REDWOOD TRUST INC
Form 10-K
February 20, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ý	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the fiscal year ended: December 31, 2006** **OR**
¨	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from _______________ to _______________**

Commission file number: 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**68-0329422**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

One Belvedere Place, Suite 300
Mill Valley, California 94941

(Address of Principal Executive Offices)(Zip Code)

Registrant s Telephone Number, Including Area Code: **(415) 389-7373**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class:	**Name of Exchange on Which Registered:**

Common Stock, par value $0.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý 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 ý

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 ý 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 ý	Accelerated Filer ¨	Non-Accelerated Filer ¨

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

At June 30, 2006, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $1,253,346,613 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 19, 2007 was 26,825,390.

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.

REDWOOD TRUST, INC.
2006 FORM 10-K ANNUAL REPORT

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PART I

ITEM 1. BUSINESS

Cautionary Statement

This Annual Report on Form 10-K and the documents incorporated by reference herein contain forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including the words anticipated, estimated, should, expect, believe, intend, ar expressions, are intended to identify forward-looking statements. 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 Item 1A Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are detailed from time to time in reports filed by us with the Securities and Exchange Commission (SEC), including Forms 10-Q and 8-K. Important factors that may impact our actual results include changes in interest rates and fair market values; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the level of liquidity in the capital markets as it affects our ability to finance our real estate asset portfolio and other factors not presently identified. In light of these risks, uncertainties, and assumptions, the forward-looking events mentioned, discussed in, or incorporated by reference into this Annual Report on Form 10-K might not occur. Accordingly, our actual results may differ from our current expectations, estimates, and projections. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Redwood Trust, Inc.

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consol subsidiaries, unless the context otherwise requires.

Business Model, Strategy, and Competition

Redwood Trust is a financial institution with competitive advantages in the business of investing in real estate loans and securities. Since Redwood was founded in 1994, our goal has been to create a company that is more efficient than banks, thrifts, insurance companies, and other financial institutions at investing in, financing, and managing residential and commercial real estate loans and securities.

Like many financial institutions, our primary source of income is net interest income, which equals the interest income we earn from our investments in loans and securities less the interest expenses we incur from our borrowed funds and other liabilities.

Most financial institutions fund their asset investments with borrowed money sourced by taking bank deposits, writing insurance policies, or issuing corporate debt. By contrast, securitization is the primary source of funding for our investments.

We also borrow money on a collateralized and uncollateralized basis, typically at very competitive rates. We do not, however, take deposits or raise money in any other way that would subject us to consumer lending or banking regulations. Since we are not regulated as a financial institution and do not deal directly with consumers, our operating costs are far lower than other financial institutions, and we have far greater freedom to use securitization as a source of funding.

In a securitization, we sell assets to an independent securitization entity that creates securities backed by those assets (asset-backed securities, or ABS) and sells these newly-created securities to both domestic and international investors. Most of the securities created and sold earn the highest credit rating of AAA, so the interest paid out is relatively low. We typically generate a profit from these securitization entities, consisting of the yield on the securitized assets less the interest payments made to the holders of the ABS securities sold.

Advances in securitization technology have enabled securitization to become increasingly competitive as a funding source relative to corporate debt, deposits, insurance contracts, and other borrowings. The cost of funds for ABS securities issued continues to improve relative to the cost of other borrowings. More importantly, the range of assets that can be efficiently securitized continues to broaden and the capital efficiency of securitization as a source of funding continues to improve.

As global capital markets continue to develop and evolve, we expect securitization to become an even more efficient source of funding. There are trillions of dollars of real estate loans and securities in the U.S. and the world, and the amount outstanding has been and is expected to continue to grow every year. We believe many of these assets would be better funded through securitization than by other means. Since we are highly efficient at using securitization as a source of funding, we believe we will continue to grow and diversify our business over time.

Our tax structure gives us an additional competitive advantage that cannot be easily replicated by most other financial institutions. We have structured our company for tax purposes as a real estate investment trust (REIT) because our primary business is investing in real estate assets. As a REIT, we are required to distribute the bulk of our profits as dividends. By doing so, we avoid paying corporate taxes on most of the income we generate. This lowers our costs, as taxes are one of the largest costs of doing business for most financial institutions.

In terms of capital employed, our largest area of investment is real estate credit-enhancement securities. Typically, 1% to 15% of the principal value of the securities created in a securitization of real estate assets are credit-enhancement securities (CES). These securities bear most of the credit risk with respect to the underlying assets that were securitized. If the underlying loans or securities suffer a loss of principal due to default, that loss is passed on by reducing the principal value of the CES. As a result of the high level of assumed credit risks, CES carry credit ratings that are below investment-grade. Because the CES absorb most or all of the credit risk that would normally be expected to occur, they reduce the credit risk of the more senior securities, allowing them to earn investment-grade ratings and to be sold at higher prices.

We are a leading investor in CES issued from securitizations of prime-quality residential real estate loans and we are an increasingly important investor in CES issued from securitizations of commercial real estate loans made on income-producing properties. In the last year, we have also made small investments in CES issued from securitizations of alt-a and subprime quality residential loans. In total, at December 31, 2006, we owned residential, commercial, and CDO CES with a principal value of $2.0 billion and a market value of $1.2 billion. Many of these securities are deep discount securities where our cost is far less than the principal value. Since we receive interest payments based on the principal value of a CES security, our interest income cash flow returns are strong. In addition, if credit losses are low, we will receive principal payments in excess of our cost basis, thus generating additional investment returns. Conversely, larger than expected credit losses could rapidly reduce the principal value of our CES, causing our investment returns from CES to suffer.

At December 31, 2006, our CES were first in line to absorb credit losses from $268 billion of real estate loans and securities that underlie the securitizations from which our CES investments were issued. However, our potential losses are far smaller and are limited to the purchase price of the CES in our portfolio.

With respect to these CES investments, we have a high degree of structural leverage since the principal value of our CES equals only a small percentage of the underlying asset pools. We do not, however, use a high degree of financial leverage with respect to our CES assets. We use capital rather than debt to finance most of our investments in the more junior subordinated CES (the first-loss and second-loss securities, or equivalent) and we use capital plus a modest amount of securitization financing through our Acacia CDO issuance program to finance the more senior CES that are closer to investment-grade quality.

In the near term, we anticipate that our net growth in CES assets will continue to be more focused on commercial real estate CES, since for many types of residential CES we believe the underwriting quality remains questionable and there is an elevated risk of loss. Later in 2007, we believe acquisition opportunities in residential CES may improve because we expect underwriting quality to improve.

We are increasing our investment in investment-grade rated real estate securities. We are increasing our investments in residential and commercial real estate investment-grade securities (IGS) rated AAA, AA, A, and BBB for three reasons. First, advances in securitization technology (such as CDOs) allow us to re-securitize portfolios of certain types of residential and commercial investment-grade securities and earn attractive returns on invested capital, as well as asset management fees. Secondly, in an environment of flat or falling housing prices and increased residential loan delinquencies and credit losses, we have for some time been tilting our investment focus towards assets that are credit-enhanced by others (investment-grade securities) rather than towards assets that cause us to carry concentrated credit risk (credit-enhancement securities). Finally, we intend to acquire some AAA- and AA-rated residential real estate securities, fund them with short-term Redwood debt, and reduce any resulting interest rate mismatches between these assets and liabilities using interest rate agreements. We pursued this investment strategy on a large scale from 1994 to 2000, after which we focused our investment strategy almost

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exclusively on assets with highly concentrated credit risks such as CES. Debt-funding AAA and AA real estate securities can be a good investment strategy in most economic environments. In addition, it fits our current balance sheet needs well, as we believe it will help us increase our capital utilization rate in a flexible manner and also will offset some of the risks we have in our balance sheet. Currently, our balance sheet is set up to benefit somewhat more from rising short-term interest rates and faster prepayment speeds, whereas debt-funded AAA and AA asset strategies typically benefit from falling short-term interest rates and slower prepayment speeds.

We are increasing our investment in residential real estate loans. We have been increasing our acquisitions of high-quality residential loans, and we are using both securitization proceeds and Redwood debt to fund these assets. Our residential loan portfolio declined in size over the last few years as we purchased fewer loans and the adjustable-rate residential loans in our portfolio prepaid at rapid rates. Because we have been increasing our loan purchases and our loan prepayment rate has slowed, we expect our loan portfolio size to start to stabilize. We are buying hybrid loans (fixed rate for 3-10 years, converting to adjustable rate thereafter) as well as adjustable-rate loans. Our interest in acquiring loans has increased because we have greater control over the underwriting quality of acquired loans than we do with respect to the loans underlying the residential CES we acquire. Quality control has become more important as residential underwriting standards have deteriorated. In addition, we are buying more loans because we want to hold a portion of our loan portfolio in whole loan form (unsecuritized) and use Redwood debt (including collateralized commercial paper) to fund the whole loans. Compared to the alternative of using securitization proceeds to fund these loans, using debt funding will increase our flexibility in utilizing more of our capital. Debt-funding loans requires a much larger capital commitment (8% of loan value versus 3%), and it generates a somewhat lower expected return on that capital than would a securitization. This is a flexible capital commitment, however, as we can easily recycle the capital utilized in this debt-funded strategy into other investments by either securitizing or selling the loans. Employing capital in this manner is useful at a time when we want to build our capital base to take advantage of future growth opportunities but we also want to improve profits by increasing our capital utilization rate, which has been lower than optimal in the last few years as we have cut back our acquisition rate of CES.

We also intend to replace some of our existing securitization funding with debt funding. In 2007 and 2008, we expect to exercise our rights to call many of our older Sequoia securitizations of residential loans. The terms of these securitizations generally allow us to call the deals when the current loan balance of the underlying loan pool pays down to 10% or 20% of its original balance. When calling a securitization, we pay off all the security holders at 100% of principal value and repurchase the underlying loans. We typically call our securitizations when we have the right to do so because the capital structure of a securitization becomes less efficient when the remaining balance of loans is small. It is better to call the deal so we can refinance the underlying loans more efficiently. We intend to finance a portion of the loans we acquire from called deals with Redwood debt and hold them as an ongoing investment. The remainder we will either re-securitize or sell.

We buy most of our assets rather than originate them. Our primary strategy for sourcing assets is to acquire loans and securities directly from other financial institutions or from the capital markets. We do not originate or service loans. Most of the real estate securities we invest in are created by others, some are created by us, but in both cases the underlying loans have been originated by others. This role allows us to have an independent point of view on asset quality and attractiveness, as well as the flexibility to change investment strategies as markets evolve. In our experience over the years, many financial institutions that have origination operations have produced sub-optimal asset investment results. We believe this is because, in some cases, there may have been incentives to retain loans that might not be the best investment (in terms of price and/or quality) in order to maintain or boost origination volumes and fees. In addition, origination (especially residential loan origination) is a business that is highly cyclical, operations intensive, and increasingly fraught with lender liability. Residential origination is becoming concentrated in

the hands of a few large companies that have either banking or brokerage operations as well. Rather than competing with these companies, we develop close relationships with them and help them build their businesses. They need companies like Redwood to buy their loans and credit-enhance their securitizations.

We previously built a successful commercial real estate loan origination operation at Redwood, and we may do so again in the future now that CDO securitization technology has improved the efficiency and ease of securitizing commercial real estate loans. We may also build a commercial real estate loan special servicing operation. However, we expect to continue to source most of our residential and commercial assets through acquisition rather than origination.

Competition for assets is strong, but we believe our operating efficiencies allow us to remain competitive. Our competitors are banks, thrifts, insurance companies, Fannie Mae, Freddie Mac, Wall Street brokerage firms, hedge funds, specialty finance companies, mortgage REITs, mortgage insurance companies, CDO securitization managers, asset management companies, foreign investors, and other financial institutions.

Our corporate structure and competitive strengths differ from most other financial institutions. With our differentiated capabilities, we interact as competitors, but also as customers and suppliers, with most of the institutions active in the vast and interconnected real estate capital markets.

We commenced operations in 1994, a period of turmoil in financial markets. This turmoil allowed us to acquire assets that produced very high returns in subsequent years. The level of competition increased dramatically through the end of 1997, at which time we generally sold assets, as the prospective risk/reward relationships for assets did not seem that attractive. There were several financial dislocations in 1998, including a prepayment acceleration crisis and a liquidity crisis. This allowed us to use our excess capital to acquire assets, including our own stock, at attractive prices. The CES we acquired in 1999 2002 performed very well, allowing us to report high return on equity results and to pay special dividends of $4.75 and $6.00 per share in 2003 and 2004.

The current competitive environment is much like 1997 new entrants and other investors are willing to buy assets at high prices (low yields) despite increased potential risks. We have responded to this current lower return/higher risk environment by selling CES assets and slowing our acquisitions. In 2007, we are increasing our acquisitions of assets (such as investment-grade securities and loans) that carry less concentrated credit risks than CES. We are also focusing on acquiring assets that are funded through securitization. For these assets, high prices are less of a concern because these high prices (and the resulting narrow spreads) are offset by the high prices at which we can sell the securities we create using these assets as collateral.

If the financial markets experience turmoil due to falling housing prices and rising residential loan defaults, we will incur increased losses but we will also be in a position to take advantage of the lower asset prices that may result. We believe competition will remain strong, however, and that any extraordinary asset acquisition opportunities will be short-lived. With our operating efficiencies, funding strategy, corporate structure, permanent capital base, and investment discipline, we believe we are prepared to continue to compete effectively in the highly competitive market that we expect will be the norm going forward.

We maintain a strong balance sheet with risks that are largely segregated and limited. Through our internal risk-adjusted capital policies, we seek to maintain a strong balance sheet with a large capital base, risks that are limited and segregated, and ample liquidity. Our $1.1 billion long-term capital base is primarily common equity but also includes $0.1 billion of unsecured junior subordinated notes (trust preferred securities) that have a 30-year maturity.

We use capital, not debt, to fund assets such as first-loss credit-enhancement securities that carry concentrated credit risks. These assets have a high degree of structural credit risk, so we do not feel it would be prudent to employ financial leverage to acquire these assets. Our risk is limited to our investment in these securities. Since we fund these assets with capital rather than debt, high credit losses should not cause liquidity concerns. Similarly, our economic risk is limited and our liquid reserves are secure with respect to securitized assets, since the assets are sold to and the securities are issued by independent securitization entities, whose liabilities are not Redwood s obligations. Our economic risk is limited to the value of any securities we may acquire as an investment from these entities. Typically, we either fund securities acquired from securitizations we sponsor with capital or we sell these securities to another securitization entity for re-securitization. In either case, the risk is segregated and limited.

We are increasingly using Redwood debt to fund assets. Expanding our funding strategy is bringing us a number of benefits, including allowing us to employ our excess capital in a flexible manner. It does, however, introduce potential liquidity risks as well as potential credit risks that are not as limited as with other parts of our balance sheet. Accordingly, we are using Redwood debt primarily to fund assets (such as investment-grade rated securities and prime-quality residential whole loans) that do not have concentrated credit risks and that typically can be sold in a reasonably liquid manner. Increasingly, we expect to use extendable collateralized commercial paper as a source of short-term Redwood debt for debt-funded asset strategies. We believe the potential liquidity risks of commercial paper are less than those of our debt facilities in the form of repurchase agreements. Finally, we allocate capital equal to 8% of assets to support our debt-funded asset strategies, an amount that is well in excess of the amount required by our lenders. We believe this gives us a margin for safety should liquidity, market value, or credit concerns arise.

With respect to interest rate and prepayment rate risks, we seek to maintain a balance sheet that is well balanced and that can generate cash flows to fund our regular dividend in a wide variety of scenarios. We believe we have achieved this the net present value of our projected cash flows does not vary materially with respect to scenarios incorporating changes in interest rates or prepayment rates. Scenarios incorporating different degrees of potential credit losses, however, show a wide variation in the long-term net present value of our cash flows. In the near-term (one to three years), our results may vary as a function of changes in interest rates, prepayments, credit results, mark to-market asset values, and other factors.

Our primary financial goal is to deliver an attractive sum of dividends per share over time. Our financial goal is to distribute the highest levels of dividends per share over the next few decades as we can. We seek to do that while also remaining within our risk tolerance levels and while increasing the inherent value of the company by building competitive advantages, diversifying risks and opportunities, developing internal capabilities, maintaining our culture, keeping operations highly efficient, and increasing book value per share.

As a REIT, we are required to distribute to our shareholders as dividends at least 90% of our REIT profits as calculated for tax purposes. We distribute our profits as a regular quarterly dividend and also, in some years, in a year-end special dividend. The regular dividend rate for 2006 was $0.70 per share per quarter and the special dividend was $3.00 per share. Total dividends for 2006 were $5.80 per share.

We expect the regular dividend to be $0.75 per share per quarter for 2007, an increase from 2006 s rate of $0.70 per share per quarter. We set the regular dividend at a rate low enough so that we believe there is a relatively small chance that we would need to reduce it in the next few years. Whether we pay a special dividend or not in 2007 will depend primarily on how much REIT taxable income we generate during the year. We expect our total annual dividend payout amounts (regular plus special) will be variable from year to year.

