REDWOOD TRUST INC
Form 424B5
September 22, 2004

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Filing pursuant to Rule 424(b)(5)
Registration Statement No. 333-25643

PROSPECTUS SUPPLEMENT
(To Prospectus dated May 13, 2004)

[REDWOOD LOGO]

Redwood Trust, Inc.

1,000,000 Shares

Common Stock

We are offering 1,000,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange under the symbol RWT. On September 20, 2004, the last reported sale price of our common stock on the New York Stock Exchange was $58.60 per share.

Investing in our common stock involves risks.
See Risk Factors beginning on page S-7.

	Per Share	Total
Public offering price	$58.600	$58,600,000
Underwriting discounts and commissions	$ 2.344	$ 2,344,000
Proceeds, before expenses, to us	$56.256	$56,256,000

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement and the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

We have granted the underwriters the right to purchase up to an additional 150,000 shares of our common stock to cover over-allotments. The underwriters expect to deliver the shares to purchasers on or about September 24, 2004.

JMP Securities **Jefferies & Company, Inc.**

Prospectus Supplement dated September 21, 2004

You should rely on the information contained in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with information different from that contained in this prospectus supplement and the accompanying prospectus. Neither the delivery of this prospectus supplement and the accompanying prospectus nor the sale of any shares of our common stock means that information contained in this prospectus supplement is correct after the date of this prospectus supplement. This prospectus supplement and the accompanying prospectus are not an offer to sell or solicitation of an offer to buy these shares of common stock in any circumstances under which the offer or solicitation is unlawful. In this prospectus supplement and the accompanying prospectus, the Company, Redwood, Redwood Trust, we, us, and our refer to Redwood Trust, Inc. and its subsidia

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PROSPECTUS SUPPLEMENT

PROSPECTUS

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FORWARD-LOOKING STATEMENTS AND NOTICE ABOUT INFORMATION PRESENTED

This prospectus supplement and the accompanying prospectus contain or incorporate by reference certain forward-looking statements. When used, statements which are not historical in nature, including the words anticipate, estimate, should, expect, believe, intend, and sir 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 prospectus supplement under the caption 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, or SEC, including Forms 10-Q and 10-K.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking events mentioned, discussed in, or incorporated by reference into this prospectus supplement and the accompanying prospectus might not occur.

This prospectus supplement contains statistics and other data that in some cases have been obtained from, or compiled from, information made available by servicing entities and information service providers.

PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights information contained elsewhere or incorporated by reference in this prospectus supplement and the accompanying prospectus. This summary does not contain all of the information that you should consider before investing in our common stock. You should carefully read the entire prospectus supplement and the accompanying prospectus, including in each case the documents incorporated by reference. You should pay particular attention to the section entitled Risk Factors beginning on page S-7 and our consolidated financial statements and the notes to the consolidated financial statements incorporated by reference.

The Company

Redwood Trust is a financial institution located in Mill Valley, California. We invest in, credit-enhance, and securitize residential and commercial real estate loans and securities. Our primary focus is investing in real estate loans by acquiring and owning securities backed by high-quality real estate loans, particularly jumbo residential loans, that have features such as 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.

We are taxed under the Internal Revenue Code of 1986, as amended, or the Code, as a real estate investment trust, or REIT. As such, we are not required to pay corporate income taxes on the REIT taxable income that we distribute to stockholders as dividends. We pay corporate income taxes on REIT taxable income that we retain (*i.e.*, that portion of our REIT taxable income that we do not distribute as dividends), which is limited to 10% of REIT taxable income, and we also pay corporate income taxes on income we earn in our taxable (*i.e.*, non-REIT) subsidiaries.

Our GAAP consolidated balance sheet reflects five types of earning assets: residential real estate loans; home equity lines of credit; residential real estate loan credit-enhancement securities; commercial real estate loans; and a securities portfolio consisting of diverse residential and commercial real estate securities, primarily investment-grade and BB rated. Each of these portfolios is a component of our single business of investing in real estate loans and securities. Our current intention is to focus on investing in and managing assets in these five portfolios. We manage our real estate loan investments as a single business, with common staff and management, common financing relationships and flexible capital allocations.

Our permanent investment portfolio consists of securities we have acquired and intend to hold in portfolio for the long term to earn interest income. These securities represent securitized ownership interests in pools of real estate loans and securities. We acquire our permanent investment portfolio assets from securitizations sponsored by others and also from securitizations we have sponsored. We generally do not borrow against or leverage this portfolio and we generally fund the acquisition of and hold these securities solely with our equity. The majority of our earnings and cash flows consist of interest income and capital gains generated from our permanent investment portfolio.

We generally use the remainder of our balance sheet to support our securitization activities. We acquire and accumulate real estate loans and securities for sale (usually within a few weeks or months) to a legally independent and bankruptcy-remote trust that securitizes these loans or re-securitizes these securities. While we are holding assets temporarily prior to securitization, we typically utilize collateralized short-term debt to fund the acquisition of the bulk of these assets. Our holding period for these assets typically ranges from one week to five months, depending on asset type and the frequency of the securitizations we sponsor. We sell these assets to a securitization trust that issues (sells) various securities (asset-backed securities or ABS) backed by the assets of the trust. The trust pays us for the assets it purchases from us using the funds it raises from the sale of ABS. We then use the asset sale proceeds we receive from the securitization trust to repay the short-term debt we used to finance the acquisition of these assets. Most of the residential real estate loan securitizations we sponsor are a part of our Sequoia securitization program and most of the re-securitizations of residential and commercial real estate securities we sponsor are a part of our Acacia securitization program.

We often acquire for our permanent investment portfolio a small portion of the ABS issued by the Sequoia securitization and Acacia re-securitization entities we sponsor. Generally, we acquire the securities that have the most concentrated credit and/or prepayment risk (and/or interest rate, if any) with respect to the underlying loans or securities. Our goal for our securitization programs is to create attractive assets, particularly with respect to asset quality, that we can acquire for our permanent investment portfolio. In addition, we seek to make an economic profit with each securitization. A securitization is profitable when the cash received by us from a trust (which equals the market value of the ABS sold by the trust less securitization expenses) exceeds our cost of acquiring the assets that we sold to the trust.

