company's financial statements. In applying the 2009 Company performance bonus formula, the Company's income for 2009 was adjusted to include \$60 million of income that the Company will be precluded from recognizing as a result of the mandatory adoption of ASC 320 and the resulting one-time adjustment to the Company's 2009 financial statements.

In recognition of the fact that, in the absence of ASC 320, a portion of that \$60 million of income would have been recognized over the course of the next several years, the portions of the 2009 Company performance bonuses paid to the Company's four most senior executive officers attributable to the future period effects of ASC 320 were paid in the form of deferred stock units. These deferred stock units were structured to have terms consistent with past compensation-related grants, except that (i) they would have a vesting schedule that was related to the Company's current estimate of the future period effects of ASC 320 and (ii) they would be subject to a minimum mandatory

holding period of 2 years (inclusive of the vesting periods). In particular, given that 45% of the post-2009 effect was estimated to relate to 2010, 45% of those deferred stock units were

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granted with a one-year vesting period, and given that the remaining 55% of the post-2009 effect was estimated to relate to periods during and after 2011, the remaining 55% of those deferred stock units were granted with a two-year vesting period. As a result of the vesting and mandatory holding period, the value of the deferred stock units to the recipients will be affected by the future performance of the Company over these vesting and mandatory holding periods.

Based on the foregoing, the Company's four most senior executive officers received the following 2009 Company performance bonuses.

Mr. George Bull, Chairman and Chief Executive Officer, received a bonus consisting of a cash payment of \$1.1 million and an award of deferred stock units subject to the vesting terms and mandatory holding period described above with a grant date fair value of \$1.8 million;

Mr. Martin Hughes, President, Co-Chief Operating Officer, and Chief Financial Officer, received a bonus consisting of a cash payment of \$696,000 and an award of deferred stock units subject to the vesting terms and mandatory holding period described above with a grant date fair value of \$1.1 million;

Mr. Brett Nicholas, Co-Chief Operating Officer and Chief Investment Officer, received a bonus consisting of a cash payment of \$696,000 and an award of deferred stock units subject to the vesting terms and mandatory holding period described above with a grant date fair value of \$1.1 million; and

Mr. Harold Zagunis, Chief Risk Officer, received a bonus consisting of a cash payment of \$285,000 and an award of deferred stock units subject to the vesting terms and mandatory holding period described above with a grant date fair value of \$452,000.

Because a portion of the 2009 Company performance bonus paid to the Company's four most senior executive officers was paid in the form of deferred stock units subject to a vesting period, our 2009 accrual for variable compensation expense includes only the aggregate amount of 2009 cash bonuses paid in late February 2010. The expense associated with the portion of the 2009 Company performance bonus paid in the form of deferred stock units will be incurred over the vesting periods applicable to those deferred stock units.

Legal and accounting expenses decreased by \$5 million from 2008 to 2009 primarily due to the addition of in-house legal counsel in late 2008 and lower third-party accounting costs during 2009. Systems and other operating expenses also decreased by a combined \$3 million from 2008 to 2009. This decline was largely attributable to a \$1.3 million decrease in non-renewed consulting contracts and a \$1 million decrease in software expenses from 2008 to 2009, as well as a \$0.5 million excise tax paid in 2008.

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The following table details the components of realized gains on sales of investments, net, for the years ended December 31, 2009 and 2008.

Table 14 Realized Gains, Net

(In Thousands)	Year Ended December 31,	
	2009	2008
Realized gains (losses) on sales of:		
Real estate loans	\$	\$ (18)
Real estate securities	37,752	1,901
Net gains on sales	37,752	1,883
Net gains on repurchase of Sequoia ABS		926
Net gains on extinguishment of debt	6,843	
Net losses on calls		(51)
Gains on deconsolidation	18,571	5,753
Total Realized Gains, Net	\$ 63,166	\$ 8,511

Realized gains of \$63 million for the year ended December 31, 2009, reflect \$38 million gains on the sales of securities as part of our ongoing portfolio management activities and the repurchase of \$10 million long-term debt at a significant discount to the principal amount owed, resulting in a \$7 million gain. Realized gains also include \$19 million from the deconsolidation of a Sequoia securitization entity during the second quarter of 2009.

Results of Operations the Fund

The following table presents the components of the interest income we earned on AFS securities at the Fund in the years ended December 31, 2009 and 2008.

Table 15 Interest Income AFS Securities at the Fund

Year Ended December 31, 2009	Yield as a Result of						
	Interest Income	Discount Amortization	Total Interest Income	Average Amortized Cost	Interest Income	Discount Amortization	Total Interest Income
(Dollars in Thousands)							
Senior Residential	\$ 688	\$ 4,493	\$ 5,181	\$ 35,602	1.93 %	12.62 %	14.55 %
Subordinate						&n	