

REDWOOD TRUST INC
Form 10-K
February 26, 2009

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

FORM 10-K

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

For the Fiscal Year Ended: December 31, 2008

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)

(State or Other Jurisdiction of
Incorporation or Organization)

(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:

Common Stock, par value \$0.01 per share

Name of Exchange on Which Registered:

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 Exchange 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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 or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

At June 30, 2008, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$491,007,240 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 25, 2008 was 60,222,048.

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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REDWOOD TRUST, INC.

2008 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 focused on investing in, financing, and managing residential and commercial real estate loans and securities. We seek to invest in assets that have the potential to provide cash flow returns 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.

All references to 2008, 2007, and 2006 refer to our fiscal years ended December 31, 2008, December 31, 2007, and December 31, 2006, respectively. References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires.

Our primary real estate investments include investments in real estate loans and securities, investments in the securitization entities that we sponsor, and investments in a private fund that we sponsor.

Financial information concerning our business for each of 2008, 2007, and 2006 is set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations, the consolidated financial statements and the notes thereto, and the supplemental financial information, which are in Part II, Items 7, 7A, and 8 of this Annual Report on Form 10-K.

Our web site can be found at www.redwoodtrust.com. We make available free of charge on, or 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). 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-GAAP 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

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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 Securities and Exchange Commission (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.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) the ability of our current and future investments to generate attractive future cash flows and returns with a comfortable margin of safety, (ii) our belief that our common stock offering in January 2009, and the investment of the proceeds thereof, will be accretive to our future financial results and significantly extend the duration of our investment cash flows, (iii) our expectation that we will generate over \$100 million in positive cash flow from existing investments after operating and interest expenses in 2009, (iv) our expectations regarding future declines in home values, (v) our credit loss expectations for investments in investment grade securities and the sensitivity of investment grade securities to credit risk, (vi) our Board of Directors' intention to pay a regular quarterly dividend of \$0.25 per share in 2009, and (vii) our belief that government initiatives could result in an increase in mortgage prepayment rates.

Important factors, among others, that may affect our actual results include: changes in interest rates; changes in mortgage prepayment rates; the timing of credit losses within our portfolio; our exposure to adjustable-rate and negative amortization mortgage loans; the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the concentration of the credit risks we are exposed to; the ability of counterparties to satisfy their obligations to us; legislative and regulatory actions affecting the mortgage industry or our business; the availability of high quality assets for purchase at attractive prices; declines in home prices and commercial real estate prices; increases in mortgage payment delinquencies; changes in the level of liquidity in the capital markets which may adversely affect our ability to finance our real estate asset portfolio; changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale, each of which may adversely affect the values of securities we own; the extent of changes in the values of securities we own and the impact of adjustments reflecting those changes on our income statement and balance sheet, including our stockholders' equity; our ability to maintain the positive stockholders' equity necessary to enable us to pay the dividends required to maintain our status as a real estate investment trust for tax purposes; our ability to generate the amount of cash flow we expect from our investment portfolio; changes in our investment, financing, and hedging strategies and the new risks that those changes may expose us to; changes in the competitive landscape within our industry, including changes that may affect our ability to retain or attract personnel; our failure to manage various operational risks associated with our business; our failure to maintain appropriate internal controls over financial reporting; our failure to properly administer and manage our securitization entities; risks we may be exposed to if we expand our business activities, such as risks relating to

significantly increasing our direct holdings of loans; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; our ability to successfully deploy the proceeds from our recent common equity offering and raise additional capital to fund our investing activity; and other factors not presently identified. Fair values for our securities and ABS issued are dependent upon a number of market-based assumptions including future interest rates, prepayment rates, discount rates, credit loss rates, and the timing of credit losses. We use these assumptions to generate cash flow estimates and internal values for each individual security.

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.

Certifications

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated February 25, 2009, 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

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certified to the New York Stock Exchange (NYSE) on June 20, 2008 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, 2008, Redwood employed 79 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.

The current turbulence in the financial markets and economy may adversely affect our business and these conditions may not improve in the near future. There can be no assurance that the actions of the U.S. government (including through the Treasury Department, the Federal Reserve System, and other governmental bodies), which are intended to stabilize the financial markets, will achieve the intended effect or that the intended effect would be beneficial to our business.

Recent market and economic conditions have been unprecedented and challenging with tighter credit conditions and slower growth through the end of 2008. Continued concerns about the systemic impact of inflation or deflation, energy costs, geopolitical issues, the availability and cost of credit, the U.S. mortgage market, and the declining real estate market in the U.S. have contributed to increased market volatility and diminished expectations for the U.S. economy. In the second half of 2008, added concerns fueled by the federal government conservatorship of the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae), the declared bankruptcy of Lehman Brothers Holdings Inc., the infusion of capital into financial institutions under the U.S. government's Troubled Asset Relief Program (TARP), and other federal government interventions in the U.S. credit markets have led to increased market uncertainty and instability in both U.S. and international capital and credit markets. These conditions, combined with volatile oil prices, declining business and consumer confidence, and increased unemployment have contributed to volatility in domestic and international markets at unprecedented levels.

As a result of these market conditions, the cost and availability of credit has been and may continue to be adversely affected by illiquid credit markets and wider credit spreads. Concern about the stability of the markets and the strength of counterparties has led many lenders and institutional investors to reduce, and in some cases cease, lending to borrowers. Continued turbulence in the U.S. and international markets and economies may contribute to a continuing deterioration in the distressed housing market and in the credit performance and book value of our assets, limit our ability to access the capital markets, and adversely affect our financial condition and results of operations.

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. For example, to the extent TARP does not function as intended to address conditions in the credit markets, our business may not be positively impacted. Alternatively, to the extent TARP is ultimately successful in stabilizing credit markets, it and other governmental actions may have the effect of influencing long-term interest rates in a manner that is not favorable to us. In addition, the federal government may, through its conservatorship of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association, expand the breadth of its lending in the U.S. housing market, resulting in increased competition and diminishing our business expansion opportunities. The U.S. government, the Treasury Department, the Federal Reserve System, and other governmental agencies may be considering taking other actions to address the financial crisis that may not benefit us and could, in fact, harm our business. 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.

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Mortgage loan modification programs and future legislative action may adversely affect the value of, and the returns on, mortgages and mortgage-related securities we own or may acquire in the future.

During the third quarter of 2008, the federal government, through the Federal Housing Administration and the Federal Deposit Insurance Corporation, commenced implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. In addition, certain mortgage lenders and servicers have voluntarily, or as part of settlements with law enforcement authorities, established loan modification programs relating to the mortgages they hold or service. In January 2009, the President announced his Homeowner Affordability and Stability Plan, which is focused on reducing foreclosures. These programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or to extend the payment terms of the loans. In addition, members of the U.S. Congress have indicated support for additional legislative relief for homeowners, including a proposed amendment of the bankruptcy laws to permit the modification of mortgage loans in bankruptcy proceedings. These loan modification programs, as well as future law

The current turbulence in the financial markets and economy may adversely affect our business and these conditions

enforcement and legislative or regulatory actions, including amendments to the bankruptcy laws that result in the modification of outstanding mortgage loans, 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.

Continued disruption in the mortgage securitization market may adversely affect our earnings and growth.

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 current market conditions, we are not currently engaged in additional mortgage securitization transactions. 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 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. For example, the credit rating agencies have generally determined the amount of net investment we must make in a securitization entity to credit-enhance the securities issued by that entity. Increases in the amount of the net investment the credit agencies require us to make could adversely affect our ability to profitably sponsor new securitization entities.

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.

The manner in which we compete and the products for which we compete are 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 financial condition and earnings may be adversely affected.

Recently proposed legislation could alter the rights we have with respect to our Sequoia securitization entities, which could have business, operational, and legal compliance effects on us. This and other recently proposed legislation could also affect the exemptions from the Investment Company Act that we have historically relied on in structuring our business.

In January 2009, legislation was introduced in the Senate entitled the Hedge Fund Transparency Act and in February 2009 additional legislation was introduced in the Senate entitled the Real Estate Mortgage Investment Conduit Improvement Act of 2009. Although they have not been enacted into law, if enacted in their current forms each of these bills could affect our business, the way we structure our operations, and our compliance with various laws and regulations. In particular, they could affect rights relating to loan modifications with respect to loans held by our Sequoia mortgage securitization entities, the accounting treatment that applies to our Sequoia mortgage securitization entities, our ability to continue to satisfy the rules and tests that relate to our status as a REIT, and the exemptions we have relied on in structuring our business so as to not be subject to registration under the Investment Company Act.

Among other things, these

effects could result in increased losses resulting from loan modifications and increased costs of operating our business. Although it is difficult to fully assess the potential impacts on us at this time, they could be significant.

Political changes may alter the risks inherent in our business or result in changes in the industry we operate in, in each case in ways that may be adverse to our business.

The transition of control of the executive branch of the U.S. government and changes in the political make-up of the U.S. Senate and House of Representatives, particularly at a time of financial disruption and economic recession, could have long-term effects on our business that are difficult to assess. Changes in laws, regulations, or policies could negatively impact the housing market or the financial markets or could more directly and adversely affect our operations, the value of our investments, or the value of our common stock. For example, the U.S. Congress and various state and local legislatures are considering legislation, which, among other things, would permit limited assignee liability for certain violations in the mortgage loan origination process. We cannot predict whether or in what form Congress or various state and local legislatures may enact legislation affecting our business and we are also unable to predict how changes in regulations promulgated by federal, state, or local authorities may affect us.