The bulk of our permanent investment portfolio consists of securities created from pools of high-quality residential real estate loans. These include securities with concentrated credit risk (credit-enhancement securities, or CES) or concentrated loan prepayment risk (interest-only securities, or IOS). We acquire the bulk of our residential loan CES from securitizations sponsored by others, while we acquired the bulk of our IOS from the Sequoia securitizations we have sponsored. In our permanent investment portfolio, we also own ABS issued from re-securitizations of diverse pools of residential and commercial real estate loan securities. These re-securitizations are typically referred to as collateralized debt obligations, or CDOs. The CDO securities we acquire and own are equity , preference share , and non-investment grade securities. Collectively, we refer to these as CDO equity securities. The bulk of the CDO equity securities in our permanent investment portfolio was acquired from the Acacia CDO re-securitizations we have sponsored. These CDO equity securities generally have concentrated credit risk (as well as some prepayment, interest rate, and other risks) with respect to the underlying pool of diverse real estate securities. In addition to residential and CDO securities, a small but growing component of our permanent investment portfolio consists of commercial real estate assets such as commercial real estate CES, mezzanine commercial loans, junior commercial loan participations, corporate REIT debt and commercial real estate CDO equity securities.

As a result of the form of securitization we have chosen to utilize for most of the securitizations we sponsor, we consolidate and report all of the assets of the securitization trusts we have sponsored as assets on our GAAP consolidated balance sheet, and we consolidate and report all of the ABS issued by those trusts and held by unrelated third parties as liabilities on our GAAP consolidated balance sheet. The ABS we acquire for our permanent investment portfolio from securitizations we sponsor are not shown as specific assets on our GAAP consolidated balance sheet, but rather are represented by the excess of the securitized pool of assets over liabilities that have been consolidated from the securitization trusts we have sponsored. As a result of this GAAP treatment, in a securitization transaction, no gain on sale is recognized for GAAP purposes even if a securitization is economically profitable. Instead, any economic gain from a securitization is implicitly recognized as a lower net basis of consolidated assets and liabilities. The profits in a securitization are thus recognized over time as part of our GAAP income rather than as a one-time gain-on-sale event.

We have benefited from a very attractive operating environment during the last few years, with excellent credit results, favorable prepayment patterns, low prices for asset acquisitions, relatively subdued competition, and a good supply of assets available for acquisition. These environmental factors have contributed to our increase in earnings and dividends per share over the last few years, and have allowed us to report record earnings per share (as measured before mark-to-market income and expense) in the first half of 2004 as well as very high return on equity, or ROE, results. However, these environmental factors are generally now less favorable. Furthermore, our highest yielding assets (acquired under more favorable conditions) are paying down or being called. As a result, we believe our earnings per share (as measured before mark-to-market income and expense), as well as our ROE (as measured in the same way), may have reached a peak for this cycle in the first half of 2004. Even if relatively high earnings per share results should continue for a few more quarters, we expect we will most likely report some negative earnings comparisons (current quarter as compared to the same quarter the year before) during 2005. We believe these cautionary statements are also applicable to reported GAAP earnings per share results (including mark-to-market income and expenses), although these results are more variable and less predictable. We expect to continue to report generally favorable results on an absolute basis. However, the results we report could suffer somewhat on a relative basis.

Redwood Trust was incorporated under the laws of the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California, 94941 and the telephone number is (415) 389-7373.

On September 20, 2004, we had 21,996,986 outstanding shares of common stock, listed on The New York Stock Exchange under the symbol RWT.

For more information about us, please visit our website at www.redwoodtrust.com. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K (if applicable), amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, or Exchange Act, and certain supplemental financial data as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

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None of the information on our website and on websites linked to it is part of this prospectus supplement or the accompanying prospectus, except to the extent specifically incorporated herein.

Recent Developments

From July 1, 2004 to September 20, 2004, we completed the acquisition for our permanent investment portfolio of $43 million of real estate securities from securitizations sponsored by others. We also committed to acquire an additional $9 million of these securities for settlement after September 20, 2004. These acquisitions (completed and committed) include $45 million of residential CES, $1 million of residential IOS, and $6 million of commercial CES. We did not acquire any additional CDO equity securities from Acacia or other CDOs during this period. Permanent investments completed or committed in the period from July 1, 2004 through September 20, 2004 (including securities purchased from Sequoia and Acacia transactions) had a $69 million book value at September 20, 2004.

As part of our Sequoia residential loan securitization program, we completed the acquisition of $2.2 billion of high-quality, adjustable-rate real estate loans from July 1, 2004 through September 20, 2004. We also committed to acquire an additional $700 million of loans for settlement after September 20, 2004. We sold $1.9 billion of these loans, in addition to most of the unsecuritized loans reported on our June 30, 2004 GAAP consolidated balance sheet, to Sequoia Mortgage Trust 2004-7 and Sequoia Mortgage Trust 2004-8. Sequoia Mortgage Trust 2004-7 issued $1.1 billion of asset-backed securities for settlement in July 2004. Sequoia Mortgage Trust 2004-8 issued $800 million of asset-backed securities for settlement in August 2004. We anticipate that Sequoia Mortgage Trust 2004-9 will issue asset-backed securities by the end of the third quarter of 2004. We acquired a small portion of Sequoia Mortgage Trust 2004-7 and Sequoia Mortgage Trust 2004-8 securities (the CES in addition to a small portion of the IOS) with a total market value of approximately $4 million for our permanent investment portfolio. These Sequoia trusts sold the balance of the ABS they created into the capital markets. Most of the premium risk (pre-payment risk) associated with the purchase of the underlying adjustable-rate loans at prices in excess of par (or principal) value was sold to the capital markets in the form of premium priced pass-through ABS or IOS. Consistent with the trend towards more competition in the securitization business, profits for these transactions were generally lower for us than earlier in the year and in prior years. All of Sequoia Mortgage Trust 2004-7 s and Sequoia Mortgage Trust 2004-8 s assets and their related asset-backed securities obligations will be consolidated on our GAAP consolidated balance sheet, as will those of Sequoia Mortgage Trust 2004-9 upon the settlement of that anticipated securitization transaction.