Growth is our mission. In a manner consistent with our goal of distributing dividends per share in attractive amounts over time, our mission is to grow to become a larger company in terms of capital employed and market capitalization. We are targeting growth by building real estate investment, financing, and management operations with competitive advantages. Over the long term, growth should bring several advantages, including book value accretion and a diversified income stream.

We plan to grow organically as markets grow and as we gain long-term market share, rather than simply growing for growth s sake or through short-term acquisition of market share, which would be irresponsible and inconsistent with our long-term goal of distributing attractive dividends per share. But we do not expect growth to be linear, because in cyclical markets growth is not always the appropriate short-term strategy.

Information Concerning Redwood Trust

Our website can be found at www.redwoodtrust.com. We make available, free of charge on or through 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 pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after those materials are filed with, or furnished to, the SEC. We also make available, free of charge, access to our Code of Ethics, Corporate Governance Standards, Audit Committee Charter, Compensation Committee Charter, and Governance and Nominating Committee Charter.

Certifications

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated February 19, 2007, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to our Annual Report on Form 10-K for the year ended December 31, 2006. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on June 7, 2006 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, 2006, Redwood employed 91 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 that, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. You should understand that it is not possible to predict or identify all such factors, and consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events, or otherwise. You are advised, however, to consult any further disclosure we make on related subjects in our reports on forms 10-Q and 8-K filed with the SEC.

Risks Related to our Business

The securities we own expose us to concentrated risks and thus are likely to lead to variable returns.

Many of the securities we own have concentrated credit, interest rate, prepayment, or other risks. No amount of risk management or mitigation can change the variable nature of the cash flows, fair market values, and financial results generated by these securities, which, in turn, can result in variable returns. Changes in the credit performance and/or the prepayments on the underlying real estate loans and changes in interest rates will impact the cash flows on our investments, and the impact could be significant on many of our 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 will result in changes in our reported earnings on that asset. In addition, we may be forced to recognize adverse changes in future cash flows as a current expense, further adding to earnings volatility.

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

We assume credit risk with respect to residential real estate loans primarily through the ownership of residential loan CES and residential loans. CES securities have below investment-grade credit ratings due to their high degree of credit risk with respect to the residential real estate loans within the securitizations that issued these securities. Credit losses from any of the loans in the securitized loan pools reduce the principal value of and economic returns from residential loan CES.

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; decline in the value of homes; special hazards; earthquakes and other natural events; over-leveraging of the borrower; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market weakens, our credit losses could be increased beyond levels that we have anticipated. The interest rate is adjustable for most of the loans securitized by securitization trusts sponsored by us and for a portion of the loans underlying residential loan 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. In addition, for hybrid loans we own and underlying our CES, the loan rate may increase at the end of the fixed rate period. If we incur increased credit losses, our taxable income would be reduced, our GAAP earnings might be reduced (if these increased credit losses are greater than we have anticipated and we need to increase our credit reserves or mark-to-market assets that have declined in value) and our cash flows, dividend payments, asset fair market values, access to short-term borrowings (typically used to acquire assets for sale

to securitization entities), and our ability to securitize assets might be adversely affected. Owning mortgage assets may expose us to legal risks and class action suits. 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, dividend cuts, liquidity issues, and solvency issues.

Significant losses on residential credit-enhancement securities could diminish our equity capital base, reduce our earnings, and otherwise negatively affect our business.

The credit performance of residential loans underlying residential loan CES directly affects our results. Our total potential credit loss from the underlying residential real estate loans is limited to our total investment in

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residential loan CES. Nevertheless, significant realized losses from residential CES could harm our results from operations and significantly diminish our capital base.

If we incur increased credit losses, our taxable income would be reduced, our GAAP earnings might be reduced (if these increased credit losses are greater than we have anticipated), and our cash flows, dividend payments, asset fair market values, our access to short-term borrowings, and our ability to securitize assets might be adversely affected. 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, dividend cuts, liquidity issues, and solvency issues.

Significant credit losses could also reduce our ability to sponsor new securitizations of residential loans. We generally expect to increase our portfolio of residential loan CES and our credit exposure to the residential real estate loan pools that underlie these securities.

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 loan CES. If unanticipated losses occur within the first few years after a securitization is completed, they will have a larger negative impact on CES investment returns. In addition, larger 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. This would also lower our economic returns.

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 that we cannot control. Our quality control and loss mitigation operations may not be successful in limiting future delinquencies, defaults, and losses. 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 counter-parties. Loan servicing companies may not cooperate with our loss mitigation efforts, or such efforts may be ineffective. Service providers to securitizations, such as trustees, bond insurance providers, and custodians, may not perform in a manner that promotes our interests. The value of the homes collateralizing residential loans may decline. The frequency of default, and the loss severity on loans upon default, may be greater than we anticipated. Interest-only loans, negative amortization loans, adjustable-rate loans, loans with balances over $1 million, 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 risk, and severity of loss. If loans become real estate owned we bear the risk of not being able to sell the property and recovering our investment. Changes in consumer behavior, bankruptcy laws, tax laws, and other laws may exacerbate loan losses. 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. Expanded loss mitigation efforts in the event that defaults increase could increase our operating costs.

We have significant credit risk in California. We also have credit risk in other states and our business may be adversely affected by a slowdown in the economy or by natural disasters in these states.

We have a concentration of residential and commercial real estate loans secured by property in California. We also have a significant number of residential and commercial real estate loans that underlie the securities we own are secured by property in California. Factors specific to California could aversely affect our results.

We have residential credit risk in all states, although we do not have more than 1% of our loans in any one zip code. We have commercial credit risk in most states. Factors specific to each of these states economies could adversely affect our results.

An overall decline in the economy or the real estate market could decrease the value of residential and commercial properties. This, in turn, would increase the risk of delinquency, default, or foreclosure on real estate loans underlying our CES portfolios. This could adversely affect our credit loss experience and other aspects of our business, including our ability to securitize real estate loans.

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 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 such disasters. Borrowers may not repair their property or may stop paying their mortgage loans under such 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 underlying pool of mortgage loans on which we are providing credit-enhancement.

We assume credit risk on a variety of residential and commercial mortgage assets.

In addition to residential and commercial loan CES we own, the Acacia entities we sponsor (sometimes collectively referred as Acacia) own investment-grade and non-investment-grade securities (typically rated AAA through B, and in a second-loss position or better, or otherwise effectively more senior in the credit structure as compared to a first-loss residential loan CES or equivalent) issued by residential and commercial real estate loan securitization entities. The Acacia securities 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. These lower-quality loans can be expected to have higher rates of delinquency and loss, and losses to Acacia (and thus Redwood as owner of the Acacia CDO equity securities) could occur. 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 securities issued from securitizations of equivalent-quality loans that we did not sponsor. If the pools of residential loans underlying any of these securitizations were to experience poor credit results, Acacia s securities could have their credit ratings down-graded, could suffer losses in fair market value, or could experience principal losses. If any of these events occurs, it would likely reduce our long-term returns and near-term cash flows from the Acacia CDO equity securities we have acquired, and may also reduce our ability to sponsor Acacia transactions in the future. We may securitize first-loss residential and commercial CES in Acacia in the future, which would add to the risks we undertake in our Acacia program.

The risks of credit-enhancing commercial real estate loans may exceed those of credit-enhancing residential loans.

The commercial real estate assets in which we have a direct or indirect interest may have significant degrees of credit and other risks, including various environmental and legal risks. The net operating income and fair market values of commercial real estate properties may vary with economic cycles and as a result of other factors, so that debt service coverage is unstable. The value of the property may not support the value of the loan if there is a default. Each commercial real estate loan is at risk for local and regional factors. 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. For some commercial real estate loans in which we have an economic interest, the real estate is in transition. Such lending entails higher risks than traditional commercial property lending against stabilized properties. Initial debt service coverage ratios, loan-to-value ratios, and other indicators of credit quality 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 we benefit from on some loans may not be effective. We own some mezzanine loans that do not have a direct lien on the underlying property. We generally do not service commercial real estate loans; we rely on our servicers to a great extent to manage commercial assets and workout loans and properties if there are delinquencies or defaults. This may not work to our advantage. As

part of the workout process of a troubled commercial real estate loan, we may assume ownership of the property, and the ultimate value of this asset would depend on our management of, and eventual sale of, the property that secured the loan.

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.

We have purchased distressed commercial loans at discount prices where there is a reasonable chance we may not recover full principal value. We have sold senior loan participations on some of our loans, with the result that the asset we retain is junior. 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 certain credit, legal, and other risks that may be greater than is usually present with acquired loans. We have acquired and intend to acquire commercial loans for sale to Acacia that require a specific credit rating to be efficient as a securitized asset, and we may not be able to get the rating on the loan that we need. We would be forced to hold the loan with capital, short-term financing or sell the loan.

Our commercial CES have concentrated risks with respect to commercial real estate loans. In general, losses on an asset securing a 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 a cash reserve fund or letter of credit, if any, and then by the first-loss commercial CES holder. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit, and classes of securities junior to those in which we invest (if any), we will not be able to recover all of our principal investment in the securities we purchase. 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, the first-loss securities may suffer a total loss of principal, and the second-loss securities (or other CES or IGS) in which we invest (or have an indirect interest) may effectively become the first-loss position behind the more senior securities, which may result in significant losses to us.

The prices of commercial CES are more sensitive to adverse economic downturns or individual issuer developments than more highly rated commercial 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 commercial ABS to continue to make principal and interest payments.

We acquire and manage a portion of our commercial assets in conjunction with partners. Our partners may have greater control over the management of commercial securitizations than we do. Working with partners in this manner may expose us to increased risks.

We are increasing our financial leverage and this could expose us to increased risks.

We are investing in investment-grade securities and residential whole loans and financing them 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 this increased leverage, we could incur significant losses if our borrowing costs increased relative to the earnings on our assets and hedges. These financing facilities may also force us to sell assets under adverse market conditions. This could occur when we are forced to meet the lenders margin calls as a result of a decrease in the fair market values of the assets pledged as collateral. To the extent we did not have sufficient cash or other assets to post the margin calls, we could be forced to sell the assets. Furthermore, liquidation of the collateral could create negative tax consequences and raise REIT qualification issues.

For this leveraged asset strategy and for other reasons, we expect to materially increase our debt balances. Although we will seek a variety of financing facilities and counterparties, there can be no assurance that we would be able to renew such facilities. The failure to renew facilities could also force us to sell assets in adverse market conditions.

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

We have invested in and intend to 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 securitization, 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, 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 CDO equity

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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 IO securities from residential and commercial securitizations sponsored by us or by others. The higher credit and/or 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 have exposure under representations and warranties we make in the contracts of sale of loans to securitization entities.

With respect to loans that have been securitized by entities sponsored by us, we have potential credit and liquidity exposure for loans that default and are the subject of fraud, irregularities in their loan files or process, or other issues that potentially could expose us to liability as a result of representations and warranties in the contract of sale of loans to the securitization entity. In these cases, we may be obligated to repurchase loans from the securitization entities at principal value. However, we have obtained representations and warranties from the counter-parties that sold the loans to us that generally parallel the representations and warranties we have provided to the entities. As a result, we believe that we should, in most circumstances, be able to compel the original seller of the loan to repurchase any loans that we are obligated to repurchase from the securitization trusts. 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 loan, we may have to use some of our cash resources to repurchase loans.

Our results could be harmed by counter-party credit risk.

We have other credit risks that are generally related to the counter-parties with which we do business. In the event a counter-party 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 counter-party to our interest rate agreements becomes insolvent or interprets our agreements with it in a manner unfavorable to us, our ability to realize benefits from hedging may be diminished, and any cash or collateral that we pledged to such a counter-party may be unrecoverable and we may be forced to unwind these agreements at a loss. In the event that one of our servicers becomes insolvent or fails to perform, loan delinquencies and credit losses may increase and we may not receive funds to which we are entitled. In other aspects of our business, we depend on the performance of third parties that we do not control. We attempt to diversify our counter-party exposure and (except with respect to loan representations and warranties) limit our counter-party exposure to strong companies with investment-grade credit ratings; however, we are not always able to do so. Our counter-party risk management strategy may prove ineffective and, accordingly, our earnings could be adversely affected.

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.

Our loans and loans underlying securities are serviced by third-party service providers. These arrangements allow us to increase the volume of the loans we purchase and securitize without incurring the expenses associated with servicing operations. However, as with any external service provider, we are subject to the risks associated with inadequate or untimely services. Servicers may not advance funds to us that would ordinarily be due because of errors, miscalculations, or for other reasons. Many borrowers require notices and reminders to keep their loans current and to prevent delinquencies and foreclosures. A substantial increase in our delinquency rate that results from improper servicing or loan performance in general could harm our ability to securitize our real estate loans in the future and may

have an adverse effect on our earnings.

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 market 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 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 want to 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 do the GAAP earnings generated by these assets. We also own debt-funded loans and securities as inventory prior to sale to a securitization entity and as a longer term investment. We fund these assets with equity and with floating rate debt. 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 exists and we would earn less (and incur fair market value declines) if interest rates rise. We usually, but not always, seek to mitigate interest rate mismatches for these assets with a hedging program using interest rate swaps and futures.

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 market value of our assets, and decrease our liquidity.

Except with respect to our adjustable rate assets, higher interest rates generally reduce the fair market 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, and possibly driving asset acquisition prices higher.

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.

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 we (or Sequoia or Acacia) own are affected by the rate of prepayment of the underlying residential real estate loans. Adverse changes in the rate of prepayment could reduce our earnings and dividends. They could delay cash payments or reduce the total of cash payments we would otherwise eventually receive. Adverse changes in cash flows would likely reduce an affected asset s fair market value, which would likely reduce our access to liquidity if we borrowed against that asset and may cause a fair market value write-down for GAAP purposes, which would reduce our reported earnings. While we estimate prepayment rates to determine the effective yield of our assets and valuations, these estimates are not precise, and prepayment rates do not necessarily change in a predictable manner as a function of interest rate changes. Prepayment rates can change rapidly. As a result, such 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.

Hedging activities may reduce long-term earnings and may fail to reduce earnings volatility or to protect our capital in difficult economic environments. Our failure to hedge may also harm our results.

We attempt to hedge certain interest rate risks (and, to a much lesser degree, prepayment risks) by balancing the characteristics of our assets with respect to these risks and by entering into various interest rate agreements. The amount and level of interest rate agreements that we utilize may vary significantly over time. We generally attempt to enter into interest rate hedges 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 long periods of 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 market values, to 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. Such 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 to hedge may increase short-term earnings volatility, especially if we do not elect hedge accounting treatment for our hedges (i.e., our hedges are accounted for as trading instruments). Reductions in fair market values of interest rate agreements may not be offset by increases in fair market values of the assets or liabilities being hedged. Conversely, increases in fair market values of interest rate agreements may not fully offset declines in fair market values of assets or liabilities being hedged. Changes in

fair market values of interest rate agreements may require us to pledge significant amounts of collateral or cash. Hedging exposes us to counter-party risks.

We also may hedge by taking short, forward, or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. We intend to 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 counter-party risks.

Our quarterly earnings may reflect volatility in earnings as a result of the accounting treatment for certain interest rate agreements, as a result of accounting treatments for assets or liabilities that do not necessarily match those used for interest rate agreements, or our failure to meet the requirements to obtain desired hedge accounting treatment for certain interest rate agreements.

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 are acquiring today are unlikely to generate economic returns or GAAP yields at the same levels as our historical assets generated. We receive monthly payments from most of our assets, consisting of principal and interest. In addition, occasionally some of our residential loan CES are called (effectively sold). Principal payments and calls reduce the size of our current portfolio and generate cash for us. We also sell assets from time to time as part of our portfolio management and capital recycling strategies. In order to maintain our portfolio size and our earnings, we need to reinvest in new earning assets a portion of the cash flows we receive from principal, interest, calls, and sales.

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 most of our assets, we recognize yields on assets based on our assumptions regarding future cash flows. A portion of the cash flows we receive that exceeds the anticipated cash flows reduces our basis in these assets. As a result of these various factors, our basis for GAAP amortization purposes for many of our current assets is lower than their current fair market values. Assets with a lower GAAP basis 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 unlikely to be as favorable as they have been for the last few years.

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

In order to continue our securitization operations, we require access to short-term debt to finance inventory accumulation prior to sale to securitization entities. In times of market dislocation, this type of short-term debt might become unavailable from time to time. We pledge the inventory assets we buy to secure our short-term debt. This debt is recourse to us, and if the fair market value of the collateral declines we will need to use our liquidity to increase the amount of collateral pledged to secure the debt or to reduce the debt amount. Our goal is to sell these assets to a securitization entity; however, if our ability to sponsor a securitization is disrupted, we may need to sell these assets (most likely at a loss) into the secondary mortgage or securities markets, or we would need to extend the term of the short-term debt used to fund these assets.

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 a lower amount of proceeds than initially assumed. This could result in a loss to us for tax purposes and reduced on-going earnings for GAAP purposes.

Our short-term borrowing arrangements used to support our securitization operations subject us to debt covenants. While these covenants have not meaningfully restricted our operations to date, as a practical matter, they could be restrictive or harmful to us in the future. In the event we violate debt covenants, we may incur expenses, losses, or a reduced ability to access debt.