Residential and commercial real estate loan delinquencies, defaults, and credit losses could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

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. Residential and commercial credit-enhancement securities (CES) have below investment-grade credit ratings and, correspondingly, a higher degree of credit risk with respect to the residential and commercial real estate loans within the securitizations that issued these securities as compared to investment grade securities (IGS).

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 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 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 originally anticipated or that we currently anticipate.

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 CES 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.

Recently proposed legislation could alter the rights we have with respect to our Sequoia securitization entities, which

The IGS we hold are exposed to the same types of credit-related risks described above. These assets initially received investment-grade ratings, but these initial ratings do not ensure that these securities will be free from credit losses, especially in a housing or economic downturn such as the one the U.S. is currently experiencing. In particular, certain of the IGS we hold are part of so-called shifting interest securitization structures, in which losses attributable to bankruptcy are distributed more evenly among IGS and CES issued

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as part of the same securitization. To the extent losses arise due to bankruptcy, which may occur more frequently if the proposed changes to the bankruptcy laws are enacted into law, IGS we hold may be exposed to significant losses.

We attempt to manage these risks by periodically 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, reductions or suspensions in regular dividends, 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.

The nature of the securities we hold exposes us to concentrated credit risk that could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

Our residential and commercial CES have concentrated risks with respect to residential and commercial real estate loans, respectively. 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 CES holder, and then by holders of more senior CES. 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 ABS, 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 CES or residential and commercial IGS) in which we invest (or have an indirect interest).

We have significant credit risk in California and may be disproportionately affected by an economic or housing downturn, natural disaster, terrorist event, or any other adverse event specific to California. We also have credit risk in other states and our business may be harmed by an economic or housing downturn, natural disaster, terrorist event, or any other adverse event in an area where we have credit risk.

We have a concentration of residential and commercial real estate loans secured by property in California. In addition, a significant number of residential and commercial real estate loans that underlie the securities we own are secured by property in California. 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. We also have commercial credit risk in most states. Nonetheless, we still have a significantly higher exposure in California and any event that adversely affected the California economy or real estate market could have a disproportionately adverse effect on our business.

A decline in the economy or difficulties in the real estate markets 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. 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) may cause a sudden decrease in the value of real estate 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.

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We have credit risk and other risk exposure to commercial real estate.

The commercial real estate assets we own or in which we have an indirect interest through our investment in commercial mortgage backed securities and our investment in Acacia entities may be subject to significant credit and other risks, including environmental and legal risks. The net operating income and fair values of commercial real estate properties may fluctuate with economic cycles and as a result of other factors, so that debt service coverage may be unstable. The value of the property may not support the value of the loan if there is a default. 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. Many commercial real estate loans are not fully amortizing and, therefore, the timely recovery of principal is dependent on the borrower's ability to refinance or sell the property at maturity.

The prices of commercial CES are more sensitive to adverse economic downturns or individual issuer developments than more highly rated real estate securities. A projection of an economic downturn, for example, could cause a decline in the price of commercial CES because of increasing concerns regarding the ability of obligors of loans underlying CES to continue to make principal and interest payments.

For some types of commercial loans, the commercial real estate securing the loan is in transition, such as a former office building that is in the process of being converted into condominiums. These loans entail higher risks than traditional commercial property loans made against stabilized properties. Initial debt service coverage ratios, loan-to-value ratios, and other indicators of credit quality for these loans may not meet standard market criteria for stabilized commercial real estate loans. The underlying properties may not transition or stabilize as expected. The personal guarantees and forms of cross-collateralization that are secured in connection with some of these loans may not be effective.

We have significant credit risk in California and may be disproportionately affected by an economic or housing downturn.

Our commercial loans are illiquid. If we choose to sell them, we may not be able to do so in a timely manner or for a satisfactory price. Financing these loans may be difficult, and may become more difficult if credit quality deteriorates.

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. This may expose us to credit, legal, and other risks that may be greater than is usually present with acquired loans.

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 losses as a result.

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 investment-grade and non-investment-grade securities issued by residential and commercial real estate loan securitization entities. Acacia also owns 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, without limitation, 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 owns are backed by subprime loans and alt-a loans that have substantially higher risk characteristics than prime-quality loans and are expected to have higher rates of delinquency and loss than prime loans. Some of the assets Acacia has acquired are investment-grade and non-investment-grade residential loan securities from the Sequoia securitization entities we have sponsored. Although we may have a limited degree of control or influence over the selection and management of the loans underlying Sequoia securitizations, we believe the possibility of loss on these assets remains approximately the same as it is for

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securities issued from securitizations of equivalent-quality loans that we did not sponsor. When the pools of residential loans underlying any of these securitizations experience poor credit results, Acacia's securities could have their credit ratings down-graded, could suffer declines in fair value, or could experience principal losses. When any of these events occurs, it likely reduces our long-term returns and near-term cash flows from the Acacia CDO equity securities we have acquired. As a result of poor credit performance and outlook, a significant number of securities owned by the Acacia entities have been downgraded and cash flows to most of our Acacia CDO equity securities have been cut off. We expect the remaining Acacia CDO equity security that has not yet been cut off from cash flows to be cut off sometime in 2009 for similar reasons. We do not currently anticipate sponsoring any new Acacia transactions.

The nature of the assets underlying some of the securities we hold could increase the credit risk of those securities, which, in turn, could reduce our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.

For certain types of loans underlying our CES or IGS, 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 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 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.

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 mature 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 the creditworthiness of the borrower and the borrower's to continue to make payments as well as new legislation, legal actions, or programs that allow for the modification of loans or ability for borrowers to get relief through bankruptcy.

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

The economic returns we expect to 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

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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 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 earnings volatility.

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 portion of our equity-funded assets have adjustable-rate coupons. 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 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 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 adjustable-rate residential whole loans.

When short-term interest rates fall, our premium amortization expense may increase on loans acquired by Sequoia prior to July 2004, which are reported on our consolidated balance sheet. Under the applicable GAAP accounting elections, the amortization expense for the current period is a function of actual and projected prepayments and the current LIBOR interest rate. During a period of rapidly falling rates, the effect that the interest rate has on the amortized amount may become the more significant factor and may increase the amount of premium amortized thereby decreasing our reported income for that period, all other factors being equal.

The securities and loans we own are likely to lead to variable returns.

We actively manage the risks associated with acquiring, holding, and disposing of 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 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

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

these securities, and the impact could be significant for our

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securities with concentrated risks. Changes in cash flows lead to changes in our return 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, 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.

A decrease in fair value may not necessarily be the result of a 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-rate 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.

Effective January 1, 2008, we adopted a new accounting standard, Financial Accounting Standards Board Statement No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159), which enabled us to mark-to-market both the consolidated assets and liabilities of Acacia. Our adoption of FAS 159 resulted in a one-time cumulative-effect adjustment to retained earnings on the balance sheet on January 1, 2008, for the unrealized gains or losses on Acacia assets and liabilities at that time. We believe the adoption of FAS 159 reduced the magnitude of the disparity that existed between the value of Acacia under GAAP presentation and the economic value of Acacia at and prior to December 31, 2007. Even following the adoption of FAS 159, however, there will be differences between the value of Acacia under GAAP presentation and the economic value of our investments in Acacia, and they could be significant. Discrepancies arise as a result of market dynamics and the limitations of the measurement techniques required by FAS 159. In addition to affecting our consolidated GAAP balance sheet, the adoption of FAS 159 with respect to the Acacia assets and liabilities also affects our consolidated statements of income (loss), as we are required

The securities and loans we own are likely to lead to variable returns.

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to record any changes in the fair value of those assets and liabilities in any given period. Fair values for illiquid assets can be difficult to estimate, which may lead to volatility and uncertainty of earnings.

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. The use of different assumptions could materially affect our fair value calculations and our results of operations and financial condition. Recent market disruptions have generated fewer third-party 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.

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

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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 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.

Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated with those securities.

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. We try to reduce the impact of the risk that a credit rating may not accurately reflect the risks associated with a particular debt security by not relying solely on credit ratings as the indicator of the quality of an investment. We make our acquisition decisions after factoring in other information. However, our assessment of the quality of an investment may also prove to be inaccurate and we may incur credit losses in excess of our initial expectations.

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 will 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.

Changes in the fair values of our assets, liabilities, and derivatives can have various negative effects on us, including reduced

The assignment of an investment grade rating to a security by a rating agency (or our reference to a security as investment grade or IGS) 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 remote. For example, a large number of RMBS that were rated triple-A by one or more rating agencies have recently been downgraded, in many cases by several rating levels at one time.

Further 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.

Downgrades on 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. The underlying documents of each Acacia securitization entity state that certain average rating levels must be met, and if not met on the securities held by the entity, 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 in the 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 on 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.

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Some of the loans held by our Sequoia securitization entities, or in which we have an indirect interest through securities we hold through Acacia 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 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.

Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or losses on our investments.

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

Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated

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. Changes in consumer behavior, bankruptcy laws, tax laws, regulation on 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 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.