As part of our Acacia real estate securities re-securitization program, we completed the acquisition of $130 million in market value of diverse real estate securities from July 1, 2004 through September 20, 2004. During this period, we also committed to acquire $18 million of these securities for settlement after September 20, 2004. We sold a portion of these securities, in addition to most of the collateral securities that we accumulated and held for the Acacia program and that were included on our June 30, 2004 GAAP consolidated balance sheet, to Acacia CDO 5, Ltd. Acacia 5 issued $300 million in principal value of asset-backed securities. We acquired the Acacia 5 CDO equity securities at a cost of approximately $4 million. The CDO equity securities are the functional equivalent of the combination of CES and IOS for this securitization. All of the assets and asset-backed securities obligations of Acacia 5 will be consolidated on our GAAP consolidated balance sheet.

From July 1, 2004 through September 20, 2004, residential loan CES with a principal value of $36 million were called.

For July and August 2004, delinquencies and credit losses remained low for the residential CES that we own in our permanent investment portfolio (including CES acquired from Sequoia and from securitizations sponsored by others).

For July and August 2004, the annualized average prepayment rate was 20% to 25% per year (conditional prepayment rate or CPR) for the adjustable rate mortgage, or ARM, loans underlying the Sequoia transactions from which we have acquired a majority of the IOS for our permanent portfolio. This is faster than the 10% to 20% CPR that generally occurred during the last few years, but is slower than our long-term assumption of 25% CPR we generally make when we acquire IOS from Sequoia. Slower prepayment rates on the underlying ARM loans generally improve our economic returns from these IOS.

In August 2004, we declared a regular dividend of $0.67 per share for the third quarter, payable on October 21, 2004 to stockholders of record on September 30, 2004.

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The Offering(1)

Common stock offered	1,000,000 shares
Common stock outstanding after this offering(2)	22,996,986 shares
Use of proceeds	We intend to use the net proceeds of this offering (i) to purchase new real estate assets for our permanent investment portfolio, (ii) to support our securitization activities and (iii) for general corporate purposes. See Use of Proceeds.
New York Stock Exchange trading symbol	RWT

(1) Does not include up to 150,000 shares of our common stock that may be issued in connection with the underwriters over-allotment option.

(2) Based on shares of common stock outstanding as of September 20, 2004.

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Summary of Selected Financial Data
(in thousands except share data)

The summary information presented below at or for each of the periods presented is derived in part from the consolidated financial statements of Redwood Trust, Inc. The information presented as of or for the six months ended June 30, 2004 is unaudited; however, in the opinion of management, the information contains all adjustments (none of which were other than normal recurring entries) necessary for a fair presentation of the results for this period. The results of operations for the six months ended June 30, 2004 are not necessarily indicative of results that may be expected for the full year ending December 31, 2004. The following information is only a summary and should be read in conjunction with the Consolidated Financial Statements and Notes thereto, Selected Financial Data and Management s Discussion and Analysis of Financial Condition and Results of Operations, included in our Annual Report on Form 10-K for the year ended December 31, 2003 and Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.

Our GAAP earnings (as calculated in accordance with generally accepted accounting principles) totaled approximately $132 million, or $7.09 per share, for 2003, as compared to approximately $54 million, or $3.44 per share, for 2002, and approximately $30 million, or $2.88 per share, for 2001. Our GAAP earnings totaled approximately $106 million, or $5.08 per share, for the first six months of 2004, as compared to approximately $37 million, or $2.09 per share, for the first six months of 2003. Our 2003 and year-to-date 2004 results were driven by the quality of our existing real estate investments, a favorable operating environment, excellent credit results, favorable prepayment patterns, increased capital efficiencies, and income generated from discount residential CES securities that were called during 2003 and 2004 at full par value.

	As of or for the years ended December 31,			As of or for the six months ended June 30,	
	2003	2002	2001	2004	2003
				(Unaudited)	
Statement of Income Data:					
Interest income	$ 330,976	$ 163,216	$ 144,539	$ 262,816	$ 132,551
Interest expense	(202,861)	(91,705)	(98,069)	(169,936)	(78,735)
Net interest income	128,115	71,511	46,470	92,880	53,816
Operating expenses	(36,895)	(20,005)	(12,747)	(18,487)	(17,075)
Net recognized gains and valuation adjustments	46,676	5,111	1,532	29,695	3,859
Provision for income taxes	(5,502)			1,791	(2,775)
Dividends on Class B preferred stock	(681)	(2,724)	(2,724)		(681)
Net income before change in accounting principle	131,713	53,893	32,531	105,879	37,144
Cumulative effect of adopting EITF 99-20			(2,368)		
Net income available to common stockholders	$ 131,713	$ 53,893	$ 30,163	$ 105,879	$ 37,144
Average common shares basic	17,759,346	15,177,449	10,163,581	20,028,267	17,036,286
Net income per share basic	$ 7.42	$ 3.55	$ 2.97	$ 5.29	$ 2.18
Average common shares diluted	18,586,649	15,658,623	10,474,764	20,855,647	17,730,304
Net income per share diluted	$ 7.09	$ 3.44	$ 2.88	$ 5.08	$ 2.09
Dividends declared per Class B preferred share	$ 0.755	$ 3.020	$ 3.020	$	$ 0.755
Regular dividends declared per common share	2.600	2.510	2.220	1.340	1.300
	4.750	0.375	0.330	0.500	

Special dividends declared per common share					
Total dividends declared per common share	$ 7.350	$ 2.885	$ 2.550	$ 1.840	$ 1.300