Our payment of commitment fees and other expenses to secure borrowing lines may not protect us from liquidity issues or losses. Variations in lenders ability to access funds, lender confidence in us, lender collateral requirements, available borrowing rates, the acceptability and fair market values of our collateral, and other factors

could force us to utilize our liquidity reserves or to sell assets, to fund the purchase of assets for sale to securitization entities, thus affecting our liquidity, financial soundness, and earnings.

In the fourth quarter of 2006, we initiated a collateralized commercial paper program to supplement our existing debt arrangements. This could expose us to new risks including the risk of not renewing our commercial paper issuance.

We may enter into derivative contracts that could expose us to contingent liabilities.

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

Our cash balances and cash flows may become limited relative to our cash needs.

We need cash to meet our interest expense payments, working capital, minimum REIT dividend distribution requirements, and other needs. Cash could be required to pay down our recourse short-term borrowings in the event that the fair market values of our assets that collateralize our debt decline, the terms of short-term debt become less attractive, or for other reasons. Cash flows from principal repayments could be reduced should prepayments slow or credit quality trends deteriorate (in the latter case since, for certain of our assets, credit tests must be met for us to receive cash flows). 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. 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 become large relative to our cash flows if our income as calculated for tax purposes significantly exceeds our net cash flows. 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.

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

We manage our business based on long-term opportunities to generate cash flows. Our dividend distributions are 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 the cash flows and our taxable income.

Fair market values for our assets, liabilities, and hedges can be volatile. A decrease in fair market value may not necessarily be the result of deterioration in future cash flows. For GAAP purposes, we mark-to-market some, but not all, of our consolidated assets and liabilities through our consolidated balance sheets. In addition, under various circumstances, some fair market valuation adjustments on assets may be realized in our consolidated statements 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 statements of income at a reduced market price relative to its basis, our reported earnings will be reduced. Changes in our consolidated statements of income and consolidated balance sheets due to fair market value adjustments should be interpreted with care.

We establish credit reserves for GAAP accounting purposes, but there are no reserves established for tax accounting purposes.

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). Since, for GAAP purposes, we are able to incorporate an assumption about the amount and timing of credit losses, the occurrence of these losses as assumed 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).

Our reported income depends on accounting conventions and assumptions about the future that may change.

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 revenue recognition and other aspects of our reported results are based on estimates of future events. These estimates are reevaluated on at least a quarterly basis and may give rise to additional expense or revenue recognition.

The Financial Accounting Standards Board has issued exposure drafts for a number of proposed amendments to FASB No. 140, *Accounting for Transfers of Financial Assets* (FAS 140), and has indicated that additional revisions to FAS 140 are under consideration. While the proposals released to date would not have a material impact on our operations or results, any future amendments that required a change in the way we account for our securitizations through our Sequoia or Acacia programs could adversely after our business strategy and reported results.

For GAAP accounting purposes, we use the effective yield method for many of our consolidated assets and ABS issued. We calculate projected cash flows for each of these assets and ABS issued, incorporating assumptions about the amount and timing of credit losses, loan prepayment rates, and other factors. The yield we recognize for GAAP purposes generally equals the discount rate that produces a net present value for actual and projected cash flows that equals our GAAP basis in that asset or ABS issued. We change the yield we recognize on these assets and ABS issued based on actual performance and as we change our estimates of future cash flows which we reevaluate at least quarterly. As a result of a change in cash flow estimates we may reduce the GAAP yield we recognize for an asset and/or write down the basis of the asset to its current fair market value (if the fair market value is lower than the basis). For a consolidated ABS-issued liability, a change in assumptions could lead to a higher consolidated interest expense. These types of actions reduce our reported GAAP earnings.

Risks Related to our Company Structure and Operations

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

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 factual matters and an application of the legal requirements to such factual matters in situations where there is only limited judicial and administrative guidance. Thus, no assurance can be given that the Internal Revenue Service or a court would agree with our conclusion that we have qualified as a REIT or that future changes in our factual situation or the law will allow us to remain qualified as a REIT. 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. 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 may reduce our flexibility.

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:

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

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

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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 affiliates 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.

- 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 our flexibility in pursuing certain transactions. 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.

The requirements for maintaining REIT status and/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.

Failure to qualify for the Investment Company Act exclusion could harm 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 (i.e., qualifying interests) are excluded from the requirements of the Investment Company Act. To qualify for the Investment Company Act exclusion, 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% in qualifying assets or other real estate-related assets (the 25% Requirement).

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 harm us. Further, if we were deemed an unregistered investment company, we could be subject to monetary penalties and injunctive relief. We may 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 of 1940, as amended.

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.

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.

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. 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

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cquisitions. 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 may deter offers to acquire our stock or large blocks of our stock upon terms attractive to our stockholders, thereby limiting the opportunity for stockholders to receive a premium for their shares over then-prevailing market prices.

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. Experienced personnel are in high demand and competition for their talents is intense. There can be no assurance that we will continue to attract and retain key personnel.

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

The design and effectiveness of our disclosure controls and procedures and internal control 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 control over financial reporting, there can be no assurance that our disclosure controls and procedures or internal control over financial reporting will be effective in accomplishing all control objectives all of the time. Deficiencies, particularly material weaknesses, in internal control 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.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Redwood has two leases and one sublease for executive and administrative offices at One Belvedere Place, Mill Valley, California 94941. One lease expires in 2013, the second lease expires in 2018, and the sublease expires at the end of 2007. The 2007 rent obligation for these leases is approximately $1.4 million.

ITEM 3. LEGAL PROCEEDINGS

At December 31, 2006, to our knowledge there were no legal proceedings to which we were a party or to which any of our properties was subject.

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

No matters were submitted to a vote of Redwood s stockholders during the fourth quarter of 2006.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Redwood s common stock is listed and traded on the NYSE under the symbol RWT. As of February 19, 2007, Redwood s common stock was held by approximately 1,800 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 37,000. As of February 19, 2007, there were 26,825,390 shares outstanding. The high and low sales prices of shares of the common stock as reported on the NYSE and the cash dividends declared on Redwood s common stock for the periods indicated below were as follows:

	Stock Prices		Common Dividends Declared			
	High	Low	Record Date	Payable Date	Per Share	Dividend Type
Year Ended December 31, 2006						
Fourth Quarter	$ 59.75	$ 50.23	12/29/06	1/22/07	$ 0.70	Regular
			11/27/06	12/8/06	$ 3.00	Special
Third Quarter	$ 51.82	$ 47.07	9/29/06	10/23/06	$ 0.70	Regular
Second Quarter	$ 48.83	$ 40.36	6/30/06	7/21/06	$ 0.70	Regular
First Quarter	$ 44.85	$ 40.98	3/31/06	4/21/06	$ 0.70	Regular
Year Ended December 31, 2005						
Fourth Quarter	$ 47.59	$ 41.26	12/30/05	1/23/06	$ 0.70	Regular
			11/25/05	12/9/05	$ 3.00	Special
Third Quarter	$ 54.98	$ 48.61	9/30/05	10/21/05	$ 0.70	Regular
Second Quarter	$ 54.08	$ 49.97	6/30/05	7/21/05	$ 0.70	Regular
First Quarter	$ 62.45	$ 48.73	3/31/05	4/21/05	$ 0.70	Regular

We intend to distribute to our stockholders at least 90% of our REIT taxable income. All dividend distributions are made with the authorization of the board of directors at its discretion and will depend on our REIT taxable earnings, financial condition, maintenance of REIT status, and such other factors as the board of directors may deem relevant from time to time.

We announced stock repurchase plans on various dates from September 1997 through November 1999 for the total repurchase of a total of 7,455,000 shares. None of these plans have expiration dates. There were no repurchases during

2006 and as of December 31, 2006, 1,000,000 shares remained available for repurchase under those plans.

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, 2001 through December 31, 2006

	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Redwood Trust, Inc	100.00	126.50	270.02	380.42	286.42	403.19
S&P Composite-500 Index	100.00	77.90	100.24	111.15	116.60	132.49
NAREIT Mortgage REIT Index	100.00	131.08	206.30	244.33	187.67	223.93

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data for 2006, 2005, 2004, 2003, and 2002 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. Certain amounts for prior periods have been reclassified to conform to the 2006 presentation.

(In thousands, except per share data)	2006	2005	2004	2003	2002
Selected Statement of Operations Data:					
Interest income	$ 885,160	$ 962,197	$ 651,618	$ 330,976	$ 163,216
Interest expense	(701,704)	(757,270)	(431,421)	(202,861)	(91,705)
Net interest income	183,456	204,927	220,197	128,115	71,511
Operating expenses	(55,925)	(48,382)	(38,692)	(36,895)	(20,005)
Gains (losses) on sales	19,577	46,730	7,639	(2,171)	7,603
Gains on calls	2,980	19,149	58,739	55,702	
Valuation adjustments, net	(12,586)	(5,031)	(7,251)	(6,855)	(2,492)
Provision for income taxes	(9,970)	(17,521)	(7,997)	(5,502)	
Dividends on Class B preferred stock				(681)	(2,724)
Undistributed earnings allocated to Class B preferred stock				(15)	(452)
Net income available to common stockholders	$ 127,532	$ 199,872	$ 232,635	$ 131,698	$ 53,441
Average common shares basic	25,718,435	24,637,016	21,437,253	17,759,346	15,177,449
Net income per share basic	$ 4.96	$ 8.11	$ 10.85	$ 7.42	$ 3.52
Average common shares diluted	26,313,826	25,121,467	22,228,929	18,812,166	15,658,623

Net income per share diluted	$ 4.85	$ 7.96	$ 10.47	$ 7.04	$ 3.41
Dividends declared per Class B preferred share				$ 0.755	$ 3.020
Regular dividends declared per common share	$ 2.80	$ 2.80	$ 2.68	$ 2.600	$ 2.510
Special dividends declared per common share	$ 3.00	$ 3.00	$ 6.00	$ 4.750	$ 0.375
Total dividends declared per common share	$ 5.80	$ 5.80	$ 8.68	$ 7.350	$ 2.885
Selected Balance Sheet Data:					
Earning assets	$ 12,752,890	$ 16,529,286	$ 24,572,723	$ 17,543,487	$ 6,971,794
Total assets	$ 13,030,473	$ 16,776,960	$ 24,778,065	$ 17,670,386	$ 7,028,939
Redwood debt	$ 1,856,208	$ 169,707	$ 203,281	$ 236,437	$ 99,714
Asset-backed securities issued	$ 9,979,224	$ 15,585,277	$ 23,630,162	$ 16,826,202	$ 6,418,187
Junior subordinated notes	$ 100,000				
Total liabilities	$ 12,027,783	$ 15,842,000	$ 23,913,909	$ 17,117,058	$ 6,555,906
Total stockholders equity	$ 1,002,690	$ 934,960	$ 864,156	$ 553,328	$ 473,033
Number of Class B preferred shares outstanding					902,068
Number of common shares outstanding	26,733,460	25,132,625	24,153,576	19,062,983	16,277,285
Book value per common share	$ 37.51	$ 37.20	$ 35.78	$ 29.03	$ 27.43
Other Selected Data:					
Average assets	$ 14,123,151	$ 21,797,922	$ 21,559,604	$ 11,058,272	$ 4,039,652
Average debt and ABS outstanding	$ 12,996,244	$ 20,710,057	$ 20,748,658	$ 10,489,614	$ 3,616,506
Average common equity	$ 988,495	$ 970,269	$ 730,499	$ 526,808	$ 402,986
Net income/average common equity	12.9 %	20.6 %	31.8 %	25.3 %	14.2 %

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

Summary and Outlook

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), 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 high cash flow returns over a long period of time to help support our goal of distributing attractive levels of dividends per share. For tax purposes, we are structured as a real estate investment trust (REIT).

We assume a range of credit risks in our investments, and the level of assumed risk dictates the manner in which we finance our purchase of, and derive income from, these investments. Our primary source of income is net interest income, which equals the interest income we earn from our investments in loans and securities less the interest expenses we incur from our borrowed funds and other liabilities.

Our investments in residential, commercial, and CDO credit enhancement securities (CES, or below investment-grade securities) have concentrated credit risk. We finance the acquisition of most of our first and second-loss CES that are directly exposed to credit losses, with capital. We generally finance the acquisition of our third-loss securities through our Acacia securitization program. Our CES investments accounted for over 50% of net interest income in 2006. To date, our primary credit enhancement investment focus has been in 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. Our CES investment returns depend on the amount and timing of the interest and principal collected on the loans in the pools supporting the securities. In an ideal environment for our residential CES, we would experience fast loan prepayments and low credit losses which would, in turn, lead to attractive CES returns. We encountered that type of environment from 2003 to 2006. The return on our residential CES investments would be adversely affected by slow loan prepayments and high credit losses.

Our investments in real estate loans and investment-grade securities have less concentrated credit risk. To produce an attractive investment return on these lower credit risk assets, we use leverage. We earn income based upon the spread between the yield on the acquired asset and the cost of funds we borrowed to acquire the asset. We have obtained most of the debt financing used to acquire these assets through the issuance of asset-backed securities (ABS) under our Sequoia and Acacia securitization programs. The debt incurred to acquire assets through Sequoia and Acacia is non-recourse to Redwood.

Our reported GAAP net income was $128 million ($4.85 per share) for 2006. Our GAAP net income was $200 million ($7.96 per share) in 2005 and was $233 million ($10.47 per share) in 2004. Our GAAP return on equity was 13% for 2006 compared to 21% for 2005 and 32% for 2004. In 2006, we declared four regular quarterly dividends of $0.70 per share and a special dividend of $3.00 per share.

Table 1 Net Income

(In thousands, except share data)	**2006**	**2005**	**2004**
Total interest income	$ 885,160	$ 962,197	$ 651,618
Total interest expense	(701,704)	(757,270)	(431,421)
Net interest income	183,456	204,927	220,197
Operating expenses	(55,925)	(48,382)	(38,692)
Gains on sales	19,577	46,730	7,639
Gains on calls	2,980	19,149	58,739
Valuation adjustments, net	(12,586)	(5,031)	(7,251)
Provision for income taxes	(9,970)	(17,521)	(7,997)
Net income	$ 127,532	$ 199,872	$ 232,635
Diluted common shares	26,313,826	25,121,467	22,228,929
Net income per share	$ 4.85	$ 7.96	$ 10.47

The largest factor in the decline in net income over the past year was a $43 million drop in income from gains generated on the sale and call of assets. In 2005, we sold a significant amount of CES as part of a portfolio management strategy to reduce our level of residential credit risk and to free up capital. We also benefited from a large number of calls of securities in 2005. Another factor contributing to the decline in earnings was a decrease in net interest income of $21 million primarily due to high prepayments on adjustable rate loans securitized under our Sequoia program. This decline was partially offset by an increase in yields from our securities portfolio (primarily residential CES). Other factors include an increase of operating expenses of $8 million and an increase in negative mark-to-market valuation adjustments of $8 million primarily related to interest rate agreements. The assets associated with these interest rate agreements generally increased in value, but those increases were not recognized in GAAP income. These items were partially offset by a decrease in the tax provision of $8 million due to a decrease in net income.

Over the past two years, our strategy has been to lay the foundation for future growth by diversifying our investment and financing capabilities, strengthening the Redwood team, and bolstering our systems and infrastructure. At the same time, we have been steering our way through the disruption in the housing and loan markets by selling some of our riskiest credit assets, sticking to our investment discipline, and preserving capital.

In 2006, we raised $66 million of capital through the sale of common stock via our direct stock purchase plan and we raised $100 million of capital from the sale of trust preferred securities. Additionally, we freed up $97 million of capital for investment by selling and re-securitizing a portion of our CES. We absorbed all of this capital in 2006, primarily through new investments in commercial and residential CES and investment-grade securities. At year end 2006, we had $182 million of excess capital, $7 million less than at the beginning of the year.

We plan to increase our residential and commercial investment activity in 2007 compared to 2006. We expect that capital absorption will be fairly evenly split between investments in assets with less credit sensitivity and investments in cautiously selected credit-enhancement securities. We currently expect net capital absorption for 2007 will be between $200 million and $400 million.

To finance planned investments, we expect to use a combination of Redwood debt, proceeds from securitization financings, and capital. We plan to raise additional capital this year. Although the precise amount and sources of that additional capital are uncertain at this time, potential sources include the sale of stock through our direct stock purchase plan, public or private sales of common stock, and/or issuance of trust preferred securities or other long-term debt.

At year-end, we had over $2 billion of residential and commercial securities funded through our Acacia CDO program. The growth within this program over the past four years has been a significant achievement, as Acacia has allowed us to more efficiently finance our assets and to diversify and expand our investment capabilities and product lines. We achieved this growth in CDO financing by combining the acquisition skills of our residential and commercial portfolio managers with the well-respected debt structuring skills of our CDO finance team.

During 2007, we expect Acacia s assets to continue to grow with the addition of a mix of less-credit-sensitive commercial and residential securities. Some of these assets may also be synthetic or derivative assets. We believe that

derivative assets can be an attractive investment alternative at a time of declining availability of new loans and securities.

Over the next several years, we expect to continue diversifying the type of assets funded through Acacia. Commercial real estate whole loans is one of the asset types we are exploring. We feel strongly that real estate assets funded through Acacia will continue to be a significant growth area for us.