New assets we acquire may not generate yields as attractive as yields on our current assets, resulting 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, but acquiring assets in an uncertain economic environment poses risks. Potential cash flow 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 assets that may experience higher than expected levels of delinquency and default.

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). Principal payments and calls reduce the size of our current portfolio and generate cash for us. We may also sell assets from time to time as part of our portfolio management and capital recycling strategies.

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 pay down, are called, or are sold. Under the effective yield method of accounting that we use for GAAP accounting purposes for some of our

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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. Business 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.

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, service, 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 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.

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 loans and 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, the volume of all types of loan originations was significantly lower than in recent 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.

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

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The supply of new 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 2008 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 IGS 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 CES could be significantly diminished. In addition, the risks 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.

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 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. We will develop methodologies for allocating investment opportunities between Redwood and these limited partnerships and separately managed accounts. 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.

Many of our investments have limited liquidity.

The residential, commercial, and CDO CES we acquire are generally less liquid than the residential, commercial, and CDO IGS we acquire. In turbulent markets, it is likely that the liquidity of the lower-rated securities, and some of the higher-rated securities that we hold, 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 may incur significant losses upon sale of the assets.

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 IGS and residential whole 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.

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To the extent the use of short-term financial leverage is or were to become critical to our business, the inability to access financial leverage through warehouse and repurchase facilities, credit facilities, or commercial paper 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, credit facilities, and commercial paper. We can provide no assurance that we would be successful in establishing sufficient warehouse, repurchase, credit facilities, and issuing commercial paper. In addition, because warehouse, repurchase, 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.

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

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

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stabilize our economic returns from or meet rating agency requirements with respect to a securitization, or to stabilize the future cost of anticipated ABS issuance 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 interest rate agreements or for assets or liabilities that do not necessarily match those used for interest rate agreements, or as a result of our failure to meet the requirements necessary to obtain specific hedge accounting treatment for certain interest rate agreements.

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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 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, which expose us to additional risks.

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 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 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.

Hedging activities may reduce long-term earnings, may fail to reduce earnings volatility, and may fail to protect our c

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

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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 could be adversely affected.

Our securitization operations expose us to liquidity, fair value, and execution risks.

Residential loan and CDO securitization operations require access to short-term debt to finance inventory accumulation prior to sale to the securitization entities. This debt may be unavailable or the terms of the available debt may be unfavorable to us. We expect to pledge the inventory assets we acquire to secure the short-term debt we incur. This type of debt is recourse to us and if the fair value of the collateral declines, we would be required to increase the amount of collateral pledged to secure the debt or to reduce the debt amount. Our goal is to sell the assets acquired with the proceeds from the debt to a securitization entity; however, if our ability to complete the securitization is disrupted and we are unable to extend the term of the debt incurred to finance the inventory of assets, we would need to sell the assets instead of completing the planned securitization, which typically would result in a loss.

We may invest in synthetic securities, credit default swaps, and other credit derivatives, which expose us to additional

When we acquire assets for a securitization, we make assumptions about the cash flows that will be generated from the securitization of these assets. Widening ABS spreads, rising ABS yields, incorrect estimation of rating agency securitization requirements, poor hedging results, and other factors could result in a securitization execution that provides lower cash flows than initially assumed. This could result in significant losses to us for tax purposes and reduced earnings for GAAP purposes.

Short-term borrowing arrangements used to support securitization operations include debt covenants. While these covenants have not meaningfully restricted our operations in the past, they could be restrictive to us in the future. In the event we violate debt covenants, we may incur expenses or losses, or our ability to incur additional debt may be restricted.

Our payment of commitment fees and other expenses to secure borrowing lines may not protect us from liquidity issues or losses. Variations in lenders' abilities to access funds, lender confidence in us, lender collateral requirements, available borrowing rates, the acceptability and fair values of our collateral, and other factors could force us to utilize our liquidity reserves or to sell assets, thus affecting our liquidity, financial soundness, and earnings.

Our securitization activities could expose us to litigation which may adversely affect our business.

We sponsor securitization entities which issue asset-backed securities. Through our Sequoia securitization entities, we issue ABS that are backed by mortgage loans held by the Sequoia entities. Through our Acacia securitization entities, we issue ABS that are backed by securities held by the 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 held by the Acacia entities may be insufficient to repay in full the ABS issued. 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 the securities laws. 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 due diligence of potential investments may not reveal all of the liabilities associated with such investments and may not reveal aspects of such investments which could lead to investment losses, and our ability to manage exposures to assets in which we have an indirect interest is limited.

Before making certain investments we may undertake due diligence efforts with respect to various aspects of the investment, including investigating the strengths and weaknesses of the originator or issuer of the asset and, in the case of investments in ABS, verifying certain aspects of the underlying assets themselves as well as other factors and characteristics that may be material to the performance of the investment. In making the assessment and otherwise conducting due diligence, we rely on resources available to us and, in some cases, an investigation by third parties. There can be no assurance that any due diligence process that we conduct will uncover relevant facts that could be determinative of whether or not an investment will be successful.

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Moreover, our ability to manage our exposures on residential mortgage assets and other assets held indirectly by us through securitization programs (such as Sequoia and Acacia) is significantly limited by contractual and other constraints of the securitization vehicle structures in which such assets are held.

We have exposure under representations and warranties we make in the loan sale contracts with securitization entities.

In connection with our securitization activities, we sell the loans to the securitization entities we sponsor pursuant to agreements in which we make representations and warranties to those securitization entities with respect to the assets we transfer to them. If our representations and warranties are inaccurate, for example, because of irregularities in the underlying loans, we may be obligated to repurchase the loans from the securitization entities at principal value, which may exceed fair value. We generally obtain representations and warranties that parallel those we provide to the securitization entities from the parties from whom we acquired the loans. As a result, we believe that we should, in most circumstances, be able to compel the original sellers of the loans to repurchase from us the loans we are obligated to repurchase from the securitization entities. However, if the representations and warranties are not parallel, or if the original seller is not in a financial position to be able to repurchase the loans or disputes its obligation to repurchase the loans, we may incur a loss upon repurchase of the loans from the securitization entity. Furthermore, if we were to establish a reserve to cover this contingency for GAAP purposes, the amount we reserve could turn out to be inadequate to cover losses incurred.

We may be subject to the risks associated with inadequate or untimely services from third-party service providers, which may harm our results of operations. We also rely on corporate trustees to act on behalf of us and other holders of securities in enforcing our rights.

Our loans and loans underlying securities we own are serviced by third-party service providers. In the case of our securitization entities, these arrangements allow us to increase the volume of the loans we purchase and securitize without incurring the expenses associated with servicing operations. Should a servicer experience financial difficulties, it may not be able to perform these obligations. Servicers who have sought bankruptcy protection may, due to application of provisions of bankruptcy law, not be required to make advance payments to us of amounts due from loan obligors. Even if a servicer were able to advance amounts in respect of delinquent loans, its obligation to make the advances may be limited to the extent that it does not expect to recover the advances due to the deteriorating credit of the delinquent loans. In addition, as with any external service provider, we are subject to the risks associated with inadequate or untimely services for other reasons. Servicers may not advance funds to us that would ordinarily be due because of errors, miscalculations, or other reasons. Many borrowers require notices and reminders to keep their loans current and to prevent delinquencies and foreclosures, which our servicers may fail to provide. 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. A substantial increase in our delinquency rate that results from improper servicing or loan performance in general may result in credit losses, may increase our cost of doing business, and could harm our ability to securitize our real estate loans in the future.

We also rely on corporate trustees to act on behalf of us and other holders of securities in enforcing our rights. Under the terms of most securities 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 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.

Our sources of cash flow may not be sufficient to satisfy these needs. Cash flows from principal repayments could be reduced if prepayments slow or if credit quality deteriorates. Cash flows from most of

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our investments in CDOs (including investments in Acacia) 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 the fully amortized amount. Operating cash flows could be reduced if earnings are reduced, if discount amortization income significantly exceeds premium amortization expense, or for other reasons. 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. Our competitors include other mortgage REITS, Fannie Mae, Freddie Mac, financial institutions, securities dealers, insurance companies, investment funds, and other investors in real estate securities. In addition, other companies may be formed that will compete with us for investments or otherwise pursue investment strategies similar to ours. Some of our competitors have greater resources than us and we may not be able to compete successfully for investments. Furthermore, competition for investments may lead to a decrease in the returns available from the investments which may further limit our ability to generate desired returns.

Recent legislation may lead to increased competition. Until recently, Fannie Mae and Freddie Mac have been statutorily prohibited from purchasing loans for single unit residences in the continental United States with a principal amount in excess of \$417,000. On February 7, 2008, Congress passed an economic stimulus package that includes provisions that increase the size of the loans these entities may purchase to up to \$729,750 for loans originated between July 31, 2007, and December 31, 2008. Beginning on January 1, 2009, the maximum size of the loans these entities may purchase reverted back to \$417,000, with the exception that certain high-cost areas are subject to a higher cap based on median home prices in those areas (which higher cap cannot be higher than \$625,500). In the future these loan size limits could be increased, including by an act of Congress. In addition, to the extent that property values decline while these 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 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 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 cash balances and cash flows may be insufficient relative to our cash needs.

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The expansion of our asset management business may expose us to new risks and will increase our cost of doing business.