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	As of or for the years ended December 31,			As of or for the six months ended June 30,	
	2003	2002	2001	2004	2003
				(Unaudited)	
Balance Sheet Data: end of period					
Earning assets	$17,543,487	$ 6,971,794	$ 2,409,271	$21,852,110	$10,307,469
Total assets	17,626,770	7,007,772	2,435,644	21,962,372	10,356,052
Short-term debt	236,437	99,714	796,811	269,884	217,684
Asset-backed securities	16,782,586	6,397,020	1,313,715	20,870,202	9,542,631
Total liabilities	17,073,442	6,534,739	2,127,871	21,204,432	9,808,876
Total stockholders equity	$ 553,328	$ 473,033	$ 307,773	$ 757,940	$ 547,176
Number of Class B preferred shares outstanding		902,068	902,068		
Number of common shares outstanding	19,062,983	16,277,285	12,661,749	21,510,801	17,820,856
Book value per common share	$ 29.03	$ 27.43	$ 22.21	$ 35.24	$ 30.70
Other Data:					
Average assets	$11,058,272	$ 4,039,652	$ 2,223,280	$19,498,166	$ 7,961,868
Average debt and asset-backed securities	10,489,614	3,616,506	1,945,820	18,818,749	7,601,393
Average reported total equity	$ 526,808	$ 402,986	$ 254,021	$ 624,129	$ 497,275
GAAP earnings/average reported common equity	25.3%	14.3%	13.3%	33.9%	15.3%

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RISK FACTORS

You should carefully consider the following factors and other information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus before deciding to purchase shares of our common stock.

The following is a summary of the risk factors that we currently believe are important and that could cause our results to differ from expectations. This is not an exhaustive list; other factors not listed below could be material to our results.

We can provide no assurances with respect to projections or forward-looking statements made by us or by others with respect to our future results. Any one of the risk factors listed below, or other factors not so listed, could cause actual results to differ materially from expectations. It is not possible to accurately project future trends with respect to these risk factors, to project which risk factors will be most important in determining our results, or to project what our future results will be.

Risks Related To Our Business

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

Our permanent investment portfolio produces the bulk of our profits. It consists of securities we have acquired from securitizations sponsored by us and by others. We generally fund our acquisitions for our permanent investment portfolio using our equity capital. Since we are not using financial leverage, or debt, to seek to increase our returns from these securities, we only acquire securities that we believe can earn a high enough yield to enable us to provide our stockholders with an attractive equity rate of return. In general, we expect to earn an internal rate of return, or IRR, of cash flows from each of our permanent investment portfolio assets that equals or exceeds 14% on a pre-tax and pre-overhead basis. In order to earn this rate of return on an unleveraged basis, we generally acquire the most risky securities from any securitization. Most securitizations of residential and commercial real estate loans concentrate almost all the credit risk of all the securitized assets into one or more CES or CDO equity securities. To the extent that there is significant prepayment risk or interest rate risk internal to these securitization structures, those risks are generally concentrated in one or more securities. Each of the securities we own employs a high degree of internal structural leverage and concentrates its risks into a few securities that we acquire. No amount of risk management or mitigation can change the variable nature of the cash flows, market values, and financial results generated by concentrated risks in our investments backed by real estate loans and securities, which, in turn, can result in variable returns to us and our stockholders.

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 CES and similarly structured securities acquired from securitizations sponsored by others and from Sequoia securitizations sponsored by us. These 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 CES.

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

In addition to residential CES, Acacia entities own investment-grade securities (typically rated AAA through BBB, and in a fourth-loss position or better, or otherwise effectively more senior in the credit structure as compared to a residential CES or equivalent held by us) issued by residential securitization entities that were not sponsored by us. Generally, we do not control or influence the underwriting, servicing, management or loss mitigation efforts with respect to these assets. Many of the investment-grade securities Acacia owns are backed by sub-prime 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) could occur. Most of Acacia s securities are reported as part of our consolidated securities portfolio on our GAAP consolidated balance sheet. Acacia has also acquired investment-grade residential loan securities from the Sequoia securitization trusts we have sponsored. The probability of incurring a credit loss on investment-grade securities is less than the probability of loss from residential CES, as cumulative credit losses within a pool of securitized loans would have to exceed the principal value of the CES (and exhaust any other credit protections) before losses would be allocated to the investment grade securities. If the pools of residential loans underlying these securities were to experience poor credit results, however, these investment-grade securities could have their credit ratings down-graded, could suffer losses in market value, or could experience principal losses. If any of these events occurs, it would likely reduce our returns from the Acacia CDO equity securities we have acquired and may reduce our ability to sponsor Acacia transactions in the future.

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 the bulk of the loans securitized by securitization trusts sponsored by us and for a portion of the loans underlying residential 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. If we incur increased credit losses, our taxable income would be reduced, our GAAP earnings might be reduced, and our cash flows, asset market values, access to short-term borrowings (typically used to acquire assets for securitization), and our ability to securitize assets might be harmed. 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.

Although we do not normally do so, from time to time we may pledge residential CES owned by us as collateral for borrowings. A deterioration of credit results in the loans that underlie these securities may harm the terms or availability of these borrowings and, thus, our liquidity.

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 market value, which would likely reduce our access to liquidity if we borrowed against that asset and may cause a market value write-down for GAAP purposes, which would reduce our reported earnings. Prepayment rates are not predictable, nor do they change in a predictable manner as a function of interest rate changes. Prepayment rates can change rapidly. The sensitivity of our results and operations to changes in residential loan prepayment rates has increased in recent years, and the present value of the cash flows we expect to earn from our assets can be affected as much by adverse prepayment scenarios as by adverse credit loss scenarios.