Residential whole loans present another opportunity for us to invest in assets with less concentrated credit risks. Our residential conduit is now an active buyer of hybrid and adjustable rate loans from major originators throughout the country. In 2007, we expect to increase our investment in residential loans.

Expanding into less credit sensitive assets is clearly an attractive opportunity at the present time, but it is not intended to dilute the essential nature of our business. Over the long term, we expect that credit enhancing high quality residential and commercial real estate loans will remain our core activity.

Our residential CES investments to date have largely focused on securities backed by prime quality loans. The overall credit performance of loans backing our existing portfolio of prime CES is still strong, and continues to be significantly better than our initial loss estimates at the time of acquisition.

Most of the current problems in the residential loan market involve subprime loans originated in late 2005 and in 2006. Mortgage originators are being inundated by loan repurchase requests from investors due to underwriting violations and the poor credit performance of subprime borrowers. We are not a mortgage loan originator, and our investment in residential CES backed by subprime loans totaled only $10 million at year-end 2006.

We owned $518 million subprime investment-grade securities at year-end 2006. These securities are generally performing within our expectations credit-wise, and most of them are financed via Acacia CDO securitization so changes in their market value in the absence of actual credit losses are generally of little concern to us. Over 90% of these securities were rated BBB+ or higher. The area of greatest concern in the subprime investment-grade market today are subprime securities rated BBB- and BBB that were issued in 2006. We owned $44 million of 2006 subprime BBB- and BBB securities at year-end 2006. In January 2007, we identified and sold $10 million of the securities within this group that we believed were most at risk of being downgraded in the future. These sales were accomplished at a small loss relative to our purchase price.

In the current housing climate we are taking a cautious approach to credit enhancing new residential loans of any type, but we do see opportunities to make attractive investments.

Residential CES pricing continues to remain expensive due to high liquidity levels, strong demand, and a declining supply of new issuance. We believe this condition will likely persist, especially for prime-quality collateral. We believe we can still make attractive returns even at these price levels, as long as the underlying credit quality is high and we don t face a serious economic recession. We expect the quality of underwriting to improve in 2007, and we expect to become a more active buyer of residential CES in the second half of 2007.

We expect our primary target areas will be residential CES backed by prime and near-prime alt-a loans. We will also be actively looking at subprime CES, but many unanswered credit questions still exist. Unless we see opportunities to buy subprime at prices lower than those currently prevailing, we expect our subprime CES investments in 2007 will remain relatively small.

Our commercial group is now established in the marketplace as an investor in and manager of first-loss and other commercial credit-enhancement securities. We were an active investor in commercial CES in 2006. This will continue to be our primary commercial real estate focus in 2007.

Our portfolio of commercial securities and loans continues to reflect current strong commercial market fundamentals. On the whole, even though commercial properties are largely healthy, we believe the risks of credit-enhancing commercial loans are increasing. The tremendous amount of capital flowing into the CMBS sector has created more aggressive underwriting and has kept asset prices high. The volume of our commercial CES investments in 2007 will largely depend on our ability to find assets that meet our relatively conservative investment criteria.

Looking forward into 2007, our biggest concern is the depth and duration of the housing market correction, and its ultimate impact on real estate credit. To date, our assets have held up well. Our delinquencies and losses have increased somewhat, but are still at very low levels. If the housing market takes a more severe downward turn, however, our credit results (and earnings and dividends) will be more seriously impacted. Additionally, further stress in the housing and credit markets might also cause pricing dislocations for housing-related securities. This will create buying opportunities for us, but also the fair market value of our current residential CES portfolio would likely decline.

We believe we are well positioned as we move forward into the new year. We continue to expect quarter-to-quarter volatility in our GAAP and taxable earnings for a variety of reasons, including some technical accounting and tax issues more fully described later.

We believe that our core strategy to build a highly efficient and entrepreneurial financial institution focused on real estate investment has us in a good position to capitalize on a wide range of investment opportunities in 2007 and beyond.

RESULTS OF OPERATIONS

<u>2006 as Compared to 2005</u>

Interest Income

Total interest income consists of interest earned on consolidated earning assets, adjusted for amortization of discounts and premiums and provisions for loan credit losses. The table below summarizes interest income earned on real estate loans, securities, and cash.

Table 2 Interest Income and Yield

(Dollars in thousands)	2006				2005			
	Interest Income	Percent of Total Interest Income	Average Balance	Yield	Interest Income	Percent of Total Interest Income	Average Balance	Yield
Real estate loans, net of provision for credit losses	$ 608,868	68.78 %	$ 10,652,094	5.72 %	$ 779,469	81.01 %	$ 18,694,028	4.17 %
Real estate securities	265,353	29.98 %	2,612,934	10.15 %	177,524	18.45 %	2,173,295	8.17 %
Cash and cash equivalents	10,939	1.24 %	268,340	4.08 %	5,204	0.54 %	181,259	2.87 %
Total interest income	$ 885,160	100.00 %	$ 13,533,368	6.54 %	$ 962,197	100.00 %	$ 21,048,582	4.57 %

The table below details how our interest income changed by portfolio as a result of changes in consolidated asset balances (volume) and yield (rate) for 2006 as compared to 2005.

Table 3 Volume and Rate Changes for Interest Income

(In thousands)	Change in Interest Income Years Ended December 31, 2006 Versus December 31, 2005		
	Volume	Rate	Total Change

Real estate loans, net of provisions for credit losses	$	(335,318)	$	164,717	$	(170,601)
Real estate securities		35,912		51,917		87,829
Cash and cash equivalents		2,526		3,209		5,735
Total interest income	$	(296,880)	$	219,843	$	(77,037)

Volume change is the change in average portfolio balance between periods multiplied by the rate earned in the earlier period. Rate change is the change in rate between periods multiplied by the average portfolio balance in the prior period. Interest income changes that result from changes in both rate and volume were allocated to the rate change amounts shown in the table.

A further breakdown and discussion of the year over year changes for the real estate loan, real estate securities, and cash components of interest income follows below.

Interest Income Loans

The following table provides detail on interest income earned on our residential and commercial real estate loan portfolios for 2006 and 2005.

Table 4 Consolidated Real Estate Loans

(Dollars in thousands)

Year ended December 31, 2006

	Interest Income	Net (Premium) Discount Amortization	(Provision) Reversal of Credit Reserve	Total Interest Income	Average Balance	Yield as a Result of: Interest Income	(Premium) Discount Amortization/ Credit Reserve	Total Interest Income
Residential loans	$ 654,192	$ (48,700)	$ 394	$ 605,886	$ 10,611,827	6.17 %	(0.46)%	5.71 %
Commercial loans	2,849	168	(35)	2,982	40,267	7.08 %	0.33 %	7.41 %
Total loans	$ 657,041	$ (48,532)	$ 359	$ 608,868	$ 10,652,094	6.18 %	(0.46)%	5.72 %

Year ended December 31, 2005

	Interest Income	Net (Premium) Discount Amortization	(Provision) Reversal of Credit Reserve	Total Interest Income	Average Balance	Yield as a Result of: Interest Income	(Premium) Discount Amortization/ Credit Reserve	Total Interest Income
Residential loans	$ 819,113	$ (45,174)	$ 245	$ 774,184	$ 18,642,020	4.39 %	(0.24)%	4.15 %
Commercial loans	5,450	(350)	185	5,285	52,008	10.48 %	(0.32)%	10.16 %
Total loans	$ 824,563	$ (45,524)	$ 430	$ 779,469	$ 18,694,028	4.41 %	(0.24)%	4.17 %

Interest income on real estate loans decreased to $609 million in 2006 from $779 million in 2005 primarily as a result of lower average balances of real estate loans. This was due to high prepayments within our existing portfolio of LIBOR-indexed ARMs and a relatively low level of new loan acquisitions in 2006. This decline was partially offset by increased yields due to increases in the short-term interest rates to which most of the residential real estate loans are indexed.

Our residential real estate loan balance was $22.5 billion at December 31, 2004, $13.9 billion at December 31, 2005, and $9.3 billion at December 31, 2006. The vast majority of these loans were one- and six-month LIBOR adjustable-rate residential loans (LIBOR ARMs) that were financed through our Sequoia securitization program. The flattening of the yield curve that began in 2005 and continued through 2006 led to fast prepayments on our existing LIBOR ARMs and caused origination levels of new LIBOR ARMs to significantly decline. In a flat yield curve environment, hybrid or fixed-rate loans are a more attractive loan alternative. Additionally, new forms of adjustable-rate mortgages (negative amortization, option ARMs , and moving treasury average ARMs) represent an increased share of the ARM market. Prepayment rates for our residential loans increased from an average constant

prepayment rate (CPR) of 43% in 2005 to an average CPR of 46% in 2006.

Loan premium amortization expense increased to $49 million in 2006 from $46 million in 2005. The percentage increase in premium amortization expense was not commensurate with the decrease in our residential loan balance during this period. The reason for this anomaly relates to the loan premium amortization method we use for loans acquired prior to July 2004, which represented 71% of the loan balance at December 31, 2005 and 56% of the loan balance at December 31, 2006. For these loans, the premium amortization rate is somewhat influenced by prepayments, but is more significantly influenced by short-term interest rates. As short-term rates increase, premium amortization slows; as short-term rates decrease, premium amortization could accelerate in a material way. See the Potential for GAAP Earnings Volatility discussion later in this document. For the remainder of the loans which we acquired after July 2004, we use a different accounting method for premium amortization, and as a result, the percentage of amortization is more closely correlated to prepayment rates.

During 2006, we reversed $0.4 million of our existing loan credit reserve into income. On a percentage basis, the reduction in the credit reserve was lower than the overall decline in our outstanding residential loan balance. The primary reason was a rise in residential loan delinquencies, which increased from 0.27% of the current loan balance at December 31, 2005 to 0.81% at December 31, 2006. This increase in delinquencies is in line with our expectations as our loan portfolio seasons. Delinquencies as a percent of original balances increased from 0.13% at December 31, 2005 to 0.24% at December 31, 2006. Overall, residential loan credit performance remains significantly better than our original expectations.

Interest Income Securities

The tables below present the income and yields of the components of our securities for 2006 and 2005.

Table 5 Real Estate Securities Interest Income and Yield

in thousands)

ded December 31, 2006					**Yield as a Result of**		
	Interest Income	**Discount (Premium) Amortization**	**Total Interest Income**	**Average Balance**	**Interest Income**	**Discount (Premium) Amortization**	**T In In**
ent-grade securities							
ial	$ 86,181	$ 6,874	$ 93,055	$ 1,393,736	6.18 %	0.49 %	
cial	9,436	263	9,699	138,425	6.82 %	0.19 %	
	10,777	29	10,806	175,358	6.15 %	0.02 %	
vestment-grade securities	$ 106,394	$ 7,166	$ 113,560	$ 1,707,519	6.23 %	0.42 %	
nhancement securities							
ial	$ 67,135	$ 57,404	$ 124,539	$ 597,206	11.24 %	9.61 %	
cial	26,961	(1,561)	25,400	290,964	9.27 %	(0.54)%	
	1,854		1,854	17,245	10.75 %	0.00 %	
edit enhancement securities	$ 95,950	$ 55,843	$ 151,793	$ 905,415	10.60 %	6.17 %	
al estate securities	$ 202,344	$ 63,009	$ 265,353	$ 2,612,934	7.74 %	2.41 %	

ded December 31, 2005					**Yield as a Result of**		
	Interest Income	**Discount (Premium) Amortization**	**Total Interest Income**	**Average Balance**	**Interest Income**	**Discount (Premium) Amortization**	**T In In**
ent-grade securities							
ial	$ 58,029	$ 3,835	$ 61,864	$ 1,158,785	5.01 %	0.33 %	
cial	12,648	(190)	12,458	202,594	6.24 %	(0.09)%	
	7,261	15	7,276	138,207	5.25 %	0.01 %	
vestment-grade securities	$ 77,938	$ 3,660	$ 81,598	$ 1,499,586	5.20 %	0.24 %	
nhancement securities							
ial	$ 47,286	$ 36,540	$ 83,826	$ 522,704	9.05 %	6.99 %	
cial	12,269	(798)	11,471	142,850	8.59 %	(0.56)%	
	581	48	629	8,155	7.12 %	0.59 %	
edit enhancement securities	$ 60,136	$ 35,790	$ 95,926	$ 673,709	8.93 %	5.31 %	

al estate securities	$ 138,074	$ 39,450	$ 177,524	$ 2,173,295	6.35 %	1.82 %

Investment-Grade Securities

Over the past year we shifted strategy to allocate more capital to investments in investment-grade securities (IGS) securities with less concentrated credit risks. Interest income from IGS increased in 2006 as compared to 2005 due to portfolio growth and increased yields. The majority of the IGS acquired in 2006 were residential, in part because comparably rated commercial securities traded at relatively higher prices and lower yields. The increase in yield is generally reflective of the rise in short-term interest rates over the past year, as new securities were purchased in a higher interest rate environment and many existing securities have a variable interest rate that reset to higher levels. Most of the IGS acquired in 2006 were financed through our Acacia CDO securitization program. In 2007, we intend to continue to build our IGS portfolio, with purchases financed with Redwood debt in addition to funding through Acacia.

Residential CES

We acquire many first-loss bonds at 25% to 35% of their principal value and other, more senior, credit-enhancement securities at 50% to 100% of their principal value. Many of these securities are priced at a substantial discount to their principal value as future credit losses could reduce or eliminate the principal value of these securities. Our yields on these investments depend on how much principal and interest we eventually collect and

how quickly we receive those payments. The faster we collect principal and the longer it takes to realize credit losses, the better it is for our investment returns.

Interest income from our residential CES was $125 million in 2006, a $41 million increase over 2005. This increase is largely the result of higher yields (21% in 2006 vs. 16% in 2005), which resulted from the strong credit performance and faster than anticipated prepayments rates on CES on the underlying ARMs loans. ARMs represented 57% of our residential CES portfolio, and average actual prepayment rates were in excess of 40% in 2006 compared to our initial expectations (at the time of acquisition) of 20% to 25%.

The increase in interest income also resulted from a higher average balance of residential CES in our portfolio. This growth reflected our ability to find new assets at a pace in excess of our sales, calls, and principal payments.

IGS and CES Backed by Option ARMs

We own IGS and CES that are backed by option ARM mortgages, which give the borrower the option of making a minimum payment that is less than the amount of interest owed for that loan period. The unpaid interest is added to the loan balance creating negative amortization (neg am). The amount of neg am interest we currently recognize or defer for GAAP purposes on option ARMs securities depends on our expectation of collectibility. We currently expect that accumulated neg am interest for securities rated BB and higher will be paid in full. We will continue to monitor and assess this assumption.

In 2006 and 2005, we recognized $7 million and $1 million, respectively, of neg am interest on securities rated BB and higher. During these same time periods, we deferred recognition of neg am interest of $4.0 million and $0.8 million, respectively, on our unrated and B-rated securities. For these securities we will recognize this deferred interest as cash is received. Our cumulative deferred neg am interest is $4.8 million at December 31, 2006.

Commercial CES

Interest income from our commercial CES was $25 million in 2006, a $14 million increase over 2005. This increase is almost entirely the result of higher average balances. We were active buyers of commercial CES in 2006 as we have become more established in this marketplace.

The average yield earned on our commercial CES portfolio in 2006 was 8.73%. The yield was low relative to other CES due to credit loss assumptions. Similar to residential, commercial CES are acquired at a net discount. Commercial CES generally have a ten year maturity and are not expected to receive principal prepayments prior to maturity. As a result, it will take several years to reasonably assess credit performance and recognize any potential upside in yield from discount amortization.

Interest Income Cash and Cash Equivalents

Interest income from cash and cash equivalents was $11 million in 2006, a $6 million increase over 2005. This increase is largely the result of higher average excess cash balances and an increase in yield earned on cash.

Interest Expense

Interest expense consists of interest payments on Redwood debt, consolidated asset-backed securities (ABS) issued from sponsored securitization entities, and junior subordinated notes. The table below presents our interest income and balances for these components for 2006 and 2005.

Table 6 Total Interest Expense

(Dollars in thousands)	Year Ended December 31, 2006	2005
Interest expense on Redwood debt	$ 29,836	$ 11,793
Interest expense on consolidated ABS	671,445	745,477
Interest expense on junior subordinated notes	423	
Total interest expense	$ 701,704	$ 757,270
Average Redwood debt balance	$ 493,357	$ 261,322
Average ABS issued balance	12,497,551	20,448,735
Average junior subordinated notes balance	5,336	
Average total obligations	$ 12,996,244	$ 20,710,057
Cost of funds of Redwood debt	6.05 %	4.51 %
Cost of funds of ABS issued	5.37 %	3.65 %
Cost of funds of junior subordinated notes	7.93 %	
Cost of funds of total obligations	5.40 %	3.66 %

Total consolidated interest expense decreased to $702 million in 2006 from $757 million in 2005. This was caused by a significant decline in the balance of outstanding consolidated ABS issued in 2006 as a result of rapid prepayments of the loans within these securitization entities. Offsetting much of the decline in balances was the higher cost of funds due to an increase in short-term interest rates as most of our debt and consolidated ABS issued is indexed to one-, three-, or six-month LIBOR. These factors are illustrated in the table below.