We currently manage and receive a fee for managing the assets in our Acacia entities. We expanded our asset management business in 2008 by forming the Redwood Opportunity Fund, LP, and we may form additional limited partnerships and expand further into the asset management business in the future. New asset management activities may increase our exposure to litigation, fiduciary responsibilities, conflicts of 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 effectively. In addition, as we expand our asset management business, our asset management subsidiary may register with the SEC as an investment advisor and, as a result, become subject to additional regulation and associated additional costs of compliance.

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If we expand our asset management business, we will incur additional costs to establish new funds, limited partnerships, and other investment vehicles and to maintain appropriate controls and procedures and comply with applicable law and regulations. Our efforts to raise capital for these ventures may not succeed, or the capital we raise may not be sufficient to offset the initial and ongoing costs of these ventures.

If we purchase mortgage loans in the secondary market in the future, we may be required to obtain various state licenses and there is no assurance we would be able to obtain or maintain those licenses.

While we are not required to obtain licenses to purchase mortgage-backed securities, we may be required to obtain various state licenses to purchase mortgage loans in the secondary market. If we were to purchase mortgage loans in the secondary market, we may have to apply for and obtain these licenses before we could commence purchasing loans. We expect the licensing process would take several months. 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 informational and other requirements to maintain those licenses, and there is no assurance that we would be able to satisfy those requirements on an ongoing basis. If we purchase mortgage loans in the secondary market in the future, our failure to obtain or maintain the required licenses may restrict our investment options and could harm our business.

To the extent we own mortgage loans, 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 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.

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.

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 operations risks, credit risks, interest rate risks, prepayment

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risks, liquidity risks, and other market risks related to our business, assets, and liabilities. We actively manage our risks but our risk management policies, procedures, and techniques may not be sufficient to mitigate the risks we have identified or to identify additional risks to which we are subject or may be 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.

To the extent we own mortgage loans, we may be subject to liability for potential violations of predatory lending laws

We have taken steps to provide for the security of our systems and data. However, these security measures 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 business, reputation, results of operation, financial condition, or liquidity.

Our reported GAAP financial results differ from the taxable income results that drive our dividend distributions and reliance on GAAP results may not accurately reflect future taxable income and dividend distributions.

We manage our business based on long-term opportunities to generate cash flows. Our dividend distributions are generally driven by our minimum dividend distribution requirements under the REIT tax laws and our taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. Our reported results for GAAP purposes may differ materially, however, from both our cash flows and our taxable income.

In determining our REIT taxable income (which drives our minimum dividend distribution requirements as a REIT), no current tax deduction is available for future credit losses that are anticipated to occur. Credit losses can only be deducted for tax purposes when they are actually realized. As a result, for tax purposes, there is no credit reserve or reduction of yield accruals based on anticipated losses, and an increase in our credit losses in the future will reduce our taxable income (and dividend distribution requirements). By contrast, for GAAP purposes, we are required to reflect in our results of operations assumptions about the amount and timing of credit losses in advance of when the losses are actually realized. As a result, the occurrence of these assumed losses will not directly impact our future GAAP income (although they could lead to additional provisions or credit reserve designations to provide for potential additional losses in the event we revise our assumptions).

For tax purposes, we generally do not mark-to-market any asset or liability. Any potential gain, loss, or impairment on an asset or liability is generally recognized for taxable income purposes only at the time of sale, call, or maturity of the asset or liability. For GAAP accounting purposes, certain assets and liabilities are marked-to-market with the changes in the fair values being reflected in the income statement in some cases. Thus, the amount and timing of any changes in the fair value of an asset or liability will likely be reported at substantially different periods when calculating GAAP and taxable income.

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Accounting for compensation expense also varies for GAAP and tax calculations, especially in how costs relating to equity awards (such as options and deferred stock units) are determined. For the most part, under GAAP, the total

Our technology infrastructure and systems are important and any significant disruption could have an adverse effect

expense associated with an award is determined at the award date and is recognized over the vesting period. For tax purposes, the expense is recognized at the date of distribution or exercise. This leads to the potential that the total expense related to equity awards, as well as the timing for the recognition of the expense, could be significantly different for GAAP and tax purposes.

There are other differences in calculating taxable and GAAP income and there could be further differences as accounting principles and tax regulations change.

As a result of these differences in GAAP and tax accounting, our cumulative taxable income and our cumulative dividend distributions have been far greater than our cumulative earnings reported under GAAP. To the extent that the credit loss assumptions we use for GAAP purposes on our existing portfolio do occur, then we would expect our future taxable income to decrease as the credit losses occur. To the extent the other-than-temporary impairments we have recognized for GAAP income purposes reflect a decrease in future cash flows, then our taxable income will decrease in future periods.

Our GAAP income to date also includes the expense of vested equity awards that have not yet been distributed or exercised. The taxable expense we will incur on these equity awards will be dependent on the value of our common stock at future dates and this amount could be significant in any one period depending on the timing of distributions and exercises.

Taxable income consists of ordinary income and capital gains and losses. In order to recognize capital losses, we can only offset them against capital gains. There can be no assurance that we could generate capital gains to offset any capital losses we incur. Thus, in such instances, our dividend distributions would not be reduced by the amounts of any unused capital losses.

Furthermore, we establish the amount of our dividend distributions during each year based in part on our estimate of taxable income for that year. Our estimates may not be accurate and this could affect our ability to make the dividend distributions we planned and could affect the character of dividend distributions as return or capital, ordinary income, or capital gains. As a result, our dividend distributions may not end up being made in the most economic or tax-advantaged manner.

Our reported income depends on estimates and assumptions about the future and actual results may vary from our estimates, resulting in fluctuations in our balance sheet and earnings.

The preparation of financial statements in conformity with GAAP requires us to make a significant number of estimates. These estimates include the fair value of certain assets and liabilities, the amount and timing of credit losses, prepayment rates, and other items that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses recognized during the reported period. Our estimates are inherently subjective in nature and fluctuations in our reported earnings will result when actual results differ from our estimates.

To prepare our financial statements we depend on accounting principles, conventions, and interpretations. Over time, accounting principles, conventions, and interpretations may change, which could affect our reported income, 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.

Our reported GAAP financial results differ from the taxable income results that drive our dividend distributions and re

Failure to qualify as a REIT would adversely affect our dividend distributions and could adversely affect the value of our securities, including 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

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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.

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. 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.

Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source. 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

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

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

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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.

New subsidiaries that we may establish to conduct certain types of activities or for other for specific purposes may be taxable subsidiaries of a REIT and increase our costs of operations.

In order to expand our business, seek new opportunities, or for other business reasons, we may create new subsidiaries. Generally, these 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. Some of these entities may be incorporated in states other than Maryland and some may be set up to expand into regulated or international businesses.

Some of these entities will be taxable subsidiaries. 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.

Maintaining REIT status and avoiding the generation of excess exclusion income may reduce our flexibility and could

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, among other things, must 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. Further, 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.

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Recently proposed legislation which could affect our ability to continue to qualify for an exemption from the Investment Company Act is described above under the risk factor entitled Recently proposed legislation could alter the rights we have with respect to our Sequoia securitization entities, which could have business, operational and legal compliance effects on us. This and other recently proposed legislation could also affect the exemptions from the Investment Company Act that we have historically relied on in structuring our business.

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 long-term debt. Following the completion of our recent public offering of common stock in January 2009, we have less than 15 million additional shares authorized for issuance under our charter, which will limit the amount of capital we can raise through share issuances unless our stockholders approve an increase in the authorized number of our shares in our charter.

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 would make investments in real estate loans and securities attractive, such as the availability of assets from distressed owners who need to liquidate 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. Our plan is to grow and we build our infrastructure accordingly. If we are unable to raise capital and expand our portfolios, our operating expenses may increase significantly relative to our capital base.

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 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, one institutional shareholder owned in excess of 9.8% of our outstanding common stock and our board of directors has granted a waiver to that shareholder to own shares in excess of 9.8%, 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% by 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 (MCGL) 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 MCGL 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

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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 you as a shareholder 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 indemnification agreements with our directors and certain of our officers and the directors 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.

Other Risks Related to Ownership of Our Common Stock

Investing in our common stock may involve a high degree of risk.

An investment in our common stock may involve a high degree of risk, particularly when compared to other types of investments. Risks related to our industry, our investing activity, our other business activities, and the manner in which we conduct our business, and the way we have structured our operations, including to comply with various laws and regulations, could result in the reduction or 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 in our common stock may experience losses, volatility, and poor liquidity, and we may reduce our dividends in a variety of circumstances.

Our earnings, cash flows, book value, and dividends can be volatile and difficult to predict. Investors should not rely on estimates, predictions, or management beliefs. The sustainability of our cash from operations will depend on a number of factors, including our level of investment activity, the amount and timing of credit losses, prepayments, and other factors. As a consequence, there can be no assurance about the sustainability of our cash flows. Although we seek to pay a regular common stock dividend rate that is sustainable, we may reduce our regular dividend rate in the future for a variety of reasons. We have paid special dividends in the past, but we did not pay a special dividend in 2008 and may not do so in the future. We may not provide public warnings of dividend reductions prior to their occurrence. Fluctuations in our current and prospective earnings, cash flows, and dividends, as well as many other factors such as perceptions, economic conditions, stock market conditions, and the like, can affect our stock price. Investors may experience volatile returns and material losses. In addition, liquidity in the trading of our stock may be insufficient to allow investors to sell their stock in a timely manner or at a reasonable price.