Given our current asset base, we believe a sustained increase in prepayment rates for ARMs could harm our results. In our permanent investment portfolio, we own IOS acquired from many of the Sequoia securitizations of adjustable-rate one- and six-month LIBOR-indexed residential real estate loans that we have sponsored. (These ARMs are consolidated for GAAP purposes and appear on our GAAP consolidated balance sheet as loans. Since all the assets and liabilities of these trusts are consolidated on our GAAP consolidated balance sheet, these IOS are not shown there.) IOS do not have a principal balance and do not receive principal payments. They do receive interest payments, generally calculated based on a notional balance of principal. Typically, the notional balance of principal for the IOS declines as the amount of loans in the securitization declines (although not always in a linear fashion). Therefore, faster prepayments lead to a lower amount of cumulative interest payments (and lower potentially negative economic returns) for the owner of the IOS. Total cash returned to an IOS owner could be less than the amount paid for the IOS if prepayments accelerate rapidly. There are many factors that affect prepayment rates on ARMs. One important factor is the relationship between short-term interest rates and long-term interest rates. When short-term interest rates are slightly less than, equal to, or greater than long-term interest rates (*i.e.*, the yield curve is flat or inverted), prepayment rates on ARMs often increase as borrowers refinance into fixed rate or hybrid rate (a fixed rate period followed by an adjustable rate period) loans. For this and other reasons, prepayment rates on ARMs backing the securities in our portfolio have increased recently, from the 10% to 15% per year range to the 20% to 25% per year range. In general, for our internal economic analysis, we assume ARM loans will prepay at a rate of 25% per year over the life of a pool of loans. If the ARMs underlying our IOS prepay at a rate faster than 25% per year on a sustained basis, our economic returns will be lower than we have assumed. A sustained acceleration of ARM prepayments would likely increase our returns from the residential CES we own that are backed by adjustable-rate loans. However, this increase of returns would only partially offset the negative effect such an acceleration would have on our residential IOS. Furthermore, the timing of the recognition of these off-setting returns would likely not match, as residential CES are longer-lived securities and the recognition of economic gains from faster ARM prepayments would occur at a subsequent point in time.

Changes in prepayment rates for fixed-rate and hybrid-rate loans affect our earnings, dividends, cash flows and liquidity, although to a lesser degree than do ARM prepayments (given our current asset base). A slower rate of prepayment for fixed and hybrid loans would reduce the returns we earn from residential CES backed by these types of loans. We acquire residential CES at a discount to par (principal) value. For this reason, our economic returns are enhanced when we receive a return of the principal value of a CES earlier rather than later. Slowing prepayment rates delay our principal payments and, thus, reduce our economic returns. Prepayment rates on fixed and hybrid loans have slowed recently, in part because long-term interest rates have risen. When longer-term interest rates rise, fewer borrowers with fixed and hybrid loans refinance and thus prepayment rates are reduced.

Changes in residential loan prepayment patterns can affect us in a variety of other ways that can be complex and difficult to predict. In addition, our exposure to prepayment changes over time. We generally do not believe that we can predict prepayment rate changes. As a result, changes in prepayment rates will likely cause volatility in our financial results in ways that are not necessarily obvious or predictable and that may harm our results from operations.

Our loss exposure on residential credit-enhancement securities is large relative to our equity capital base.

The credit performance of residential loans underlying residential CES directly affects our results for the CES securities we own in our permanent investment portfolio, and indirectly affects our results for CES owned by Acacia securitization entities from which we have acquired CDO equity ABS (consisting of equity, preference share, non-investment grade and similar concentrated credit risk securities) for our permanent investment portfolio. The total amount of residential real estate loans underlying residential CES owned in our permanent investment portfolio was $97 billion at June 30, 2004. This was a large amount of potential credit risk relative to our equity capital base of $758 million at June 30, 2004. Our total potential credit loss from the underlying residential real estate loans is limited to our total investment in residential CES and Acacia CDO equity securities. This total potential loss, however, is large relative to our equity capital base and, if realized, would harm our results from operations.

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 CES. If losses occur quickly, in the first few years after a securitization is completed, they will have a larger negative impact on our 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 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, and there can be no assurance that our quality control and loss mitigation operations will be successful in limiting future delinquencies, defaults and losses. Our underwriting reviews may not be effective. The securitizations we have invested in may not receive funds that we believe are due from mortgage insurance companies. Loan servicing companies may not cooperate with our loss mitigation efforts, or such efforts may otherwise be ineffective. Various 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

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balances over $1 million, reduced documentation loans, sub-prime loans, home equity lines of credit, or HELOCs, second lien loans, and loans that are partially collateralized by non-real estate assets may have special risks. If loans become real estate owned, or REO, servicing companies will have to manage these properties and may not be able to sell them. Changes in consumer behavior, bankruptcy laws, and other laws may exacerbate loan losses. In some states and circumstances, the securitizations in which we invest have recourse 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 source of funds for any recoveries. Expanded loss mitigation efforts in the event that defaults increase could increase our operating costs.

Our business may be significantly harmed by a slowdown in the economy of California.

As of June 30, 2004, nearly half of the residential real estate loans that underlie the residential CES we owned were secured by property in California. An overall decline in the economy or the residential real estate market, or the occurrence of a natural disaster that is not covered by standard homeowners insurance policies, such as an earthquake, could decrease the value of residential properties in California. This, in turn, would increase the risk of delinquency, default or foreclosure on real estate loans underlying our residential CES portfolio. This could adversely affect our credit loss experience and other aspects of our business, including our ability to securitize real estate loans. As of June 30, 2004, approximately 72% of our commercial real estate loans and approximately one-quarter of the loans underlying investment-grade residential securities owned by Acacia were also secured by properties located in California.

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 receive monthly payments from most of our assets, consisting of principal and interest. In addition, each month some of our residential CES are called (effectively sold). 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 a portion of the cash flows we receive from principal, interest, calls and sales into new earning assets.

We believe the assets we are acquiring today are unlikely to generate economic returns or GAAP yields at the same levels as our current assets have done. Our permanent investment portfolio assets are currently generating attractive yields. We acquired most of these assets in a period of reduced competition and lower asset prices relative to market conditions today. In addition, business conditions have been generally attractive over the last few years, with favorable credit, prepayment and interest rate trends. As a result, our cash flows and the timing of cash flows we have received from our current assets have been more favorable than we initially expected. Under the effective yield method of accounting that we use for GAAP accounting purposes for most of our assets, we generally recognize yields on assets based in part on our initial assumptions. A portion of the cash flows we receive that exceeds our initial assumptions reduces our basis in these assets. As a result of these various factors, our basis for GAAP purposes for many of our current assets is lower than their current 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. As a result, the new assets we acquire at current market values are unlikely to generate GAAP yields or economic returns as attractive as our current assets. A reduction in the supply of newly originated real estate loans resulting from higher interest rates and increased competition from banks, hedge funds and others, could further exacerbate this situation.