Table 7 Volume and Rate Changes for Interest Expense

(In thousands)	Change in Interest Expense Years Ended December 31, 2006 vs. December 31, 2005		
	Volume	Rate	Total Change
Interest expense on Redwood debt	$ 10,471	$ 7,572	$ 18,043

Interest expense on ABS	(289,868)	215,836	(74,032)
Interest expense on junior subordinated notes	423		423
Total interest expense	$ (278,974)	$ 223,408	$ (55,566)

Volume change is the change in average balance of obligations between periods multiplied by the rate paid in the earlier period. Rate change is the change in rate between periods multiplied by the average outstanding obligations in the current period. Interest expense changes that resulted from changes in both rate and volume were allocated to the rate change amounts shown in the table.

The table below presents the different components of our interest costs on ABS issued for 2006 and 2005. ABS issuance premiums are created when ABS are issued at prices greater than principal value, such as interest-only (IO) securities.

Table 8 Cost of Funds of Asset-Backed Securities Issued

(Dollars in thousands)	Year Ended December 31,	
	2006	2005
ABS interest expense	$ 667,061	$ 742,542
ABS issuance expense amortization	25,669	21,890
Net ABS interest rate agreement income	(12,472)	(6,542)
Net ABS issuance premium income amortization on ABS issue	(8,813)	(12,413)
Total ABS interest expense	$ 671,445	$ 745,477
Average balance of ABS	$ 12,497,551	$ 20,448,735
ABS interest expense	5.34 %	3.63 %
ABS issuance expense amortization	0.21 %	0.11 %
Net ABS interest rate agreement income	(0.10)%	(0.03)%
Net ABS issuance premium income amortization on ABS issued	(0.07)%	(0.06)%
Cost of funds of ABS	5.38 %	3.65 %

Operating Expenses

Total operating expenses increased by 15% in 2006 as compared to 2005. Components of our operating expenses for 2006 and 2005 are presented in the table below.

Table 9 Operating Expenses

(In thousands)	Year Ended December 31,	
	2006	2005
Fixed compensation expense	$ 13,871	$ 11,082
Variable compensation expense	19,207	18,558
Systems	7,947	5,666
Due diligence	4,035	2,246
Office costs	4,278	4,076
Accounting and legal	3,533	4,102
Other	3,054	2,652
Total operating expenses	$ 55,925	$ 48,382

Operating expenses increased as we continued to add personnel, systems, and additional internal controls to lay the foundation for future growth. We have expanded our product lines and made significant investments in further developing our business processes and information technology systems. Our efforts to build for future growth are

ongoing and we expect that our operating expenses will continue to increase in 2007.

Fixed compensation expense includes employee salaries and related employee benefits. Fixed compensation expense has increased in 2006 as compared to 2005 due to increased staffing levels. Our headcount increased from 79 at December 31, 2005 to 91 at December 31, 2006. Variable compensation expense includes employee bonuses and the expense of equity awards granted to employees and directors. Employee bonuses are based on the adjusted return on equity earned by Redwood and individual performance.

Due diligence expenses are costs for services related to re-underwriting and analyzing the loans we acquire or the loans we credit-enhance through the purchase of securities. Due diligence expenses increased in 2006 compared to 2005 due to increased commercial CES activity. These costs will fluctuate from period to period, depending on many factors such as the level of asset acquisitions.

Other expenses include custodial fees, excise taxes, training, recruiting, and shareholder relations.

Recognized Gains on Sales and Calls

The table below provides a detail of the net recognized gains on sales and calls for 2006 and 2005.

Table 10 Gains on Sales and Calls, net

(In thousands)	Year Ended December 31, 2006	2005
Real estate loan sales	$ (14)	$ 856
Real estate securities sales	11,205	42,714
Realized gains on interest rate agreements	8,386	3,160
Gains on sales	19,577	46,730
Gains on calls of residential CES	2,980	19,149
Total gains on sales and calls	$ 22,557	$ 65,879

Gains on sales of securities were lower in 2006 compared to 2005, as we sold a significantly higher level of CES in 2005 as part of our portfolio restructuring. Gains on calls were also significantly lower in 2006 compared to 2005 as we had fewer securities called by their issuers in 2006, compared to 2005. Based on the timing of call dates and anticipated prepayment speeds, we expect a continued low level of call income in 2007.

Valuation Adjustments

Valuation adjustments reflect those changes in fair market values of assets that we recognize through our income statement. These include writedowns of assets that are impaired under the provisions of EITF 99-20. Impairments are generally caused by an adverse change in projected cash flows in conjunction with a decrease in the fair market value. There is no reversal of this impairment on assets, even if projected cash flows improve in the future.

The fair market value changes of those interest rate agreements accounted for as trading are also included in valuation adjustment. All changes, whether positive or negative, of these particular interest rate agreements are recognized through the income statement. We use interest rate agreements to manage our interest rate risks, and the changes in the value of the hedged asset or liability is not included in the valuation adjustment. Thus, our use of interest rate agreements accounted for as trading instruments could lead to volatile reported earnings even when they are accomplishing the goal of hedging some of our interest rate risks.

Changes in fair market values of our loan purchase commitments are reflected in our income statement. We commit to purchase certain loans and generally do not take possession of the loans for up to a month. During that time, the value of the loan may change from our commitment purchase price and the resulting change in value is recognized through our income statement.

The table below provides the components of valuation adjustments for 2006 and 2005.

Table 11 Recognized Valuation Adjustments, net

(In thousands)	Year Ended December 31,	
	2006	2005
Write downs to fair market value under EITF 99-20	$ (6,831)	$ (4,370)
Changes in values of interest rate agreements that are accounted for as trading instruments	(5,731)	(661)
Change in value of purchase commitments	(24)	
Recognized valuation adjustments, net	$ (12,586)	$ (5,031)

Other Comprehensive Income

Our real estate securities are accounted for as available-for-sale (AFS) and are reported on our consolidated balance sheets at fair market value. Many of our derivative instruments are accounted for as cash flow hedges and

are also reported on our consolidated balance sheets at fair market value. The differences between the value of these assets and our amortized cost are shown as a component of stockholders equity as accumulated other comprehensive income. Periodic changes in the fair market value of these assets relative to amortized cost are included in other comprehensive income.

There are a number of factors that affect the fair market value of our assets. For most securities and derivative instruments, changes in interest rates can have an impact on the current value. During 2006, the fair market value adjustments on AFS assets increased by $30 million and the fair market value adjustments on cash flow hedges decreased by $10 million.

Taxes

Provisions for Income Taxes

As a REIT, we are able to pass through substantially all of our earnings generated at the REIT level to 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. We provide for income taxes for GAAP purposes based on our estimates of our taxable income, the amount of taxable income we plan to permanently retain, and the taxable income we estimate was earned at our taxable subsidiaries. A portion of our income tax provision is based on current tax provisions and another portion includes changes in our deferred taxes arising from timing differences between our GAAP and taxable income recognition.

Our income tax provision in 2006 was $10 million, a decrease from the $18 million income tax provision recorded in 2005, primarily due to a decline in net income.

Taxable Income and Dividends

During 2006, we earned an estimated $175 million of total taxable income. Of this amount, $168 million was earned at the REIT and $7 million was earned at our taxable subsidiaries. Total taxable income is not a measure calculated in accordance with GAAP. It is the pre-tax income calculated for tax purposes. Estimated REIT taxable income is an important measure as it is the basis of our required dividend distributions to shareholders. REIT taxable income is that portion of our taxable income that we earn in our parent (REIT) company and its REIT subsidiaries. It does not include taxable income earned in taxable subsidiaries.

As in the past few years, in 2007 we intend to permanently retain 10% of our taxable REIT income and defer a portion to distribute to shareholders in the subsequent year. In 2006, we declared four regular quarterly dividends of $0.70 per share and a special dividend of $3.00 per share. These dividends completed the distribution of our 2005 REIT taxable income and included the distribution of a part of our 2006 REIT taxable income. All of the 2006 dividends were distributions of ordinary income there were no capital gains distributed and there was no return of capital. At December 31, 2006, there was $50 million ($1.85 per share) of estimated 2006 REIT taxable income still undistributed that we will distribute to our shareholders during 2007. We currently anticipate following our historical pattern of retention of taxable income and distribution of dividends in 2007. Our board of directors currently has indicated its intention to increase the regular quarterly dividend to $0.75 per share in 2007.

Taxable income calculations differ from GAAP income calculations in a variety of ways. The most significant differences include the timing of amortization of premium and discounts and the timing of the recognition of gains or losses on assets. The rules for both GAAP and tax accounting for loans and securities are technical and complicated,

and the impact of changing interest rates, actual and projected prepayment rates, and actual and projected credit losses can have a very different impact on the amount of GAAP and tax income recognized in any one period. See the discussions under Potential GAAP Earnings Volatility and Potential Tax Earnings Volatility below.

The table below reconciles GAAP income to total taxable income for 2006 and 2005. For the most part, the assets and liabilities of the securitization entities we sponsor are not consolidated for tax purposes as they are for GAAP purposes because the securitized assets are owned by independent securitization entities and the ABS issued liabilities are obligations of those entities. Thus, the associated income and expense of most securitized assets and liabilities are not included in our income for tax purposes, and there are large differences between total interest income and total interest expense for GAAP and tax purposes. For tax purposes, the income reported reflects those assets owned by the REIT or its taxable subsidiaries but not assets owned by the securitization entities, and the

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expense reflects interest expense on debt but does not include the interest on the liabilities of the securitization entities.

Table 12 Differences between GAAP Net Income and Total Taxable Income

(In thousands, except per share data)	**2006**			**2005**		
	GAAP	**Differences**	**Taxable**	**GAAP**	**Differences**	**Taxable**
Interest income	$ 885,160	$ (516,673)	$ 368,487	$ 962,197	$ (749,388)	$ 212,809
Interest expense	(701,281)	573,331	(127,950)	(757,270)	721,895	35,375
Junior subordinated notes	(423)		(423)			
Net interest income	183,456	56,658	240,114	204,927	(27,494)	177,434
Operating expenses	(55,925)	(8,734)	(64,659)	(48,382)	5,429	(42,953)
Realized gains on sales and calls	22,557	(20,609)	1,948	65,879	(11,191)	54,688
Valuation adjustments	(12,586)	12,586		(5,031)	5,031	
Provision for income taxes	(9,970)	7,090	(2,880)	(17,521)	12,278	(5,243)
Net income	$ 127,532	$ 46,991	$ 174,523	$ 199,872	$ (15,947)	$ 183,925
Shares used for EPS calculations	26,317		25,971	25,121		24,754
Earnings per share	$ 4.85		$ 6.72	$ 7.96		$ 7.43

Total taxable income per share is computed on a quarterly basis by dividing the estimated pretax total taxable income earned in the calendar quarter by the number of shares outstanding at the end of the quarter. Total taxable income per share for the year is the sum of the four quarters total taxable income per share.

Total taxable income in 2006 of $175 million ($6.72 per share) decreased from the $184 million ($7.43 per share) earned in 2005. One reason for this decrease was a reduction in gains on sales and calls of assets. For tax purposes, we realized $2 million of gains in 2006, a decrease from the $55 million of gains realized in 2005. Another reason was the increase in operating expense in 2006 of $22 million, which was primarily the result of the timing of the exercise of stock options and the distributions of other equity awards. Operating expenses increased as well due to increases in

staffing in 2006.

Partially offsetting the decrease in net gains and the increase in operating expense was a $63 million increase in net interest income as calculated for tax purposes in 2006. Continued strong credit performance, fast prepayments, and rising short-term interest rates all contributed to increased net yields on our portfolios. For tax purposes, our yields on our residential, commercial, and CDO CES are higher than for GAAP, primarily due to the difference in timing of amortizing the discount into income. In 2006, we amortized $30 million more discount into income on our CES portfolios for tax purposes than for GAAP purposes. As a result, at December 31, 2006 the tax basis of our residential, commercial, and CDO CES was $95 million higher than the GAAP basis.

The other contributor to the increase in net interest income as calculated for tax was tax accounting for IOs. Given the fast prepayments on the underlying loans in 2006, the yield we would currently recognize on these IOs would be negative if accounted for based on economics. For tax purposes, however, we cannot recognize a negative yield, and, thus, we are not amortizing the premium on these IOs as quickly as the fast prepayments would indicate. We are recognizing a zero yield for tax, not a negative yield as would otherwise be indicated. As a result, our taxable income in 2006 was higher by $25 million than it would have been otherwise (cumulatively the difference is $56 million). Our taxable income over the next few years will be lower than it would have been otherwise by this same amount. See the discussion of Sequoia IOs under Potential Tax Earnings Volatility below.

We continue to be in compliance with REIT tests. We generally attempt to avoid acquiring assets or structuring financings or sales at the REIT that could generate unrelated business taxable income or excess inclusion income that would be distributed to our shareholders or that would cause prohibited transaction taxes on the REIT. There can be no assurance that we will be successful in doing so.

Potential GAAP Earnings Volatility

We expect quarter-to-quarter GAAP earnings volatility for a variety of reasons, including the timing of sales and calls of assets, changes in interest rates, prepayments, credit losses, and capital utilization. In addition, volatility may occur because of technical accounting issues, some of which are described below.

Loan Premium

Our unamortized loan premium on our consolidated residential loans at December 31, 2006 was $132 million. This will be expensed over the remaining life of these loans. This represents a GAAP cost basis of 101.43% of par value on the $9.2 billion of principal underlying these loans. The premium balance for these loans has not been amortized over time as quickly as these loans have prepaid. As a consequence, our reported earnings have been higher than they would have been if, for example, the proportion of total premium amortized equaled the proportion of total principal prepaid on loans. Amortization for a significant portion of this premium balance is driven by effective yield calculations that depend on interest rates and prepayments (see Critical Accounting Policies for further details). Loan premium amortization was $49 million in 2006 and $45 million in 2005. Declines in short-term interest rates could cause a significant increase in required amortization in subsequent periods.

In addition, premium amortization expense acceleration could occur if we reclassify a portion of the underlying loans from held-for-investment to held-for-sale, as the GAAP carrying value of these loans are currently in excess of their fair market value. This reclassification could occur as the various underlying pools of loans become callable and we decide to sell these loans, or it could occur if there is a change in accounting principles.

Real Estate Securities

Currently, all of our real estate securities are classified as available-for-sale (AFS) and are carried on our balance sheets at their estimated fair market value. Cumulative unrealized market value gains and losses are reported as a component of accumulated other comprehensive income in our Consolidated Statements of Stockholders Equity. However, adverse changes to projected cash flows related to poor credit performance or adverse changes to prepayment speeds could create an other-than-temporary impairment for accounting purposes and could cause fair market value losses, if any, to be reported through our income statement.

Earnings volatility related to real estate securities may also occur if we changed the GAAP classification for existing securities from AFS to trading or if we use trading accounting for new securities acquired. Changes in the fair market value of trading securities are required to flow through our income statement.

Derivative Instruments

Currently we have two classifications for derivative instruments; trading and cash flow hedges. All derivative instruments, regardless of classification, are reported on our consolidated balance sheets at fair market value. Changes to the fair market value of the derivatives classified as trading instruments are recognized through the consolidated statements of income. For those derivatives accounted for as cash flow hedges, the changes in fair market values, are reported through our consolidated balance sheets with only the ineffective portions (as determined according to the accounting provisions) reported through our income statement.

We could experience significant earnings volatility from our use of derivatives. This could occur, for example, when the recognition in changes in the fair market value of the derivatives are reported through our income statement and

changes in the fair market value in the hedged asset or liability are not recognized through our income statement.

Potential Tax Earnings Volatility

Taxable income may vary from quarter to quarter based on the timing for tax purposes of transactions and events, or based on the application of technical regulations. This could occur for many reasons, three of which are discussed below.

CES and Loans

We are not permitted for tax purposes to anticipate, or reserve for, credit losses. Taxable income can only be reduced by actual losses. As a consequence, we are required to accrete the entire purchase discount on CES into taxable income over their expected life. For GAAP purposes, we do anticipate credit losses and thus only accrete a portion of the CES discount into income. As a result, our income recognition on CES is faster for tax as compared to GAAP, especially in the early years of owning the assets (when there are generally few credit losses). At December 31, 2006, the cumulative difference between the GAAP and tax amortized costs basis of our residential, commercial, and CDO CES was $95 million. In addition, as of December 31, 2006, we had a credit reserve of $28 million for GAAP on our residential and commercial loans, and none for tax. As we have no credit reserves for tax and a higher CES basis, any future credit losses on our CES or loans would have a more significant impact on tax earnings as compared to GAAP and may create significant taxable income volatility to the extent the level of credit losses varies during periods.

Sequoia Interest-Only Certificates (IOs)

As a result of rapid prepayments, we are experiencing negative economic returns on some IOs we acquired from prior Sequoia securitizations. For tax purposes, however, we are not permitted to recognize a negative yield, so premium amortization expenses for tax have not been as high as they otherwise could have been. As a result, our current tax basis on these IOs are higher than the fair market values. We expect to call most Sequoia securitization entities over the next two years, at which time the remaining IO tax basis will be written off and a capital loss for tax created. Capital losses do not reduce ordinary income (or our requirement to distribute ordinary income as dividends). Capital losses do offset capital gains realized from sales or calls of assets, and thus will reduce future distributions of these capital gains. Our taxable earnings will vary from period to period based on the exact timing of these Sequoia calls.