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.

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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.

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, terrorist attacks, natural or man-made disasters, or threatened or actual armed conflicts.

In addition, prices of stocks on U.S. and international stock markets have recently been subject to significant fluctuations, and the market price of our common stock has also fluctuated significantly during this period. Some of these fluctuations have been limited to specific industries, including ours, but some have affected markets overall. Furthermore, these fluctuations do not always relate directly to the financial performance of the companies 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.

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 January 31, 2009, we believe that several institutional shareholders each owned in excess of 5% of our outstanding common stock and on that date one institutional shareholder owned in excess of 9.8% of our outstanding common stock. Furthermore, one or more of these investors or other investors could significantly increase their ownership stake in us. These significant ownership stakes 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 or 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 Redwood common stock, it could have an adverse effect on the market price of our common stock.

Although any beneficial owner's voting rights associated with ownership levels above 9.8% are generally limited to casting 9.8% of votes eligible to be cast, the institutional stockholder that beneficially owns in excess of 9.8% of our outstanding common stock is a party to an agreement with us pursuant to which (i) we have granted a limited waiver of the restriction on beneficial ownership of in excess of 9.8% of our outstanding common stock and (ii) it has granted irrevocable proxies to members of our management with respect to the number of shares it beneficially owns in excess of 9.8% of our outstanding common stock (which we refer to as "excess shares"). The excess shares of common stock owned by this stockholder will be voted on all matters in the same proportion as the votes cast on such matters by all stockholders, excluding, in each case, votes cast by it. While this agreement is irrevocable, the agreement provides that if George E. Bull, III, chairman of the board of directors and Chief Executive Officer, ceases to be employed by us and ceases to serve on our board of directors, the transfer of voting rights and the appointment of proxies for the excess shares will terminate immediately, and the voting power with respect to those shares will revert to that stockholder. If this were to occur, that stockholder would be able to vote all shares beneficially owned, thereby potentially increasing such stockholder's ability to influence the outcome of matters submitted to a vote of our stockholders. We may amend this agreement or enter into similar agreements with other stockholders in the future, in each case in a manner which allows 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 shares to participants in our direct stock purchase and dividend reinvestment plan and to our 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

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

stockholders on a preemptive basis. Therefore, it may not be possible for existing stockholders to participate in such future share issues, which may dilute the existing stockholders' interests in

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wus. In addition, if market participants buy shares from us in any such future share issuances it may result in them buying fewer of our shares in the open market, which in turn could have the effect of reducing the volume of shares traded in the marketplace, which could have the effect of reducing the market price of our common stock.

Our current and former directors and officers collectively beneficially own in excess of 5% of our common stock. Sales 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.

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 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 taxable income.

In the recent past we have consistently paid dividends; however, in November 2008, we announced our intention to reduce our 2009 regular dividend to a rate of \$0.25 per share per quarter. Our ability to pay a dividend of \$0.25 per share per quarter in 2009 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.

We have broad discretion over the use of our cash and cash equivalents, including the net proceeds to us from our recent public offering of common stock in January 2009.

As of December 31, 2008 we had cash and cash equivalents of \$126 million and in January 2009 we completed a public offering of common stock and raised additional funds. We also generate cash from investments we make and from other sources. We have broad discretion over the use of our cash and cash equivalents and you will be relying on the judgment of our management regarding their use. For example, although we currently expect to use the net proceeds from our January 2009 offering in the manner described under "Use of Proceeds" in the prospectus supplement relating to the offering (which was filed with the SEC on January 22, 2009), we have not allocated all of the proceeds for specific purposes. In addition, we may not be successful in investing cash and cash equivalents to yield favorable returns.

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

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 2009 rent obligation for these leases is \$1.7 million. Additionally, Redwood also has one lease for administrative offices at 245 Park Ave., 39th Floor, New York, NY 10167, which expires in 2009. The 2009 rent obligation for this lease is \$0.1 million.

ITEM 3. LEGAL PROCEEDINGS

At December 31, 2008, to our knowledge there were no material pending legal proceedings to which we or any of our subsidiaries were a party or to which any of our properties, or the properties of our subsidiaries, was subject.

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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, 2008.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, 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 20, 2009, our common stock was held by approximately 1,885 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 21,850. As of February 25, 2009, there were 60,222,048 shares of common stock outstanding. This amount includes 26,450,000 shares issued upon completion of a public offering on January 27, 2009.

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 2008 and 2007 were as follows:

	Stock Prices		Common Dividends Declared			
	High	Low	Record Date	Payable Date	Per Share	Dividend Type
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
Year Ended December 31, 2007						
Fourth Quarter	\$ 37.06	\$ 23.58	12/31/2007	1/22/2008	\$ 0.75	Regular
			11/26/2007	12/7/2007	\$ 2.00	Special
Third Quarter	\$ 46.75	\$ 27.16	9/28/2007	10/22/2007	\$ 0.75	Regular
Second Quarter	\$ 51.15	\$ 44.96	6/29/2007	7/23/2007	\$ 0.75	Regular
First Quarter	\$ 62.24	\$ 47.33	3/30/2007	4/23/2007	\$ 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. During the third quarter of 2008, our board of directors decided to distribute 100% of our REIT taxable income generated during 2008 and 2007.

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 replaced 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, 2008.

	Total Number of Shares Purchased	Average Price per Share Paid	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet be Purchased Under the Plans or Programs
January 1, 2008 - July 31, 2008		\$		5,000,000
August 1, 2008 - August 31, 2008	341,656	18.05	341,656	4,658,344
September 1, 2008 - December 31, 2008				4,658,344
Total	341,656	\$ 18.05	341,656	4,658,344

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Performance Graph

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, 2003 through December 31, 2008

	2003	2004	2005	2006	2007	2008
Redwood Trust, Inc	100.00	140.89	106.08	166.47	112.38	55.92
S&P Composite-500 Index	100.00	110.88	116.32	134.69	142.10	89.52
NAREIT Mortgage REIT Index	100.00	107.92	74.60	86.76	50.39	34.57

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ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data for 2008, 2007, 2006, 2005, and 2004, 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 2007, 2006, 2005, and 2004. Certain amounts for prior periods have been reclassified to conform to the 2008 presentation.

(In Thousands, Except Per Share Data)	2008	2007	2006	2005	2004
Selected Statement of Operations Data:					
Interest income	\$567,545	\$868,348	\$884,801	\$961,766	\$658,854
Management fees	5,390	6,408	3,184	2,140	1,328
Interest expense	(420,871)	(658,170)	(704,888)	(759,410)	(432,749)
Net interest income	152,064	216,586	183,097	204,496	227,433
(Provision for) reversal of loan losses	(55,111)	(12,808)	359	431	(7,236)
Market valuation adjustments, net	(492,887)	(1,261,449)	(12,586)	(5,031)	(7,251)
Net interest (loss) income after provision and market valuation adjustments	(395,934)	(1,057,671)	170,870	199,896	212,946
Operating expenses	(62,094)	(58,555)	(55,925)	(48,382)	(38,692)
Realized gains on sales and calls, net	8,496	12,781	22,557	65,879	66,378
Minority interest allocation	1,936				
Benefit from (provision for) income taxes	3,210	(5,192)	(9,970)	(17,521)	(7,997)
Net (loss) income	\$(444,386)	\$(1,108,637)	\$127,532	\$199,872	\$232,635
Average common shares basic	33,022,622	27,928,234	25,718,435	24,637,016	21,437,253
Net (loss) income per share	\$(13.46)	\$(39.70)	\$4.96	\$8.11	\$10.85

basic						
Average common shares diluted	33,022,622	27,928,234	26,313,826	25,121,467	22,228,929	
Net (loss) income per share diluted	\$(13.46)	\$(39.70)	\$4.85	\$7.96	\$10.47	
Regular dividends declared per common share	\$3.00	\$3.00	\$2.80	\$2.80	\$2.68	
Special dividends declared per common share	\$ -	\$2.00	\$3.00	\$3.00	\$6.00	
Total dividends declared per common share	\$3.00	\$5.00	\$5.80	\$5.80	\$8.68	
Selected Balance Sheet Data:						
Earning assets	\$5,436,184	\$9,695,240	\$12,752,890	\$16,529,286	\$24,572,723	
Total assets	\$5,581,749	\$9,938,472	\$13,030,473	\$16,776,960	\$24,778,065	
Short-term debt	\$	\$7,561	\$1,856,208	\$169,707	\$203,281	
Asset-backed securities issued	\$4,855,058	\$10,329,279	\$9,979,224	\$15,585,277	\$23,630,162	
Long-term debt	\$150,000	\$150,000	\$100,000			
Total liabilities	\$5,257,286	\$10,656,751	\$12,027,783	\$15,842,000	\$23,913,909	
Total stockholders equity (deficit)	\$301,852	\$(718,279)	\$1,002,690	\$934,960	\$864,156	
Number of common shares outstanding	33,470,557	32,385,073	26,733,460	25,132,625	24,153,576	
Book value per common share	\$9.02	\$(22.18)	\$37.51	\$37.20	\$35.78	
Other Selected Data:						
Average assets	\$8,026,050	\$12,177,451	\$14,123,151	\$21,797,922	\$21,559,604	
Average debt and ABS issued outstanding	\$7,386,690	\$11,322,898	\$12,996,244	\$20,710,057	\$20,748,658	
Average common equity	\$556,354	\$723,807	\$988,495	\$970,269	\$730,499	
Net income/average common equity	(79.9) %	(153.2) %	12.9 %	20.6 %	31.8 %	

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

Our Business

Redwood Trust, Inc., together with its subsidiaries, is a financial institution focused on investing in, financing, and managing residential and commercial real estate loans and securities. We seek to invest in assets that have the potential to provide cash flow returns 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.