If the assets we acquire today 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.

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

In order to continue our securitization operations, we require access to short-term debt. In times of market dislocation, this type of short-term debt might become unavailable from time to time. We use the assets we buy to collateralize the debt. The debt is recourse to us, and if the market value of the collateral declines we 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 trust; 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 proceeds 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 or 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 and our stockholders interests 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 market values of our collateral, and other factors could force us to utilize our liquidity reserves or to sell assets, and, thus, affect our liquidity, financial soundness and earnings. We may initiate a collateralized commercial paper program to supplement the current short-term debt arrangements we use for our securitization program, and this could expose us to new risks and expenses.

Our earnings and ability to continue to grow may be harmed by a reduction in securitization and volume resulting from increased competition or other industry trends.

A reduction in securitization volume or profitability, caused by increased competition, reduced asset supply, market fluctuations, ABS spread widening, poor hedging results or other factors, could have a material adverse impact on our taxable income and also on our GAAP income. Competition in the business of sponsoring securitizations of the type we focus on is increasing as Wall Street broker-dealers, mortgage REITs, investment management companies, and other financial institutions expand their activities or enter this field. In general, this has reduced our securitization margins as we have had to pay a higher price for securitizable assets relative to the proceeds available from securitization.

Market dislocations resulting in failed or disadvantageous securitizations or asset sales could have also a material liquidity effect on us and reduce our profitability. For example, if the securitization market were to experience a long-term disruption due to an adverse court decision or bankruptcy law change relating to the bankruptcy-remote structures of the securitizations, our ability to issue securitizations may be impaired or eliminated for a protracted period or permanently. In such event, our earnings and ability to grow would likely be harmed.

We assume credit risk in our investments in commercial real estate securities and loans that may be greater than the risk in our investments in residential real estate assets.

The commercial real estate assets in which we have a direct or indirect interest may have higher degrees of credit and other risks than do residential real estate assets, including various environmental and legal risks. The net operating income and 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 protect 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 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 generally do not service commercial real estate loans; we rely on our servicers to a great extent to manage commercial assets and work-out loans and properties if there are delinquencies or defaults. This may not work to our advantage. As part of the work-out 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 which 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 own mezzanine loans that do not have a direct lien on the underlying property.

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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 directly originated some of our commercial loans and participated in the origination of others. This may expose us to certain credit, legal and other risks that may be greater than is usually present with acquired loans. We have sold commercial real estate loans. The representations and warranties we made on these sales are limited, but could cause losses and claims in some circumstances. 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.

Our first-loss and second-loss 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 equity holder of the property and, thereafter, by a cash reserve fund or letter of credit, if any, and lastly 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 any classes of securities junior to those in which we invest, we will not be able to recover all of our investment in the securities we purchase. In addition, if the underlying loan portfolio has been overvalued by the originator, or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related asset-backed securities, the first-loss securities may suffer a total loss of principal, and the second-loss (or more highly rated) securities 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 development than more highly rated commercial real estate investments. A projection of an economic downturn, for example, could cause a decline in the price of commercial CES because the ability of obligors of loans underlying commercial asset-backed securities to make principal and interest payments may become impaired.

We have invested in, and intend to increase our investment in, diverse types of assets with credit risks and other risks that could cause losses.

We have made investments in CDO equity securities issued by CDO securitizations that were not sponsored by us and that own various types of assets, generally real estate related. These CDOs and the Acacia entities have also invested in manufactured housing securities, sub-prime 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 securities issued by CDOs that own trust preferred issued by banks or other types of non real estate assets. We may invest directly or indirectly in real property. We have invested in diverse types of IOS 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.

Interest rate fluctuations can have various effects on us, and could lead to reduced earnings and/or increased earnings volatility.

Our balance sheet and asset/liability operations are complex and diverse with respect to interest rate movements. We do not seek to eliminate all interest rate risk. Changes in interest rates, the interrelationships between various interest rates, and interest rate volatility could have negative effects on our earnings, the market value of our assets and liabilities, loan prepayment rates and our access to liquidity. Changes in interest rates can also harm our credit results. We seek to hedge some 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.

We generally fund our permanent investment portfolio with equity, so there is no asset/liability mismatch for these assets. However, the cash flows we receive from these assets does vary as a function of interest rates, as does the GAAP earnings generated by these assets. A portion of our permanent investment portfolio assets have adjustable-rate coupons. All other factors being equal, these assets will generally earn less as short-term interest rates decline. In addition to our permanent investment portfolio assets, we own loans and securities on a temporary basis prior to sale to a securitization trust. We fund these assets with equity and with one-month floating rate debt. To the extent these assets have fixed or hybrid coupons (or are adjustable with an adjustment period longer than one month), an interest rate mismatch exists and we would earn less (and incur market value declines) if interest rates rise. We usually seek to reduce asset/liability mismatches for these temporary assets with a hedging program using interest rate swaps and futures.

The returns we earn from the residential IOS we have acquired from the securitizations of ARMs we have sponsored can be affected by rapid changes in short-term interest rates. Payments received by these securities typically vary as a function of the net interest income (the interest income payments received by the trust on ARM loans owned by the trust less payments made to the ABS issued by the trust) of the trust that issued the IOS. The interest rate characteristics of the ARM loans in these trusts closely match the interest rate characteristics of the ABS issued, as both the assets and the liabilities generally have interest payments that adjust monthly as a function of the one-month LIBOR rate or semi-annually as a function of the six-month LIBOR rate. However, the amount of six-month ARMs is greater than the amount of six-month ABS within these trusts. As a result, the payments made to us as the IOS owner could be reduced if short-term interest rates increased rapidly. We seek to stabilize the payments we receive from IOS by utilizing interest rate agreements such as interest rate swaps and futures. We also face a similar risk with respect to loans we own (or have committed to purchase) on a temporary basis prior to securitization, as many of these loans have coupons that adjust each six months whereas the short-term debt we utilize to fund these loans generally has an interest rate that adjusts monthly. We use interest rate agreements to reduce this mismatch as well. However, our hedging program cannot completely stabilize the payments we will receive from IOS or from loans held prior to securitization, and variations in income as a result of changes in short-term interest rates will still occur.