Compensation

Compensation expense for tax varies depending on the timing of dividend equivalent rights payments, the exercise of stock options, the distribution of deferred stock units, and deferrals to and withdrawals from our executive deferred compensation plan.

2005 as Compared to 2004

Our analysis of 2005 as compared to 2004 has been revised from what was previously reported to reclassify assets and expenses in the manner reflected in the 2006 financial statement presentation. These reclassifications, which are outlined below, did not impact our reported net income for 2005 or 2004.

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Due diligence expenses are costs for services related to re-underwriting and analyzing loans we acquire or loans we credit-enhance through the purchase of securities. Beginning in the second quarter of 2006, we recognized these due diligence expenses as an operating expense rather than a reduction in interest income, and amounts that were recorded in 2005 and 2004 as a reduction in interest income have been reclassified to conform to the 2006 presentation. This reclassification has resulted in an increase to interest income and yield by portfolio for the years presented. The amounts reclassified in 2005 and 2004 between net interest income and operating expenses was $3 million and $4 million, respectively.

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For 2006, our commercial CES includes all below-investment-grade securities rather than just the first-loss securities that comprised this classification in prior years. There has therefore been a reclassification between the commercial CES and securities portfolios for interest income and average balances as compared to those previously reported for 2005 and 2004.

Acquisitions, Securitizations, Sales, and Calls

During 2005, we acquired $268 million residential loan CES. This was similar to the $269 million we acquired in 2004. The loans underlying the CES we acquired during 2005 were generally of above-average quality as compared to securitized residential loans as a whole.

In 2005, we had calls of our residential loan CES of $36 million principal value for GAAP gains of $19 million. This was a decrease from the calls realized in 2004 of $99 million principal value that generated GAAP gains of $59

million. We had fewer of these assets become callable during 2005. At the end of 2005, we had residential loan CES securities with principal value totaling $1 million that were callable.

During 2005, we sold $207 million residential loan CES generating GAAP gains of $40 million. During 2004, sales of residential loan CES totaled $22 million generating GAAP gains of $6 million. Sales in 2005 where higher due to our portfolio restructuring activities.

We acquired $25 million commercial real estate loans during 2005, a decrease from the $38 million acquired during 2004. We sold $11 million commercial real estate loans during 2005 and $2 million during 2004. Our commercial real estate loan activity provides additional collateral to the Acacia CDO securitizations we sponsor.

During 2005, we acquired $43 million commercial loan CES, a significant increase from the $13 million acquired in 2004. This increase reflects our ongoing efforts to increase our ability to analyze, source, and manage commercial real estate loan CES. No commercial loan CES were sold during these periods.

In 2005, our residential real estate loan acquisitions totaled $1.9 billion. We sold $1.5 billion of these loans to Sequoia entities and also sold $507 million loans as whole loans to others, leaving us with an inventory of loans of $45 million at December 31, 2005. Sequoia entities issued $1.5 billion asset-backed securities (ABS) during 2005. This level of residential loan securitization activity was a significant decrease from 2004 when Sequoia entities acquired loans of $10.0 billion and issued a like amount of ABS. Typically we acquire London Inter-Bank Offer Rate (LIBOR) adjustable-rate mortgage (ARM) residential loans for the Sequoia securitization program we sponsor; the flatter yield curve reduced the amount of LIBOR ARM residential loans originated in 2005.

We acquired $684 million of other residential and commercial real estate securities during 2005 as inventory for sale to our Acacia CDO securitization program. This was an increase from the $598 million of these acquisitions we made for Acacia during 2004. We sold securities to Acacia entities totaling $665 million during 2005 and $584 million during 2004. At December 31, 2005, we had securities of $214 million for sale to future Acacias entities. In both 2005 and 2004, Acacia entities issued $900 million CDO ABS.

Net Income

Our reported GAAP net income was $200 million ($7.96 per share) for 2005, a decrease from the $233 million ($10.47 per share) earned in 2004. Our GAAP return on equity was 21% for 2005 compared to 32% for 2004.

The reduction in our net income of $33 million from 2004 to 2005 resulted from a decrease in net interest income of $15 million, an increase in operating expenses of $10 million, an increase in provisions for income taxes of $10 million, partially offset by an increase in net gains on sales and calls (net of market valuation adjustments) of $2 million.

Net Interest Income

Net interest income decreased to $205 million in 2005 compared to $220 million in 2004. The reduction in net interest income of $15 million resulted from increased ARM prepayment rates on residential loans consolidated from Sequoia securitization entities and lower yields on our portfolio of residential CES as our older higher-yielding securities were called or sold, and from higher levels of unvested cash. In addition, net interest income was higher in 2004 due to the effect of a cumulative correcting adjustment of an error on previously reported earnings of $4.1 million. Net interest income in 2005 benefited from a reduction in credit provision expenses of $7 million as a result of excellent loan

credit performance and reduced loan balances (as prepayments for loans owned by Sequoia accelerated while Sequoia securitization volume dropped).

Prepayment rates (CPR) for residential ARM loans owned by Sequoia entities increased from an average of 17% in 2004 to 43% in 2005. Faster prepayments on ARMs have been caused primarily by the flatter yield curve (higher than average short-term interest rates relative to long- term interest rates) and the increase in popularity of negative amortization loans. Borrowers are more inclined to refinance out of ARMs and into hybrid or fixed rate loans when the effective interest rates on ARMs are not significantly lower than the fixed rate alternatives. Additionally, new forms of adjustable-rate mortgages (negative amortization, option ARMs , and Moving Treasury Average ARMs) represent an increased share of the ARM market and have increased ARM-to-ARM refinancing.

These faster prepayment rates for consolidated ARM loans had a negative impact on our net interest income in 2005. However, in the long term we believe we will likely benefit from faster residential loan prepayments due to our significant investment in discount-priced residential loan CES.

Interest Income

Total interest income consists of interest earned on consolidated earning assets, plus income from amortization of discount for assets acquired at prices below principal value, less expenses for amortization of premium for assets acquired at prices above principal value, less credit provision expenses on loans.

Table 13 Interest Income and Yield

(Dollars in thousands)		**2005**		**2004**
Interest income	$	967,840	$	655,195
Discount amortization		42,361		36,071
Premium amortization		(48,434)		(32,412)
Reversal of (provision for) credit losses		430		(7,236)
Total interest income	$	962,197	$	651,618
Average earning assets	$	21,048,582	$	21,208,757
Yield as a result of:				
Interest income		4.60 %		3.09 %
Discount amortization		0.20 %		0.17 %
Premium amortization		(0.23)%		(0.15)%
Reversal of (provision for) credit losses		0.00 %		(0.03)%
Yield on earning assets		4.57 %		3.08 %

Interest income increased to $962 million in 2005 from $652 million in 2004 primarily due to an overall increase in yield caused by an increase in short-term interest rates. Since a majority of the assets on our consolidated balance sheets are adjustable-rate residential real estate loans, yields on these loans increase as short-term interest rates rise. As a result, total interest income was higher, even though the residential real estate loans consolidated balances decreased slightly from the prior year s level.

In addition to the impact of higher short-term interest rates, the contribution from the other portfolios increased in 2005, also leading to higher interest income. The table below presents the contribution to interest income and yield from each of our portfolios.

Table 14 Interest Income and Yield by Portfolio

(Dollars in thousands)	**December 31, 2004**	
		Yield

	Interest Income	Percent of Total Interest Income	Average Balance	
Residential real estate loans, net of provision for credit losses	$ 774,184	80.46 %	$ 18,642,020	4.15 %
Residential loan credit-enhancement securities	86,621	9.00 %	541,224	16.00 %
Commercial loans, net of provision for credit losses	5,285	0.55 %	52,008	10.16 %
Commercial loan credit-enhancement securities	8,059	0.84 %	142,610	5.65 %
Securities portfolio	82,844	8.61 %	1,489,461	5.56 %
Cash and cash equivalents	5,204	0.54 %	181,259	2.87 %
Totals	$ 962,197	100.00 %	$ 21,048,582	4.57 %

	December 31, 2004			
	Interest Income	Percent of Total Interest Income	Average Balance	Yield
Residential real estate loans, net of provision for credit losses	$ 533,376	81.86 %	$ 19,665,096	2.71 %
Residential loan credit-enhancement securities	64,602	9.91 %	349,779	18.47 %
Commercial loans, net of provision for credit losses	3,769	0.58 %	30,469	12.37 %
Commercial loan credit-enhancement securities	3,071	0.47 %	40,622	7.56 %
Securities portfolio	45,878	7.04 %	1,027,540	4.46 %
Cash and cash equivalents	922	0.14 %	95,251	0.97 %
Totals	$ 651,618	100.00 %	$ 21,208,757	3.08 %

The table below details our interest income by portfolio as a result of changes in consolidated asset balances (volume) and yield (rate) for 2005 as compared to 2004.

Table 15 Volume and Rate Changes for Interest Income

(In thousands)	Change in Interest Income 2005 Versus 2004		
	Volume	Rate	Total Change
Residential real estate loans, net of provisions for credit losses	$ (27,749)	$ 268,557	$ 240,808
Residential loan credit-enhancement securities	35,359	(13,339)	22,020
Commercial loans, net of provision for credit losses	7,710	(2,722)	4,988
Commercial loan credit-enhancement securities	2,664	(1,148)	1,516
Securities portfolio	20,624	16,342	36,965
Cash and cash equivalents	833	3,449	4,282
Total interest income	$ 39,441	$ 271,139	$ 310,579

Volume change is the change in average portfolio balance between periods multiplied by the rate earned in the earlier period. Rate change is the change in rate between periods multiplied by the average portfolio balance in the prior period. Interest income changes that result from changes in both rate and volume were allocated to the rate change amounts shown in the table.

A discussion of the changes in total income, average balances, and yields for each of our portfolios is provided below.

Table 16 Consolidated Residential Real Estate Loans Interest Income and Yield

(Dollars in thousands)	**2005**	**2004**
Interest income	$ 819,113	$ 572,299
Net premium discount amortization	(45,174)	(31,687)
Reversal of (provision for) credit losses	245	(7,236)
Total interest income	$ 774,184	$ 533,376
Average consolidated residential real estate loans	$ 18,642,020	$ 19,665,096
Yields as a result of:		
Interest income	4.39 %	2.91 %
Net (premium) discount amortization	(0.24)%	(0.16)%
Reversal of (provision for) credit losses	0.00 %	(0.04)%
Yield	4.15 %	2.71 %

Interest income on residential real estate loans increased primarily as a result of higher short-term interest rates. Almost all these loans have coupon rates that adjust monthly or every six months based on the one or six-month LIBOR interest rate. Yields on these residential real estate loans increased as short-term interest rates rose. The average balance decreased as loan prepayments exceeded new acquisitions.

Higher premium amortization expenses (as a percentage of current loan balances) in 2005 were caused primarily by increasing prepayment rates on these loans.

Table 17 Residential Loan Credit-Enhancement Securities Interest Income and Yield

(Dollars in thousands)	**2005**	**2004**
Interest income	$ 48,470	$ 30,492
Net discount amortization	38,151	34,110
Total interest income	$ 86,621	$ 64,602
Average residential loan credit-enhancement securities	$ 541,224	$ 349,779
Yield as a result of:		
Interest income	8.95 %	8.72 %
Net discount amortization	7.05 %	9.75 %
Yield	16.00 %	18.47 %

Interest income recognized from residential loan CES increased primarily due to growth in our portfolio over the past year, partially offset by lower yields. Portfolio growth reflected our ability to find new assets at a pace in excess of our sales, calls, and principal prepayments. Yields decreased as many of our more seasoned, higher-yielding assets (higher yielding as a result of several years of strong credit performance and favorable prepayments) were called or sold over the last few years. The more recently acquired residential loan CES generally are being carried at lower effective yields because we do not expect the same strong credit performance or favorable prepayment patterns as we have experienced in the past, and because on average we acquired these assets at higher prices than in the past.

The yields we currently recognize on recently acquired residential loan CES may be less than the yields we will actually realize over the lives of these residential loan CES. To determine yields on residential loan CES, we make assumptions regarding loan losses and prepayments. Since the market generally has a wide range for these assumptions (and not a specific estimate), we apply assumptions within a range that generally results in yields on these assets in early periods of ownership that are lower than what we might realize over the life of the assets if future performance turns out to be better than the low range of our expectations. Specifically, the initial yield we book on certain residential loan CES may be lower than the market mid-range expectation of performance (and below our hurdle rate of 14% pre-tax and pre-overhead internal rate of return). We review the actual performance of each residential loan CES and the market s and our renewed range of expectations every quarter. We adjust the yield of the assets as a result of supportable changes in market conditions and anticipated performance. In addition, to the extent we credit-enhance loans with special credit risk (e.g., negative amortization loans), we may not recognize interest income that is not paid. We make ongoing determinations of the likelihood that any deferred interest payments will be collectible in recognizing current period yields.

Table 18 Commercial Real Estate Loans Interest Income and Yield

(Dollars in thousands)	**2005**	**2004**

Interest income	$ 5,450	$ 4,253
Net premium amortization	(350)	(484)
Reversal of credit losses	185	
Total interest income	$ 5,285	$ 3,769
Average earning assets	$ 52,008	$ 30,469
Yield as a result of:		
Interest income	10.47 %	13.96 %
Net premium amortization	(0.67)%	(1.59)%
Reversal of credit losses	0.36 %	0.00 %
Yield	10.16 %	12.37 %

The interest income earned on our commercial real estate loan portfolio increased due to the growth in our commercial loan portfolio. This increase was partially offset by lower yields recognized for newer commercial loans.

Table 19 Commercial Loan Credit-Enhancement Securities Interest Income and Yield

(Dollars in thousands)	2005	2004
Interest income	$ 12,403	$ 3,004
Net premium amortization	(4,344)	67
Total interest income	$ 8,059	$ 3,071
Average commercial loan credit-enhancement securities	$ 142,610	$ 40,622
Yield as a result of:		
Interest income	8.70 %	7.40 %
Net premium amortization	(3.05)%	0.16 %
Yield	5.65 %	7.56 %

Interest income recognized from commercial loan CES increased due to the growth in this portfolio. This increase was partially offset by lower yields on newer commercial loan CES. The yield on commercial loan CES is based on our projected cash flows over time. Although we acquire commercial loan CES at a discount, we designate the amount of credit protection based on the anticipated losses in the underlying pool of loans. Since these commercial loan CES are the first loss pieces, the amount of credit protection so designated results in a premium balance to be amortized over the remaining lives of the assets. Over time, if the loans underlying these commercial loan CES perform better than we expect, we would re-designate a portion of the credit protection to accretable discount, thereby reducing the unamortized premium balance and increasing the yield recognized on these assets.

Table 20 Consolidated Securities Portfolio Interest Income and Yield

(Dollars in thousands)	2005	2004
Interest income	$ 77,201	$ 44,225
Discount amortization	5,643	1,653
Total interest income	$ 82,844	$ 45,878
Average securities portfolio balance	$ 1,489,461	$ 1,027,540
Yield as a result of:		
Interest income	5.18 %	4.30 %
Discount amortization	0.38 %	0.16 %
Yield	5.56 %	4.46 %

Total interest income increased for the securities portfolio as the total size of the portfolio grew and as yields increased as the coupon rates on adjustable-rate loan securities (which comprise over half of the portfolio) adjusted upward with the increase in short-term interest rates.

Interest Expense

Interest expense consists of interest payments on Redwood debt and consolidated ABS issued from sponsored securitization entities, plus amortization of deferred ABS issuance costs and expenses related to certain interest rate agreements less the amortization of ABS issuance premiums. ABS issuance premiums are created when interest-only securities and other ABS are issued at prices greater than principal value.

Total consolidated interest expense increased as a result of a higher cost of funds due to an increase in short-term interest rates as most of our debt and consolidated ABS issued is indexed to one-, three-, or six-month LIBOR. The average balance of debt and consolidated ABS issued outstanding was at similar levels during these years.

Table 21 Total Interest Expense

(Dollars in thousands)	2005	2004
Interest expense on Redwood debt	$ 11,793	$ 9,764
Interest expense on ABS issued	745,477	421,657
Total interest expense	$ 757,270	$ 431,421
Average Redwood debt balance	$ 261,322	$ 434,662
Average ABS issued balance	20,448,735	20,313,996
Average total obligations	$ 20,710,057	$ 20,748,658
Cost of funds of Redwood debt	4.51 %	2.25 %
Cost of funds of ABS issued	3.65 %	2.08 %
Cost of funds of total obligations	3.66 %	2.08 %

For purposes of calculating the weighted average borrowing costs of ABS issued, we include the amortization of the deferred ABS issuance costs with interest expense. We include the average deferred ABS issuance costs in the average balances below.