Our primary source of income is net interest income, which consists of the interest income we earn from our investments in loans and securities less the interest expenses we incur on our borrowed funds and other liabilities. We assume a range of risks in our investments and the level of risk is influenced by the manner in which we finance our

purchase and derive income from our investments. Our primary real estate investments include investments in real estate 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 and Acacia.

Our direct investments in residential, commercial, and collateralized debt obligations (CDO) securities are currently financed entirely with equity and long-term debt, although we may use short-term debt financing to acquire securities and loans from time to time. Until recently, our investment focus has been on credit enhancement securities (CES, or below investment-grade securities) backed by high-quality residential and commercial real estate loans. High-quality real estate loans are loans that typically have low loan-to-value ratios, borrowers with strong credit histories, and other indications of quality relative to the range of loans within U.S. real estate markets as a whole. These investments tend to have concentrated structural credit risk that is generally reflected in their credit ratings. More recently, we have been acquiring investment-grade securities (IGS) that generally have less concentrated credit risk than CES but have the potential to provide attractive rates of return.

The entities that we sponsor the Fund, Sequoia, and Acacia invest in real estate assets. Assets held at the Fund include real estate securities, primarily non-prime residential IGS and CDO IGS, which are 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 include residential real estate loans, which are funded through the issuance of asset-backed securities (ABS) to us and to third party investors. Assets held at the Acacia entities 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.

Our investments in each of these entities are currently financed with equity and long-term debt. Our capital at risk is limited to these investments as each entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not obligations of Redwood. For financial reporting purposes, we are generally required to consolidate these entities assets, liabilities, and minority interests.

Recent Developments

We ended 2008 in the midst of a multifaceted downturn that may be the worst since the Great Depression. We were not surprised by the downturn, but we underestimated the extraordinary level and complexity of the financial risks that market participants had taken, the extreme level of leverage employed, and the degree to which the fates of most financial institutions and markets were intertwined. With the clarity of hindsight, we were too early with some of the investments we made in the first half of 2008, although we believe these investments will ultimately yield acceptable returns. On the positive side, we financed our 2008 investments with permanent capital, which allows us to hold these securities to maturity without the risk of margin calls or forced redemptions. In addition, starting in mid-June we ceased all investing activity so that we could assess the impact of the unprecedented developments occurring in the financial markets and the implications of government intervention in the mortgage market.

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The mortgage credit markets remained under intense pressure through the end of 2008 as housing and economic activity continued to deteriorate, available credit and liquidity continued to contract, and the rating agencies issued a barrage of downgrades. In response, prices for residential and commercial real estate loans and securities saw a steep decline during the year. So far in 2009, asset prices seem to be holding relatively steady from year-end levels. We caution that this price stability may be temporary, especially as we expect significant additional downgrades of AAA-rated residential and commercial mortgage-backed securities.

The chart below illustrates the prices that investors were paying to compensate for the perceived credit risk of various types of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) over the last two years. Prices for AAA RMBS and CMBS dropped dramatically in the fourth quarter of 2008 (after the Department of Treasury announced it would not use TARP funds to acquire non-agency mortgage securities). In early 2009, prices have partially recovered from their lows.

Source: Credit Suisse, JPMorgan Chase, Redwood Trust

Various arms of the federal government have announced a variety of programs and legislation, and Congress has adopted stimulus packages aimed at stemming the decline in home values, slowing the rate of foreclosures, and getting the economy and banking system back on track. Overall, these and other initiatives should be positive for Redwood. We support government policy aimed at helping homeowners. Actions that improve conditions in the housing market will directly benefit Redwood if they lead to lower losses and faster prepayments. We believe, however, that there is unlikely to be a near-term recovery in housing or the economy.

In spite of difficult times ahead, and after spending four months watching and analyzing from the sidelines, we have been active investors in residential IGS since the latter part of 2008. We believe we can now make attractive long-term residential mortgage-related investments with a comfortable margin of safety. We invested \$46 million in AAA-rated residential IGS in the fourth quarter of 2008 at a weighted average price of 64% of face value and with average credit support of 12 percentage points. In addition, we invested \$4 million in residential CES at a weighted average price of 2% of face value. We have continued to acquire assets in the first quarter of 2009 and through February 24, 2009, we invested \$98 million in residential IGS at a weighted average price of 63% of face value and with average credit support of 11 percentage points. The vast majority of these RMBS investments are in senior securities backed by prime or near-prime loans.

It had become clear from our market analysis that the size of the current investment opportunity was substantially larger than the excess capital we had on hand to invest at the end of 2008. After much research and analysis, we concluded that raising funds through the sale of common stock would be accretive to earnings after the proceeds were deployed into new investments and would, therefore, be in the best interest of Redwood and its shareholders. We commenced a common stock offering in January 2009 and were

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successful in raising \$283 million of new equity capital for the company. This was an offensive and discretionary capital raise, as our existing investments continue to generate more than sufficient cash flow to cover our operating costs. We expect to generate over \$100 million in positive cash flow in 2009 from our existing investments, and had \$126 million of unrestricted cash and no short-term debt at December 31, 2008. Additional investments made with the capital raised will significantly extend the duration of our investment cash flows and allow us to leverage our existing overhead without adding personnel, systems or space.

Outlook

Looking ahead to 2009 and 2010, we see no easy fixes to the many economic challenges we face. We expect governments and the private sector to continue probing for solutions that will enable homeowners and the markets to stabilize. Complicating the problem is the extreme level of anger from all quarters (in some cases, justifiably so) at banks, regulators, Wall Street and Washington, among others. We are not yet at the point at which emotions can subside and people can resume working with and trusting each other again. We believe it is simply going to take time,

and that eventually, market forces will take hold and provide the needed stability for the economy to recover.

Of course, of particular interest to Redwood, is the health of the housing sector. It is clearly in Redwood's interest for home values to stabilize as soon as possible. Unfortunately, despite all the good intentions of government programs, we believe that home values will continue to fall for some time until housing inventories decline and values come back in line with income and rental fundamentals. The rapid increase in home values between January 2000 and December 2006—a period during which home prices doubled—was driven not by fundamentals but by excessive leverage and creative affordability mortgage products that stretched the purchasing power of borrowers. Home ownership rates, which had averaged 65% in the 20 years prior to 2000, rose to 69% between 2004 and 2006. We believe we are now in the midst of a painful retrenchment period during which home values and home ownership rates will decline until they are in line with historical norms. Realistically, this is likely to take years.

As the government becomes further enmeshed in the banking system, and as support builds for a bankruptcy law cramdown amendment that will enable bankruptcy courts to modify mortgage loan terms, we believe the industry will continue to see mounting pressure to accept loan modifications (or be forced to accept them through a cramdown in bankruptcy). We believe those loan modifications will have a relatively small financial impact on our existing portfolio. We expect that the biggest impact of modifications will be on lower-rated non-prime securities. Our capital investment in these types of securities is minimal (\$0.24 per share at December 31, 2008). For new investments, our analysis takes into account the likely negative impact to investors from projected loan modifications.

Like loan modifications, we do not think that bankruptcy cramdowns will have a major impact on Redwood. We believe cramdowns will have more of an impact on non-prime securities, for which we have an increasingly smaller exposure. We note that as of December 2008, only 0.22% of prime borrowers were in bankruptcy proceedings compared to 2.65% for subprime borrowers according to data from LoanPerformance. Furthermore, the proposed cramdown amendment may result in additional downgrades of AAA securities and additional forced selling by investors whose capital allocation is ratings sensitive. This could present attractive investment opportunities for Redwood, as many current AAA investors are ratings sensitive and could be pressured to sell (i.e. they can only own securities that are rated AAA). Other investors, such as banks, would face significantly higher capital requirements to hold lower-rated securities.

We continue to offer support for government programs designed to alleviate the housing and credit crisis, but we believe that as a nation, we must determine what long-term role the government should play in the mortgage market. We are of the opinion that governmental entities can't do it all, and that private sector financing through securitization will be essential to getting the mortgage markets back on track. We will continue to support the creative exploration of securitization solutions and we look forward to resuming our role of facilitating credit risk transfers. In the meantime, we will continue to invest carefully and patiently in assets that we believe will generate attractive returns with comfortable margins of safety.

Our investment philosophy has not changed—we intend to continue acquiring assets that we believe will generate attractive long-term cash flows. Our primary focus will be on investments similar to our recent purchases—senior cash flows from prime and near-prime RMBS. To a lesser degree, we may selectively purchase credit-sensitive securities with a shorter duration, but with the expectation of high projected rates of

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return. As we intend to fund these investments with permanent capital, we can sustain a period of price volatility without the risk of margin calls or equity redemptions. If market discount rates go higher and asset prices go lower, it affects our opportunity cost, but does not change our long-term investment returns.