Fixed and hybrid rate securities comprise approximately 25% to 45% of the securities owned by the various Acacia entities and of the securities temporarily owned by us prior to sale to Acacia. This creates a mismatch in interest rate characteristics, as Acacia generally issues floating rate ABS with a coupon that adjusts each quarter, and we fund our accumulation of securities for Acacia with floating rate short-term debt. We use interest rate swaps and futures to reduce this mismatch (between fixed and hybrid assets and floating rate obligations) and to reduce net market value fluctuations on our balance sheet, and the Acacia entities employ interest rate swaps to stabilize their net interest earnings (which tends to stabilize our earnings as owners of the CDO equity ABS issued by the Acacia entities). However, our hedging program cannot completely stabilize net interest income or market values for these assets and liabilities, and negative volatility in our results, net worth, and liquidity could result from changes in interest rates.

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

Higher interest rates generally reduce the market value of our assets (except perhaps our adjustable rate 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. 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.

Higher short-term interest rates relative to long-term interest rates could cause an increase in adjustable-rate residential loan pre-payments, which would likely reduce our returns from owning IOS backed by these ARM loans.

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 (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. We may elect GAAP accounting treatment under FAS 133 for a portion of our hedges to obtain accounting treatment that we believe could, in some instances, more appropriately represent the economic impact of our hedging activities. However, there can be no assurance that electing FAS 133 accounting for certain hedges will improve the quality of our reported GAAP earnings or that we will continue to meet the requirements of FAS 133 when elected. In addition, the ongoing requirements of FAS 133 are complex and rigorous. If we fail

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to meet these requirements, we could not designate our interest rate agreements as hedges under FAS 133 and would be required to commence mark-to-market accounting through our GAAP consolidated statements of income.

Our quarterly earnings may reflect volatility in earnings that are exaggerated by the resulting accounting treatment for certain hedges and/or by accounting treatments for assets or liabilities that do not match those used for interest rate agreements. Hedging against interest rate movements using interest rate agreements (including interest rate swap instruments and interest rate futures) 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 market values, to stabilize our economic returns from securitization, or to stabilize the future cost of anticipated ABS issuance by a securitization trust. Such hedging may not achieve its desired goals. Using interest rate agreements to hedge may increase short-term earnings volatility, especially if we elect mark-to-market accounting for our hedges. Reductions in market values of interest rate agreements may not be offset by increases in market values of the assets or liabilities being hedged. Conversely, increases in market values of interest rate agreements may not fully offset declines in market values of assets or liabilities being hedged. Changes in 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. Such hedges may have special basis, liquidity, and other risks to us.

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 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 cash flows from operations. In the event, however, 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, 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, and our consolidated balance sheet, income statement, and statement of cash flows as reported for GAAP purposes may be difficult to interpret, which may cause trading in our stock to be relatively illiquid.

We manage our business based on long-term opportunities to earn cash flows. Our dividend distributions are driven by our minimum dividend distribution requirements under the REIT tax laws and our profits as calculated for tax purposes pursuant to Internal Revenue Code of 1986, as amended. Our reported results for GAAP purposes differ materially, however, from both our cash flows and our taxable income.

We own residential CES acquired from securitizations sponsored by others and also residential CES acquired from securitizations we have sponsored. These securities do not differ materially in their structure or cash flow generation characteristics, yet under GAAP accounting we consolidate all the assets and liabilities of trusts we have sponsored (and thus do not show the residential CES we own as an asset) while we show only the net investment as an asset for CES acquired from others. The same issue arises with residential IOS and other securities investments that we make and with CDO securitizations that we sponsor. As a result of this and other accounting issues, stockholders and analysts must undertake a complex analysis to understand our economic cash flows, actual financial leverage, and dividend distribution requirements. This complexity may cause trading in our stock to be relatively illiquid or may lead observers to misinterpret our results.

Market values for our assets, liabilities, and hedges can be volatile. A decrease in market value may or may not be the result of a deterioration in future cash flows. For GAAP purposes, we mark-to-market a sub-set of our consolidated assets and liabilities through our GAAP consolidated income statement and a different sub-set through our GAAP consolidated balance sheet (and other comprehensive income). Matching assets, liabilities, and hedges may have differing mark-to-market treatment. Some items are only marked-to-market in certain circumstances. Other items are marked-down in value if market value declines but are not marked-up in value if market value increases. If we sell an asset that has not been marked-to-market through our income statement at a reduced market price relative to its basis, our reported earnings will be reduced. As a result, changes in our GAAP consolidated income statement and balance sheet due to market value adjustments should be interpreted with care.

Our profits as calculated for GAAP purposes depend 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 accounting rules or the accepted interpretation of these rules 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 can change in a manner that harms our results or demonstrate, in retrospect, that revenue recognition in prior periods was too high or too low.

We use the effective yield method of GAAP accounting 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 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 as we change our estimates of future cash flows. The assumptions that underlie our projected cash flows and effective yield analysis have proven from time to time to be overly optimistic. In these cases, we reduce the GAAP yield we recognize for an asset and/or we write down the basis of the asset to its current market value (if the 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.

We establish credit reserves for GAAP accounting, but these reserves are not backed with cash.

In determining our REIT taxable income (which drives our minimum dividend distribution requirements as a REIT) from residential CES (whether acquired from securitizations sponsored by us or by others), CDO equity securities, or other credit-sensitive assets, 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. Since we distribute the bulk of our taxable income as dividends, there is no cash amount held by us to match GAAP credit reserves (for loans included on our GAAP consolidated balance sheet from Sequoia securitization trusts) or implied GAAP credit reserves created under the effective yield method (for residential CES acquired from securitizations sponsored by others or backed by other assets) or other ways in which our GAAP income may be reduced due to credit reasons prior to the actual realization of a credit loss. Due to our lack of reserves for tax, our GAAP reserves are not backed by cash, and an increase in our credit losses in the future will reduce our taxable income (and dividend distribution requirements) but would not necessarily reduce our GAAP income recognition.