Table 22 Average Balances of Asset-Backed Securities Issued

(In thousands)	2005	2004
Sequoia	$ 18,492,465	$ 19,129,555
Acacia	2,008,705	1,229,075
Commercial	6,367	5,654
Average balance of ABS issued	20,507,537	20,364,284
Average deferred ABS issuance costs	(58,802)	(50,288)
Average balance of ABS issued, net	$ 20,448,735	$ 20,313,996

The table below details interest expense on debt and consolidated ABS issued as a result of changes in consolidated balances (volume) and cost of funds (rate) for 2005 as compared to 2004.

Table 23 Volume and Rate Changes for Interest Expense

(In thousands)	Change in Interest Expense		
	2005 Versus 2004		
	Volume	Rate	Total Change

Interest expense on Redwood debt	$ (3,894)	$ 5,923	$ 2,029
Interest expense on ABS issued	2,797	321,023	323,820
Total interest expense	$ (1,097)	$ 326,946	$ 325,849

Volume change is the change in average balance of obligations between periods multiplied by the rate paid in the earlier period. Rate change is the change in rate between periods multiplied by the average outstanding obligations in the current period. Interest expense changes that resulted from changes in both rate and volume were allocated to the rate change amounts shown in the table.

Details of the change in cost of funds of debt and consolidated ABS issued are provided in the tables below.

Table 24 Cost of Funds of Redwood Debt

(Dollars in thousands)	2005	2004
Interest expense on Redwood debt	$ 11,793	$ 9,764
Average Redwood debt balance	$ 261,322	$ 434,662
Cost of funds of Redwood debt	4.51 %	2.25 %

Table 25 Cost of Funds of Asset-Backed Securities Issued

(Dollars in thousands)	2005	2004
ABS issued interest expense	$ 742,542	$ 398,865
ABS issuance expense amortization	21,890	16,828
Net ABS interest rate agreement (income) expense	(6,542)	13,235
Net ABS issuance premium amortization	(12,413)	(7,271)
Total ABS issued interest expense	$ 745,477	$ 421,657
Average balance of ABS	$ 20,448,735	$ 20,313,996
ABS interest expense	3.63 %	1.97 %
ABS issuance expense amortization	0.11 %	0.08 %
Net ABS interest rate agreement (income) expense	(0.03)%	0.07 %
Net ABS issuance premium amortization	(0.06)%	(0.04)%
Cost of funds of issued ABS	3.65 %	2.08 %

The coupon payments on the consolidated ABS issued are primarily indexed to one-, three-, and six-month LIBOR. Over the past year, short-term interest rates have risen and, thus, so has the cost of funds of the consolidated ABS issued by securitization entities consolidated on our reported balance sheets.

Operating Expenses

Total operating expenses increased by 25% from 2004 to 2005 due to investments in systems and infrastructure, increases in the scale of our operations, increased excise taxes, and increased accounting, consulting fees, and internal control costs. Generally, the scale of our business over the last few years has increased more rapidly than our operating expenses. Our operating costs continue to increase in part because of increased personnel needs resulting from both prior and anticipated growth. The reconciliation of GAAP operating expense to operating expense before excise tax and variable stock option income (or expense) is provided in the table below.

Table 26 Operating Expenses

(Dollars in thousands)	2005	2004
Total operating expenses	$ 48,382	$ 38,692
Less: Excise tax	(1,180)	(626)
Less: Variable stock option income/(expense) (VSOI/VSOE)	123	(1,018)
Total operating expenses before excise tax and VSOE/VSOI	$ 47,325	$ 37,048
Components of total operating expense before excise tax and VSOE/VSOI		
Fixed compensation expense	$ 11,082	$ 8,040
Other operating expense	17,135	12,624
Incentive stock expense	1,077	1,289
Variable compensation expense	18,031	15,095
Total operating expenses before excise tax and VSOE/VSOI	$ 47,325	$ 37,048
Net interest income (NII)	$ 204,927	$ 220,197
Adjusted efficiency ratio (Operating expense before excise tax and VSOE/VSOI)/net interest income	23 %	17 %

Our operating efficiency ratio was higher in 2005 than in 2004 due to continued growth in systems and infrastructure at a time when we were selling assets. We exclude excise tax and variable option expense or income (VSOE/VSOI) in determining the efficiency ratio. By excluding these items, management believes that we are providing a performance measure comparable to measures commonly used by other companies in our industry because these two types of excluded expenses do not reflect ongoing costs of day-to-day operations of our company. Stock option grant expenses under FAS 123, however, are an on-going expense and are included in operating expense before excise tax and VSOE/VSOI.

Excise tax is a function of the timing of dividend distributions. In years which we delay distributing dividends on a portion of our REIT taxable income, under the REIT tax rules, we may pay excise taxes on a portion of this delayed distribution. Excise tax is included in operating expenses on our Consolidated Statements of Income.

VSOE/VSOI is a non-cash expense or income item that varies as a function of Redwood s stock price. If our stock price increases during a quarter and the stock price is above the exercise price of certain variable options, we record a GAAP expense in that period equal to the increase in the stock price times the number of in-the-money variable options that remain outstanding. If our stock price decreases during a quarter, we record income in that period equal to the decrease in the stock price times the number of in-the-money variable options that remain outstanding. With the adoption of Financial Accounting Statement No. 123R, Share-Based Payment (FAS 123R), effective January 1, 2006, we will not have VSOE/VSOI, in future periods.

Fixed compensation expenses include employee salaries and related employee benefits. Other operating expenses include office costs, systems, legal and accounting fees, and other business expenses. We expect to continue to make significant investments in expanding our staff and developing our business processes and information technologies in order to meet the operating needs we will face as we grow in the long term. As a result, we expect these fixed and other operating expenses will continue to increase.

Incentive stock (income) expense represents the cost of equity compensation as determined under FAS 123 for options and option equity awards granted to employees and directors after December 31, 2002. Beginning January 1, 2006, with the adoption of FAS 123R, all remaining unvested incentive awards and all future awards will be accounted for under this principle. Beginning January 1, 2006, there will no longer be dividend equivalent right (DER) expenses for GAAP purposes as all remaining stock awards will be accounted for under FAS 123R (and the value of additional DERs on an award is already included in the value at the time of grant and is expensed over the requisite service period of the award).

Variable compensation includes employee bonuses (which are based on individual employee performance and the adjusted return on equity earned by Redwood) and DER expenses on certain options still outstanding and granted prior to December 31, 2002. The primary drivers of this expense are the profitability (return on equity) of Redwood, taxable income at the REIT (which determines total dividend distribution requirements), the number of employees, and the number of incentive stock awards outstanding that receive DER payments that are expensed (options granted prior to January 1, 2003).

Net Recognized Gains (Losses) and Valuation Adjustments

For 2005, our net recognized gains and valuation adjustments totaled $60.8 million as compared to $59.1 million for 2004. Realized gains due to calls were significantly less in 2005 at $19.1 million than in 2004 at $58.7 million as we had fewer securities that had reached their call factor. Gains in sales we initiated as part of our portfolio restructuring were greater in 2005 at $43.6 million than in 2004 at $7.6 million.

Accounting rules (FAS 115, EITF 99-20, and SAB 5(m)) require us to review the projected discounted cash flows on certain of our assets (based on credit, prepayment, and other assumptions), and to mark-to-market through our income statement those assets that have experienced any deterioration in discounted projected cash flows (as compared to the previous projection) that could indicate permanent impairment as defined by GAAP. Assets with reduced discounted projected cash flows are written down in value (through a non-cash income statement charge) if the current fair market value for that asset is below our current basis. If the market value is above our basis, our basis remains unchanged and there is no gain recognized in income. It is difficult to predict the timing or magnitude of these adjustments; the quarterly adjustment could be substantial. Under the accounting rules (FAS 115, EITF 99-20, and SAB 5(m)), we recognized other-than-temporary impairments of $4.4 million for 2005 and $6.4 million for 2004.

Some of our interest rate agreements are accounted for as trading instruments, and in 2005, we de-designated one agreement as such as part of our call of an Acacia securitization. As a result, we recognized gains of $2.5 million in 2005 and losses of $0.5 million in 2004 on these interest rate agreements.

Provisions for Income Taxes

As a REIT, we are required to distribute at least 90% of our REIT taxable income each year. Therefore, we generally pass through substantially all of our earnings to stockholders without paying federal income tax at the corporate level. We pay income tax on this income and the income we earn at our taxable subsidiaries. Taxable income calculations differ from GAAP income calculations. We provide for income taxes for GAAP purposes based on our estimates of our taxable income, the amount of taxable income we permanently retain, and the taxable income we estimate was earned at our taxable subsidiaries.

Our income tax provision in 2005 was $17.5 million, an increase from the $8.0 million income tax provision taken in 2004. In 2005, our income tax provision under GAAP benefited slightly from state net operating losses. In 2004, we were able to use state and federal net operating losses to reduce our tax liability. In addition, in 2004, we recognized a reversal of previously existing valuation allowances related to net operating losses (NOLs), thus recognizing the future value of remaining net operating losses at that time.

Furthermore, in 2004 we generated taxable gains-on-sales from our securitization activities at the taxable subsidiaries. Gains on these activities were much lower in 2005 due to decreased volumes and a significant decrease in the gains generated by each securitization. Since these securitizations were treated as financings under GAAP, deferred tax assets were created. The deferred tax assets are amortized through the deferred tax provision as the related GAAP income is recognized.

Taxable Income and Dividends

Total taxable income is not a measure calculated in accordance with GAAP. It is the pre-tax income calculated for tax purposes. Estimated total taxable income is an important measure as it is the basis of our dividend distributions to shareholders. Taxable income calculations differ significantly from GAAP income calculations. REIT taxable income is that portion of our taxable income that we earn in our parent company and REIT subsidiaries. It does not include taxable income earned in taxable non-REIT subsidiaries. We must distribute at least 90% of REIT taxable income as dividends to shareholders over time. As a REIT we are not subject to corporate income taxes on the REIT taxable income we distribute. The remainder of our taxable income is income we earn in taxable subsidiaries. We pay income tax on this income and we generally retain the after-tax income at the subsidiary level. We also pay income tax on the REIT taxable income we retain (we can retain up to 10% of the total). The table below reconciles GAAP net income to total taxable income and REIT taxable income for 2005 and 2004.

Table 27 Differences Between GAAP Net Income and Total Taxable and REIT Taxable Income

(In thousands, except per share data)	**Actual 2005**	**Actual 2004**
GAAP net income	$ 199,872	$ 232,635
GAAP/Tax differences in accounting for:		

Interest income and interest expense	(25,359)	(27,402)
Credit losses	(2,134)	6,352
Operating expenses	5,428	(14,701)
Gains (losses) and valuation adjustments	(6,160)	38,223
Provisions for taxes	12,278	5,870
Total taxable income (pre-tax)	183,925	240,977
Earnings from taxable subsidiaries	(12,616)	(39,104)
REIT taxable income (pre-tax)	$ 171,309	$ 201,873
GAAP net income per share	$ 7.96	$ 10.47
Total taxable income per share	$ 7.43	$ 10.89
REIT taxable income per share	$ 6.92	$ 9.12

Total taxable income per share and REIT taxable income per share are measured as, respectively, the estimated pretax total taxable income and REIT taxable income earned in a calendar quarter divided by the number of shares outstanding at the end of that quarter. Annual total taxable income per share and annual REIT taxable income per share are, respectively, the sum of the four quarterly total taxable income per share and REIT taxable income per share calculations.

Total taxable income and total taxable income per share decreased in 2005 from 2004. The primary reason for this was decreased levels of capital invested in assets (not only CES but also IO and other securities), and fewer gains on sales on securitizations (at the taxable subsidiaries) as a result of lower volume of securitizations and less gain per transaction. In addition, the current yield we report for tax purposes on our new assets is much higher than the yield we report for GAAP purposes. This is true for those assets that have concentrated credit risk as, for tax purposes, credit losses are not anticipated but rather are only expensed as incurred. It is also true for other assets as, due to fast prepayments, some premium amortization expense for tax purposes has been delayed because we cannot recognize a negative yield for tax purposes on interest-only securities; this delayed premium amortization expense will likely impact the taxable gain or loss on sale or call in a future period.

Dividends to stockholders during 2005 totaled $144 million, approximately $37 million of which represented the distribution of the balance of REIT taxable income earned in 2004. Based on our estimates of 2005 REIT taxable income, we will enter 2006 with $51 million of undistributed REIT taxable income which we will pay as dividends to our stockholders during 2006. We currently project that most of the first three regular quarterly dividends we pay in 2006 will consist of REIT taxable income earned in 2005. Our estimates of total taxable income and REIT taxable income are subject to change due to changes in interest rates and other market factors as well as changes in applicable income tax laws and regulations.

During 2005, a portion of taxable income was in the form of net capital gains resulting from the sales and calls of some of our residential loan CES. Our income from this activity was long-term capital gain income for tax purposes. Thus, during 2005, 23.291% of our dividends distributed were characterized as a distribution of long-term capital gain income and the remaining 76.709% was characterized as a distribution of ordinary income. Our tax-paying stockholders may benefit to the degree they can take advantage of the lower tax rate on capital gains versus ordinary income.

As of December 31, 2005, we had met all of the dividend distribution requirements of a REIT. We generally attempt to avoid acquiring assets or structuring financings or sales at the REIT level that would be likely to generate distributions of Unrelated Business Taxable Income (UBTI) or excess inclusion income to our stockholders, or that would cause prohibited transaction taxes on the REIT; however, there can be no assurance that we will be successful in doing so.

FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

Assets

Below we discuss our business of investing in, financing, and managing real estate loans and securities in each of our earnings asset portfolios.

Residential Real Estate Loans

We acquire high-quality residential real estate loans on a bulk or flow basis from major originators. Prior to 2006, these loan purchases were predominately short reset LIBOR indexed ARMs (LIBOR ARMs). Generally, we financed the acquisition of these loans through our Sequoia securitization program. In 2006, we expanded our residential conduit s product offerings to include high-quality hybrid loans (loans with a fixed rate coupon for a period of two to ten years before becoming adjustable). Hybrids represented 66% of our loan acquisitions in 2006.

The following table provides detail of the activity for 2006 and 2005.

Table 28 Residential Real Estate Loans Activity

(In thousands)	**2006**	**2005**
Residential real estate loans at beginning of period	$ 13,874,792	$ 22,504,765
Acquisitions	2,017,686	1,863,240
Sales		(507,444)
Recognized gains on sales, net		84
Principal repayments	(6,513,348)	(9,936,152)
Transfers to REO	(6,889)	(4,772)
Premium amortization	(48,700)	(45,174)
Reversal of credit provision	394	245
Residential real estate loans at end of period	$ 9,323,935	$ 13,874,792

The residential real estate loans carried on our consolidated balance sheets have declined from $13.9 billion at December 31, 2005 to $9.3 billion at December 31, 2006. The reason for the significant decline in the loan balance is due to the high level of prepayments on LIBOR ARM loans.

Our December 31, 2006 residential loan balance of $9.3 billion includes $8.0 billion that was funded via securitization and $1.3 billion of loans that are financed with equity and Redwood debt. In 2007, we will either securitize these loans through our Sequoia program, sell these loans to a third party, or continue to hold these loans funded with Redwood debt to earn an interest spread. Our decision will ultimately depend on a number of factors including our level of excess cash and the availability of attractive alternative investment opportunities.

Residential CES

The largest part of our business in terms of capital employed is investing in residential CES. These securities have credit ratings that are below investment-grade. Due to the large amount of underlying loans, these credit-enhancement assets have concentrated credit risks, and both the upside opportunities and downside risks that could come from taking on concentrated risks.

Our residential CES was $722 million at year-end 2006 and $593 million at year-end 2005, a growth rate of 22% during 2006. The following table provides detail of the activity for each of those years.

Table 29 Residential CES Activity

(In thousands)	**2006**	**2005**
Balance at beginning of period	$ 592,552	$ 561,658
Acquisitions	250,214	267,803
Sale proceeds	(62,232)	(207,360)
Gains recognized on sales, net	6,970	39,736
Principal repayments (including calls	(98,886)	(80,623)
Gains recognized on calls, net	1,341	18,909
Discount amortization	57,404	36,540
Upgrades to investment-grade securities	(30,667)	(23,701)
Change in fair market value adjustments, net	4,835	(20,410)
Balance at end of period	$ 721,531	$ 592,552

We acquired $250 million CES in 2006, only a slight decrease from our acquisition activity of $268 million in 2005. Sales of CES in 2006 were significantly lower than in the previous year when we sold a significant portion of our 2005 and 2004 CES vintage in order to reduce our credit risk exposure.

Prime securities are residential mortgage-backed securities backed primarily by high credit quality loans. Many of the loans are jumbos, with loan balances greater than conforming loan limits. Prime securities typically have relatively high weighted average FICO scores (700 or higher), low weighted average loan-to-value ratios (LTV) (75% or less), and limited concentrations of investor properties.

Alt-a securities are residential mortgage-backed securities that have higher credit quality than subprime and lower credit quality than prime. Alt-a originally represented loans with alternative documentation, but has shifted over time to include loans with additional risk characteristics and a higher percentage of investor loans. For example, borrowers income may not be verified, and in some cases, may not be disclosed on the loan application. Expanded criteria also allows for higher debt-to-income ratios with higher accompanying LTV than otherwise would be permissible for prime loans.