We have no current plans to purchase commercial mortgage-backed securities, although we constantly monitor the commercial market and the steps the government is taking in this area. We believe that difficult times lay ahead in the commercial real estate sector, as escalating economic woes continue to place downward pressure on property-level cash flows and valuations. Commercial lending activity has been dramatically curtailed, with no new securitizations issued since the first half of 2008. Rising delinquencies have recently prompted multiple ratings downgrades for some existing CMBS up to and including junior AAA securities. While the government appears committed to eventually facilitate liquidity to the commercial sector, it is our expectation that in the near-term, the government's aim will remain more consumer focused.

We expect that GAAP earnings will remain volatile in the near term due to mark-to-market (MTM) adjustments. We may recognize additional GAAP impairment losses on residential, commercial, and CDO securities held at Redwood. Negative MTM balance sheet write-downs that have not yet been realized through our income statement totaled \$48 million at December 31, 2008. Future income statement impairment charges related to these unrealized losses will not affect GAAP book value since these MTM losses were already deducted from stockholders' equity at December 31, 2008. The fair value accounting principles we follow for the assets and liabilities at Acacia may also contribute to future MTM volatility.

Actual REIT taxable income in 2009 will depend on the timing of credit losses and the level of taxable income generated by our new and existing investments. We currently expect that taxable income will continue to be pressured by the realization of credit losses in 2009 and it is highly probable that taxable income for 2009 will be negative. In November 2008, our Board of Directors announced its intention to distribute a regular dividend of \$0.25 per share per quarter during 2009.

Summary of Results of Operations and Financial Condition

Our reported GAAP net loss was \$444 million (\$13.46 per share) for 2008 as compared to a GAAP net loss of \$1.1 billion (\$39.70 per share) for 2007. Our GAAP book value per common share was \$9.02 at December 31, 2008, an increase from negative \$22.18 at December 31, 2007 and a decrease from \$23.18 at January 1, 2008 (our estimated book value after giving effect to our adoption of FAS 159). We declared regular dividends of \$3.00 per share for 2008, the same regular dividends per share declared for 2007. We did not declare a special dividend for 2008 and declared a \$2.00 per share special dividend for 2007.

The following table presents the components of our GAAP net (loss) income for 2008, 2007, and 2006.

Table 1 Net Income

(In Thousands, Except Share Data)	Years Ended December 31,		
	2008	2007	2006
Interest income	\$567,545	\$868,348	\$884,801
Management fees	5,390	6,408	3,184
Interest expense	(420,871)	(658,170)	(704,888)
Net interest income	152,064	216,586	183,097
(Provision for) reversal of loan losses	(55,111)	(12,808)	359
Market valuation adjustments, net	(492,887)	(1,261,449)	(12,586)
Net interest (loss) income after provision and market valuation adjustments	(395,934)	(1,057,671)	170,870
Operating expenses	(62,094)	(58,555)	(55,925)
Realized gains on sales and calls, net	8,496	12,781	22,557
Minority interest allocation	1,936		

Benefit from (provision for) income taxes	3,210	(5,192)	(9,970)
Net (Loss) Income	\$(444,386)	\$(1,108,637)	\$127,532
Diluted weighted average common shares outstanding	33,022,622	27,928,234	25,718,435
Net (loss) income per share	\$(13.46)	\$(39.70)	\$4.96

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Our results for 2008 reflect the continuing impact of an uncertain economic environment and deteriorating housing and credit markets, resulting in significant asset price declines, high levels of market volatility, and reduced levels of liquidity for mortgage-related securities. Our net loss of \$444 million for 2008 resulted from significant negative market valuation adjustments (MVA) on real estate securities and derivatives, triggered by accounting impairment charges, and declines in interest rates. Negative MVA were significantly lower in 2008 as compared to 2007 due to fewer impairment charges and our adoption of FAS 159 on January 1, 2008, which allowed us to offset asset and liability MVA at Acacia.

Our net loss for 2008 also reflects a \$42 million increase in the provision for loan losses at Sequoia as compared to 2007 due to higher expected losses on residential real estate loans. Loss allowances calculated under GAAP increased for all Sequoia pools during 2008 and in some cases exceeded our investment at risk in certain pools. During the fourth quarter of 2008, we sold our interests in three Sequoia securitizations and recorded a \$5 million net realized gain from the resulting removal of \$1.3 billion of loans and related ABS liabilities from our consolidated balance sheet.

Net interest income was \$152 million for 2008 as compared to \$217 million for 2007, a decline of \$65 million. Net interest income at Redwood declined by \$40 million due to higher credit losses, slower prepayments, and lower interest rates on securities, and due to our decision to hold larger amounts of low yielding cash balances throughout 2008. Net interest income at Sequoia declined by \$9 million due to lower interest rates on adjustable rate loans, partially offset by lower premium expenses. Net interest income at Acacia declined by \$26 million due to the absence of discount income on securities in 2008, stemming from accounting changes resulting from our adoption of FAS 159. These declines were partially offset by \$10 million of net interest income generated on securities at the Fund during 2008.

Operating expenses increased by \$3 million in 2008 as compared to 2007 primarily due to an increase in non-recurring legal and consulting expenses.

There was an \$8 million positive change in our tax provision in 2008 as compared to 2007. In August 2008, our Board of Directors decided to distribute 100% of our REIT taxable income generated in 2007 and 2008 as dividends to shareholders. Because we had previously planned to distribute 90% of REIT taxable income (the minimum REIT requirement) and retain 10%, we were able to eliminate a provision for taxes on the undistributed portion of taxable income. At December 31, 2008, there was no undistributed REIT taxable income available to our shareholders.

The Results of Operations section of this Management's Discussion and Analysis contains a detailed discussion and analysis of the components of net income for 2008, 2007, and 2006.

In 2008 and 2007, we earned an estimated \$23 million and \$161 million, of REIT taxable income, or \$0.70 per share and \$5.65 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 does not include taxable income earned in taxable subsidiaries. Our REIT taxable income determines the minimum amount of dividends we must distribute to shareholders in order to maintain our tax status as a REIT. Our declared regular dividends of \$3.00 per share for 2008 include \$0.70 per share of taxable income earned in 2008, \$2.05 per share of taxable income previously undistributed from prior years, and \$0.25 per share accounted for as a return of capital for tax purposes.

The decrease in REIT taxable income for 2008 as compared to 2007 was primarily due to an increase in realized credit losses. For tax purposes, we are not permitted to establish credit reserves on securities and do not record impairments or other changes in the fair value of financial assets or liabilities. Realized credit losses for tax purposes were \$116 million and \$11 million, or \$3.50 and \$0.39 per share, for 2008 and 2007, respectively.

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, 2008 and 2007. The following supplemental non-GAAP components of book value addresses our assets and liabilities at December 31, 2008, 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

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to highlight our specific ownership interests, as the underlying assets and liabilities of these entities are legally not ours. Our estimated economic value is calculated using bid-side asset marks, 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 at the offered-side to replace our existing assets. For additional information to consider when reviewing the following supplemental non-GAAP components of book value, please see Factors Affecting Management's Estimate of Economic Value below.

Table 2 Book Value

(In Millions, Except Per Share Data)	December 31, 2008		Management's Estimate of Economic Value
	As Reported	Adjustments	
Cash and cash equivalents	\$ 126		\$ 126
Real estate securities (excluding Sequoia and Acacia)			
Residential	145		145
Commercial	42		42
CDO	4		4
Subtotal real estate securities	191		191
Investments in the Fund	28		28
Investments in Sequoia	97	(32) ^(a)	65
Investments in Acacia	16	(7) ^(b)	9
Total securities and investments	332		293
Long-term debt	(150)	108 ^(c)	(42)
Other assets/liabilities, net ^(d)	(6)		(6)
Stockholders' Equity	\$ 302		\$ 371
Book Value Per Share	\$ 9.02		\$ 11.10

(a) Our Sequoia investments consist of credit enhancement securities, investment grade securities, and interest-only securities. We calculated the \$65 million estimate of economic value for these securities using the same valuation process that we followed to fair value our other real estate securities. In contrast, the \$97 million of GAAP carrying

value of these investments represents the difference between residential real estate loans owned by the Sequoia entities and the asset-backed securities (ABS) issued by these entities to third-party investors. We account for these loans and ABS issued at cost, not at fair value.

(b) Our Acacia investments consist of ABS issued and equity interests; we also have management agreements with each entity. The \$9 million estimate of economic value of our investments in Acacia entities represents the value of the ABS acquired using bid-side marks from third parties plus the net present value of projected cash flows from our Acacia management fees discounted at 45%. We valued our equity interests at zero. In contrast, the \$16 million GAAP value of these investments represents the difference between securities owned by the Acacia entities and the ABS issued by these entities to third-party investors. We account for these securities and ABS issued at fair value. We issued \$150 million of 30-year long-term debt at an interest rate of LIBOR plus 225 basis points. Under GAAP, these notes are carried at cost. Economic value is difficult to estimate with precision as the market for the notes is currently inactive. We estimated the \$42 million economic value using the same valuation process used to (c) fair value our other financial assets and liabilities. Estimated economic value is \$108 million lower than our GAAP carrying value because given the significant overall contraction in credit availability and re-pricing of credit risk, if we had issued this long-term debt at December 31, 2008, investors would have required a substantially higher interest rate.