Subprime securities are residential mortgage-backed securities backed by loans to borrowers who have impaired credit histories, but who appear to exhibit the ability to repay the current loan. Typically, these borrowers have lower credit scores or other credit deficiencies that prevent them from qualifying for prime or alt-a mortgages. To compensate for the greater risks and higher costs to service the loans, subprime borrowers pay higher interest rates, points, and origination fees. When evaluating the acquisition of CES backed by subprime loans, we use loss assumptions that are significantly higher than those we use for prime loans.

The following table details our 2006 and 2005 year-end residential CES portfolios by the underlying loan type (prime, alt-a, subprime) and by credit rating.

Table 30 Residential CES Credit Rating and Collateral Type

At December 31, 2006		Rating		
(In millions)	Total	BB	B	Unrated
Prime	$ 555	$ 307	$ 119	$ 129
Alt-a	157	94	23	40
Subprime	10	7		3
Total residential CES	$ 722	$ 408	$ 142	$ 172

At December 31, 2005		Rating		
(In millions)	Total	BB	B	Unrated
Prime	$ 513	$ 272	$ 107	$ 134
Alt-a	80	51	8	21
Subprime				
Total residential CES	$ 593	$ 323	$ 115	$ 155

The loans underlying all of our residential CES totaled $210 billion at December 31, 2006. Of these loans, $187 billion were prime, $18 billion were alt-a, and $5 billion were subprime. They are located nationwide with a large concentration in California. They continue to perform well from a credit perspective. During 2006, realized residential credit losses were $9.8 million of principal value, a rate that is less than one basis point (0.01%) on an annualized basis of the balance of loans. Serious delinquencies (90+ days, in foreclosure, in bankruptcy or REO) at December 31, 2006 were 0.37% of current balance and 0.23% of original balance. For loans in prime pools, delinquencies were 0.20% of current balance and 0.12% of original balance. Alt-a pools had delinquencies of 1.03% of current balance and 0.60% of original balance. Subprime loans had delinquencies of 3.87% of current balance and 2.78% of original balance.

As a result of the concentrated credit risk associated with residential loan CES, we are generally able to acquire these securities at a discount to their face (principal) value. The difference between the principal value ($1.2 billion) and carrying value ($722 million), which equals fair market value of these residential loan CES at December 31, 2006, was $459 million. Of this difference, $372 million was designated as internal credit reserve (reflecting our estimate of credit losses on the underlying loans over the life of these securities), $145 million represented a purchase discount we are accreting into income over time, and $58 million represented net unrealized mark-to-market gains.

Residential Investment-Grade Securities

We invest in investment-grade residential securities (IGS) backed by prime, alt-a, and subprime residential loans. These IGS are not directly exposed to first-loss credit risk as they benefit from credit-enhancement provided by others. The credit performance of these assets continued to be strong during 2006. At December 31, 2006 and 2005, the majority of these securities were funded through securitizations under our Acacia program.

Our residential investment-grade securities totaled $1.7 billion at year-end 2006 and $1.3 billion at year-end 2005. The growth rate for 2006 was 35%. The following table provides detail of the activity for each of those years.

Table 31 Residential Investment-Grade Securities Activity

(In thousands)	**2006**	**2005**
Balance at beginning of period	$ 1,260,090	$ 973,884
Acquisitions	732,692	481,096
Sale proceeds	(218,219)	(105,828)
Gains recognized on sales, net	2,155	2,076
Principal repayments (including calls	(117,976)	(102,983)
Gains recognized on calls, net	65	30
Discount amortization	5,265	2,444
Upgrades from residential CES	30,667	23,701
	2,511	(14,330)

Change in fair market value adjustments, net				
Balance at end of period	$	1,697,250	$	1,260,090

We acquired more residential investment-grade securities in 2006 than in 2005 as we increased acquisitions for our Acacia securitization program. Sales increased in 2006 as we called two prior Acacia CDOs and sold a portion of the underlying assets in those securitizations.

The following table details the type of underlying loans (prime, alt-a, subprime) and the current credit rating of our residential investment-grade securities as of December 31, 2006 and 2005.

Table 32 Residential Investment-Grade Securities Credit Rating and Collateral Type

At December 31, 2006			**Rating**		
(In millions)	**Total**	**AAA**	**AA**	**A**	**BBB**
Prime	$ 723	$ 14	$ 181	$ 243	$ 285
Alt-a	456	136	84	106	130
Subprime	518	8	127	209	174
Total residential IGS	$ 1,697	$ 158	$ 392	$ 558	$ 589

At December 31, 2005			**Rating**		
(In millions)	**Total**	**AAA**	**AA**	**A**	**BBB**
Prime	$ 635	$ 24	$ 191	$ 203	$ 217
Alt-a	118	6	71	11	30
Subprime	507	5	114	324	64
Total residential IGS	$ 1,260	$ 35	$ 376	$ 538	$ 311

As illustrated in the table above, the largest increase in our residential investment-grade portfolio was in alt-a securities. We believe that this area offered attractive risk/return profiles relative to other sectors.

Commercial Real Estate Loans

We have invested in commercial real estate loans since 1998. At December 31, 2006 and 2005, commercial real estate loans totaled $28 million and $60 million, respectively. These include mezzanine loans, subordinated (junior or senior lien) loans, and b-notes (b-notes represent a structured commercial real estate loan that retains a higher portion of the credit risk and generates a higher yield than the initial loan). Credit performance of our commercial loan portfolio remain strong and in line with our expectations.

The decline in the loan balance from December 31, 2005 to December 31, 2006 resulted from loan prepayments. We acquired no commercial real estate loans during 2006. This was primarily due to increasing levels of leverage underwritten by many whole loan lenders during the year, as well as lower yield (high prices) for loans. We will continue to pursue commercial real estate loans that meet our investment objectives and increase this portfolio when we feel it is appropriate.

Commercial CES

Our total commercial CES was $448 million at December 31, 2006, an increase from $219 million at December 31, 2005. These credit-enhancement securities bear concentrated credit risks with respect to $58 billion underlying loans on office, retail, multifamily, industrial, and other income-producing properties nationwide. The following table provides detail of the activity for 2006 and 2005.

Table 33 Commercial CES Activity

(In thousands)	**2006**	**2005**
Balance at beginning of period	$ 218,856	$ 87,250
Acquisitions	238,669	131,569
Sale proceeds	(16,950)	
Gains recognized on sales, net	352	
Principal repayments (including calls)	(41)	(35)
Gains recognized on calls, net		
Discount amortization	(1,561)	(798)
Upgrades to investment-grade securities	(3,966)	(2,192)
Change in fair market value adjustments, net	12,701	3,062
Balance at end of period	$ 448,060	$ 218,856

We have been building up our staff and infrastructure to invest in commercial CES. As a result, we have been able to significantly increase our acquisitions of these securities over the past two years.

The following table presents the credit ratings of our commercial CES at December 31, 2006 and 2005.

Table 34 Commercial CES Credit Rating

(In millions)		Rating		
	Total	BB	B	Unrated
December 31,2006	$ 448	$ 224	$ 90	$ 134
December 31,2005	$ 219	$ 131	$ 30	$ 58

As a result of the concentrated credit risk associated with commercial CES, we are generally able to acquire these securities at a discount to their face (principal) value. The difference between the principal value ($794 million) and carrying value ($448 million) of our commercial CES at December 31, 2006 was $346 million. Of this difference, $295 million was designated as internal credit reserve (reflecting our estimate of likely credit losses on the underlying loans over the life of these securities), $71 million represented a purchase discount we are accreting into income over time, and $20 million represented net unrealized mark-to-market gains.

Table 35 Commercial Investment-Grade Securities

Our commercial IGS totaled $120 million at December 31, 2006 and $185 million at December 31, 2005. The following table provides detail of the activity for each of those years.

Commercial Investment-Grade Securities Activity

(In thousands)	2006	2005
Balance at beginning of period	$ 185,032	$ 212,439
Acquisitions	11,172	58,208
Sale proceeds	(75,508)	(61,166)
Gains recognized on sales, net	1,380	902
Principal repayments (including calls)	(7,624)	(18,626)
Gains recognized on calls, net		
Discount amortization	(212)	(939)
Upgrades from commercial CES	3,966	2,192
	1,407	(7,978)

Change in fair market value adjustments, net		
Balance at end of period	$ 119,613	$ 185,032

We sold securities in conjunction with calls of two prior Acacia securitizations.

The following table presents the credit ratings of our commercial investment-grade securities at December 31, 2006 and 2005.

Table 36 Commercial Investment-Grade Securities Credit Rating

(In millions)		Rating			
	Total	AAA	AA	A	BBB
December 31, 2006	$ 120	$ 9	$ 2	$ 16	$ 93
December 31, 2005	$ 185	$ 11	$ 2	$ 20	$ 152

CDO CES

Collateralized debt obligations (CDOs) are a form of securitization in which a diverse portfolio of assets is acquired by a securitization entity that creates and sells securities (CDO securities) in order to fund its asset purchases. We acquire CDO securities created by others as an asset portfolio investment. These CDO securities are generally backed by residential and commercial real estate assets.

At December 31, 2006, our CDO CES totaled $22 million, an increase from $12 million at December 31, 2005. The change in balance from 2005 to 2006 consisted of $11 million of acquisitions, net of $1 million in sales. Acquisitions for 2005 totaled $10 million. There were no sales or calls during 2005.

The following tables present the credit ratings of our CDO CES at December 31, 2006 and 2005.

Table 37 CDO CES Credit Rating

(In millions)		Rating		
	Total	BB	B	Unrated
December 31, 2006	$ 22	$ 14	$	$ 8
December 31, 2005	$ 12	$ 12	$	$

CDO Investment-Grade Securities

At December 31, 2006, our CDO IGS totaled $224 million, an increase of $73 million from the December 31, 2005 balance of $151 million. The 2006 growth rate was 49%.

Acquisitions for CDO investment-grade securities totaled $79 million in 2006 and $47 million in 2005. Principal paydowns (other than calls) were $1 million in 2006 and $1 in 2005. There were no calls in 2006 and $11 million of calls in 2005. Sales for this portfolio were $5 million during 2006 and there were no sales during 2005.

The following tables present the credit ratings of our CDO IGS at December 31, 2006 and 2005.

Table 38 CDO Investment-Grade Securities Credit Rating

(In millions)			Rating		
	Total	AAA	AA	A	BBB
December 31, 2006	$ 224	$ 66	$ 30	$ 52	$ 76
December 31, 2005	$ 151	$ 39	$ 23	$ 37	$ 52

Liabilities and Stockholders Equity

Redwood Debt

We use repurchase (repo) agreements and our Madrona commercial paper facility to finance residential real estate loans. We may securitize these loans or continue to fund them with debt. To finance securities we use warehouses and repo agreements. The Acacia warehouses have limited recourse to Redwood, whereas other Redwood debt facilities have full recourse to us. Redwood debt is secured by pledges of our loans and securities. The table below shows the amount of debt outstanding by facility at December 31, 2006 and 2005.

Table 39 Redwood Debt by Facility

(In thousands)		**2006**		**2005**
Loans				
Repo agreements	$	959,139	$	
Madrona commercial paper facility		300,000		
Securities				
Acacia warehouses		597,069		169,707
Total Redwood debt	$	1,856,208	$	169,707

In the last few years, we generally used Redwood debt to fund the acquisition of loans and securities on a temporary basis prior to their sale to a securitization entity. We are now acquiring assets as a longer-term investment

that we intend to fund on an ongoing basis with Redwood debt. This accounts for most of the increase in Redwood debt during 2006. The amount of debt we use to fund assets is determined on an asset-by-asset basis by our internal policies on average we expect to allocate 8% equity under our risk management policies for debt-funded assets.

Asset-Backed Securities Issued

Redwood has securitized the majority of the assets shown on its consolidated balance sheets. In a securitization, Redwood sells assets to a securitization entity that creates and sells asset-backed securities (ABS) in order to fund its asset purchases. The residential whole loan securitization entities Redwood sponsors are called Sequoia and the CDO securitization entities Redwood sponsors are called Acacia. These securitization entities are bankruptcy-remote from Redwood, so that Redwood s liabilities cannot become liabilities of the securitization entity and the ABS issued by the securitization entity cannot become obligations of Redwood Trust. Nevertheless, since, according to accounting definitions, we control these securitization entities, we show both the assets and liabilities of these entities on our consolidated balance sheets. At December 31, 2006, our consolidated balance sheets included $10.3 billion of assets owned by the securitization entities (79% of total consolidated assets) and included $10.0 billion of liabilities of the securitization entities (83% of total consolidated liabilities).

Generally, when we securitize assets, as opposed to owning them directly and funding them with Redwood debt and equity, our reported cost of funds is higher (the cost of ABS securities issued is generally higher than that of our debt) but we utilize less equity capital. As a result, our return on equity may increase after securitization. In addition, liquidity risks are generally reduced or eliminated, as the Redwood debt associated with the accumulation of these assets during their accumulation is paid off following securitization.

The following table provides detail of the activity for asset-backed securities (ABS) issued in 2006 and 2005.

Table 40 ABS Activity

2006 (In thousands)	**Balance at December 31, 2005**	**New Issuance**	**Paydowns**	**Amortization**	**Balance at December 31, 2006**
Sequoia ABS with principal value, net	$ 13,274,192	$ 799,048	$ (6,468,345)	$ (9,892)	$ 7,595,003
Sequoia interest only ABS	142,788			(68,240)	74,548
Acacia ABS with principal value, net	2,164,063	682,801	(552,636)	401	2,294,629
Acacia CES issued		14,367		677	15,044
Commercial	4,234		(4,251)	17	
Total ABS issued	$ 15,585,277	$ 1,496,216	$ (7,025,232)	$ (77,037)	$ 9,979,224

2005 (In thousands)	**Balance at December 31, 2004**	**New Issuance**	**Paydowns**	**Amortization**	**Balance at December 31, 2005**

Sequoia ABS with principal value, net	$ 21,719,083	$ 1,455,157	$ (9,886,856)	$ (13,192)	$ 13,274,192
Sequoia interest only ABS	210,385	25,796		(93,393)	142,788
Acacia ABS with principal value, net	1,691,461	794,081	(321,502)	23	2,164,063
Acacia CES issued					
Commercial	9,234	4,229	(9,523)	293	4,234
Total ABS issued	$ 23,630,163	$ 2,279,263	$ (10,217,881)	$ (106,269)	$ 15,585,277

Junior Subordinated Notes

On December 12, 2006, we issued $100 million of junior subordinated notes (trust preferred securities) through Redwood Capital Trust I, a newly formed wholly-owned Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating rate equal to LIBOR plus 2.25% until they are redeemed in whole, or mature on January 30, 2037. The earliest optional redemption date without a penalty is January 30, 2012. In our internal risk-adjusted capital calculations, we consider these trust preferred securities as part of our capital base.

Interest Rate Agreements

We generally use interest rate agreements to reduce the potential volatility of our earnings as interest rates change. We enter into these agreements with highly rated counterparties and maintain certain risk management policies limiting our exposure concentrations to any counterparty. At December 31, 2006, we were party to interest rate agreements with an aggregate notional value of $3 billion and a net fair market value of $21 million. At December 31, 2005, we were party to interest rate agreements with an aggregate notional value of $7 billion and a net fair market value of $31 million.

Stockholders Equity

Our reported book value at December 31, 2006 was $37.51 per share, an increase from $37.20 per share at the beginning of the year. Our book value per share increased this year as a result of retained earnings, increases in the net fair market value of our assets and interest rate agreements, and accretive stock issuance.

We issue equity only when we believe equity growth will enhance long-term earnings and dividends per share, compared to what they would have been otherwise. Given the amount and quality of the asset acquisition opportunities we anticipate seeing, we currently expect to seek additional equity and/or long- term debt capital during 2007.

Cash Requirements, Sources of Cash, and Liquidity

We use cash to fund our operations and securitization activities, invest in earning assets, service and repay Redwood debt, fund working capital, and fund our dividend distributions. One primary source of cash is principal and interest payments received on a monthly basis from real estate loans and securities. Other sources of cash include proceeds from sales of assets to securitizations entities, proceeds from sales of other assets, proceeds from calls of securities, borrowings, and issuance of equity and debt.

Cash flows generated and used within consolidated ABS securitization entities are not directly available to Redwood, although they are shown on our consolidated statement of cash flows. We own the call rights for many of these securitization entities, generally allowing us, when certain targets or dates have been met, to pay off the ABS liabilities of these entities and acquire their assets at par.

We generally use capital, rather than securitization proceeds or Redwood debt, to fund investments in assets that have highly concentrated credit risks, including residential CES, commercial CES, and CDO CES and similar illiquid assets. For the acquisition of assets with less credit sensitivity, we employ leverage and the capital component is much lower, generally from 8% to 30%. We use structured leverage through Sequoia and Acacia, which is non-recourse to us, or Redwood debt.

During 2006, we raised $66 million new equity capital through our Dividend Reinvestment and Stock Purchase Plan (DSPP) and received $100 million in proceeds from the sale of trust preferred securities. Additionally, we freed up capital by selling $65 million of some of our riskiest residential CES and by recycling $32 million of capital by securitizing certain second-loss residential CES through our Acacia program. These sec