(d) Other assets/liabilities, net are comprised of real estate loans of \$3 million, \$4 million of deferred taxes, \$6 million of accrued interest receivable, and other assets of \$27 million, less dividends payable of \$25 million and accrued interest and other liabilities of \$21 million.

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The following table presents the carrying value of our real estate securities at Redwood by vintage at December 31, 2008.

Table 3 Securities at Redwood by Vintage, as a Percentage of Total Securities

December 31, 2008 (In Millions)	2004 & Earlier	2005	2006 - 2008	Total	% of Total Securities
Residential					
IGS					
Prime	\$ 16	\$ 41	\$ 16	\$ 73	38 %
Non-prime		25	17	42	22 %
Total IGS	16	66	33	115	60 %
CES					
Prime	18	2	2	22	12 %
Non-prime	1	1	6	8	4 %
Total CES	19	3	8	30	16 %
Total Residential	35	69	41	145	76 %
Commercial CES	10	9	23	42	22 %
CDO		4		4	2 %
Total Securities at Redwood	\$ 45	\$ 82	\$ 64	\$ 191	100 %

Our investment strategy for real estate securities has shifted over the past year to acquiring residential prime and near prime senior cash flows with a comfortable margin of safety to protect against escalating credit losses. As a result, the fair value of our residential IGS at December 31, 2008, was \$115 million, representing 60% of our total portfolio, an increase from 4% at December 31, 2007. This percentage change in the components of our total portfolio was also the result of declines in the value of our CES, as discussed below.

Our returns on these IGS investments will be based on how much principal and interest we ultimately receive and how quickly we receive it. We fully expect, and base our analysis on, more bad things happening in housing. In our base case, we expect, on average, another 18% decline in nationwide home values and as much as a 35% decline in some major markets. In this market, our target investment profile has been attractive mid- to high-teen returns in the unlevered base case, well-protected stress case returns, and exceptional upside returns if we benefit from faster prepayments or lower credit losses. We model these profiles based upon our forecasts of the underlying collateral cash flows and the level of subordination protecting against future credit losses. We do not rely on credit ratings as part of our investment decision process. We emphasize this point because in 2009 we expect significant rating agency downgrades of prime and non-prime AAA-rated residential IGS issued from 2005 through 2008. The overall credit performance of loans underlying these vintages is significantly worse than the rating agency original expectations. In many cases, we expect securities currently rated AAA to be downgraded below investment grade, and in some cases downgraded to CCC.

As our IGS investments primarily represent senior cash flows, we do not expect a high level of losses. Our IGS returns are generally more sensitive to changes in prepayment rates than they are to credit. As has been well-publicized, many borrowers are currently having difficulty refinancing due to high non-agency mortgage rates, insufficient home equity, and stringent underwriting. A pick-up in refinance activity either from lower non-agency mortgage rates or from the government's initiatives to stimulate refinancing would benefit our IGS returns.

The fair value of our residential CES portfolio was \$30 million representing 16% of our total portfolio at December 31, 2008, down from 44% a year ago. This decline resulted from a reduction in market values due to negative mark-to-market adjustments and from our decision to re-direct our investment focus to senior cash flows (or IGS). We acquire CES at a significant discount to principal value as credit losses could reduce or eliminate the principal value of these bonds. In an ideal environment, we would experience fast prepayments

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and low credit losses allowing us to recover a substantial part of the discount as income. Conversely, a less beneficial environment is the environment we are currently experiencing with slow prepayments and high credit losses.

Our residential CES from 2004 and prior total \$19 million and are carried on average at 9% of their face values. From a credit standpoint, those vintages are generally performing in line with or better than our initial expectations. Our CES investments from 2005 to 2008 vintages total \$11 million, representing 2% of face value. Based on the poor credit trends underlying these vintages, we expect that future credit losses will eliminate virtually all of the principal or face amount of these securities. Therefore, the value ascribed to these securities is derived from the present value of future interest we expect to collect before actual credit losses are realized.

Our commercial CES represents 22% of our securities portfolio, down from 43% a year ago. We have not purchased commercial securities since the first quarter of 2007. Due to continuing deterioration in the fundamentals (increasing vacancies, falling rents) in an increasingly weakening economy (slowdown in consumer spending, increase in layoffs and unemployment), we wrote down our commercial CES to \$42 million, or 8% of face value in the fourth quarter.

The GAAP value (which equals fair value) of our investments in the Fund was \$28 million at December 31, 2008. These investments represent a 52% interest in the Fund, which closed in March 2008 and is fully-invested. The Fund is managed by a subsidiary of Redwood. All of the Fund's cash flow (excluding expenses and management fees) is distributed to the limited partners quarterly.

The GAAP value and fair value of our investments in Sequoia was \$97 million and \$65 million, respectively, at December 31, 2008. These investments consist primarily of interest-only securities (IOs) and to a lesser extent IGS

and CES. Our returns on these investments are most sensitive to prepayments although material changes in interest rates also have a short term impact on cash flows generated.

The GAAP value and fair value of our investments in Acacia, was \$16 million and \$9 million, respectively, at December 31, 2008. These investments represent equity interests and ABS issued from our Acacia CDO securitization entities and the management fees we receive from those entities. Due to various provisions in each CDO securitization, our equity interests are generally cut off from cash flows and we only expect limited returns on the ABS issued we own. We value the management fees at \$5 million, which equals our projected fees discounted at a 45% rate.

Pro Forma Estimate of Economic Value

The following table shows the components of management's estimate of economic value on a pro forma basis after giving effect to the \$283 million common equity raised in January 2009.

Table 4 Pro Forma Estimate of Economic Value

(In Millions, Except per Share Data)	December 31, 2008		Pro Forma ^(a)	
	Management's Estimate of Economic Value	Per Share	Management's Estimate of Economic Value	Per Share
Cash and cash equivalents	\$ 126	\$ 3.76	\$ 409	\$ 6.81
Total securities and investments	293	8.77	293	4.88
Long-term debt	(42)	(1.25)	(42)	(0.70)
Other assets/liabilities, net	(6)	(0.18)	(6)	(0.10)
Stockholders' Equity	\$ 371	\$ 11.10	\$ 654	\$ 10.89

This percentage represents the mark-to-market adjustments taken as a percentage of the reported market values at (a) the beginning of the period, or the purchase price if acquired during the period. It illustrates the price declines by collateral type for 2008. These price declines may not be indicative of price declines in the market in general.

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The shares of common stock issued in the January 2009 public offering were priced at \$11.25 per share and, after underwriting fees and other expenses of \$0.53 per share, the net proceeds to Redwood were \$10.72 per share. This is the reason pro forma economic book value declined from \$11.10 per share pre-offering to \$10.89 per share post-offering.

Capital and Liquidity

Throughout 2008, we maintained our strong balance sheet and liquidity. At December 31, 2008, we had \$126 million in cash and cash equivalents, or \$3.76 per share. As adjusted to reflect the receipt of the \$283 million common stock offering in January 2009, we had \$409 million in cash and cash equivalents, or \$6.81 per share. All of our cash and cash equivalents are invested in U.S. Treasury Bills or FDIC-insured bank deposits. We ended 2008 with total capital of \$452 million, which consists of \$302 million of common equity and \$150 million of 30-year long-term debt due in 2037. We had no short-term debt at December 31, 2008, and do not anticipate adding any in the current environment since our anticipated acquisitions are generally illiquid and subject to volatile market value changes. We fund these

investments with permanent capital (equity and long-term debt) that will enable us to hold the securities to maturity without the risk of margin calls or forced redemptions.

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 balance at September 30, 2008, and the ending cash balance at December 31, 2008, which are GAAP amounts, and (ii) 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 the fourth quarter of 2008 is derived by aggregating and netting all items within our GAAP Consolidated Statement of Cash Flows that were attributable to the fourth quarter of 2008.

Table 5 Redwood Sources and Uses of Cash

(In Millions)	Three Months Ended December 31, 2008
Beginning Cash Balance at 9/30/08	\$ 177
Business cash flows:	
Cash flow from investments	40
Asset management fees	1
Operating expenses paid	(12)
Interest expense on debt	(2)
Total Business Cash Flows	27
Other sources and uses:	
Proceeds from asset sales	1
Proceeds from equity issuance	2
Changes in working capital	2
Acquisitions	(50)
Dividends paid	(26)
Repayment of debt	(7)
Total Other Uses	(78)
Net Uses of Cash	(51)
Ending Cash Balance at 12/31/08	\$ 126

Our \$40 million of cash flow from investments for the fourth quarter of 2008 declined from \$60 million in the prior quarter, as shown in the table below. This decline was due to lower principal repayments on our securities, lower interest rates, and the lack of one-time events (which had increased our third quarter cash flows from our investments in the Fund and in Acacia). Cash flow from investments does not include the gross cash flows generated by the Fund and by the Sequoia and Acacia securitization entities that are not available to Redwood, but does include the cash flow generated by our investments in these entities.

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Table 6 Cash Flow from Investments

Three Months Ended

(In Millions)

September
30,
2008