We have credit 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 trusts 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 from our subsidiary, RWT Holdings, Inc., or Holdings, to the securitization trust. In these cases, Holdings may be obligated to repurchase loans from the securitization trusts at par (principal) value. However, Holdings has obtained representations and warranties from the counter-parties that sold the loans to Holdings that generally parallel the representations and warranties Holdings has provided to the trusts. 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 Holdings is 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, Holdings may have to use some of its cash resources to repurchase loans. Additionally, Holdings credit losses from such loans would likely be higher than they would have been if Holdings had been able to enforce repurchase provisions with the original seller.

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 them in an unfavorable manner to us, our ability to realize benefits from hedging may be diminished, and any cash or collateral that we pledged to these counter-parties may be unrecoverable. 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. We may not receive funds to which we are entitled. In various 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 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 harmed.

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.

The majority of 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. 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.

Risks Related To Our Company Structure

Failure to qualify as a REIT would adversely affect our operations and ability to make distributions.

We intend to operate so as to qualify as a REIT for federal income tax purposes. Although we have not requested and do not intend to request a ruling from the Internal Revenue Service confirming that we qualify as a REIT, we have received opinions from our special tax counsel, Chapman and Cutler LLP, to the effect that Redwood Trust, exclusive of its taxable REIT subsidiaries, has been organized and operated in a manner that qualifies it as a REIT under the Code. Such REIT qualification opinions represent the view of Chapman and Cutler LLP based on its review and analysis of existing law (which includes no controlling precedent on many issues relevant to our operations) and are not binding on the IRS or courts. Furthermore, both the validity of such opinions and our ongoing qualification as a REIT will depend on actual operating results and our ability to comply on an ongoing basis with the various tests for qualifications as a REIT. If we fail to qualify as a REIT, our income would be subject to tax at regular corporate income tax rates and payment of such taxes would likely reduce our funds available to pay dividends to stockholders.

Maintaining REIT status may reduce our flexibility; changes in tax rules could adversely affect REITs.

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

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

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

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

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

Meeting minimum REIT dividend distribution requirements may require us to raise new equity capital if we wish to grow operations at a rapid pace. Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source.

Failure to meet REIT requirements may subject us to taxation, penalties and/or loss of REIT status.

The requirements for maintaining REIT status and/or the taxation of REITs could change in a manner adverse to our operations.

Our stated goal is to not generate income that would be taxable as unrelated business taxable income, or UBTI, to our tax-exempt stockholders. Achieving this goal may limit 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.

We may seek to retain a portion of our earnings from time to time so we can redeploy such earnings in our business. We will be subject to income and excise taxes under the REIT tax rules if we do so.

New tax rules regarding dividends have been enacted 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 Securities and Exchange Commission 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 so-called 55% Requirement) and are also required to maintain an additional 25% in qualifying assets or other real estate-related assets (the so-called 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 would 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 nonenforcement (or grant of rescission) and would not be inconsistent with the Investment Company Act.

Our strategies, policies, procedures, practices, product lines, risks, hedging programs, and internal risk-adjusted capital guidelines are subject to change.

In general, we are free to alter our strategies, policies, procedures, practices, product lines, leverage, risks, internal risk-adjusted capital guidelines and other aspects of our business and you, as a stockholder, will not have the ability to have input in those business decisions. We can enter new businesses or pursue acquisitions of other companies. Compared to most financial institutions, we are not heavily regulated and there are few regulatory restrictions on our actions. In most cases, we do not need to seek stockholder approval to make such changes. We will not necessarily notify stockholders of such changes.

Certain provisions of Maryland law and our charter and bylaws could delay, defer or prevent a transaction or a change in control of Redwood that might involve a premium price for holders of our common stock or otherwise be in their best interests.

The Maryland General Corporation Law, or MGCL, and our charter and bylaws contain provisions that may have the effect of delaying, deferring or preventing a change in control and preventing removal of our directors. These provisions include the following:

Classified Board of Directors. Under our charter, our board of directors is divided into three classes serving staggered terms of office of three years each. The classification and staggered terms of office of our board of directors will make it more difficult for a third party to gain control of our board. At least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of our board of directors.

Removal of Directors. Under the MGCL, unless the charter provides otherwise (which our charter does not), a director on a classified board may be removed only for cause by the affirmative vote of at least a majority of all votes entitled to be cast generally in the election of directors.

Board Vacancies. We have elected to be subject to a provision of the MGCL which provides that a vacancy on our board of directors may be filled only by a majority of the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred.

Preferred Stock. Under our charter, our board of directors has the power to classify and reclassify our common stock from time to time in one or more classes or series of stock, including preferred stock, and to establish the terms, preferences and rights of any such class or series of stock, without any action by our stockholders.

Ownership Limit. To preserve our status as a REIT under the Internal Revenue Code, 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. Pursuant to our charter, our board of directors has, from time to time, waived this limit.

Maryland Control Share Acquisition Act. We are generally subject to the Maryland Control Share Acquisition Act, or the Control Share Act, which provides that control shares of a Maryland corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast on the matter. Control shares are voting shares of stock which, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of the voting power: (i) one-tenth or more but less than one-third; (ii) one-third or more but less than a majority; or (iii) a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights for control shares acquired in a control share acquisition are not approved at a stockholders meeting, then subject to certain conditions and limitations, the issuer may redeem any or all of the control shares for fair value. If voting rights for such control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal rights. Although we are generally subject to the Control Share Act, our bylaws provide, as permitted by the Control Share Act, for the exemption of acquisitions of shares by certain persons from the provisions of the Control Share Act.

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Risks Related To This Offering

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

Our earnings, cash flows, book value and dividends can be volatile and difficult to predict. Investors should not rely on predictions or management beliefs. Although we seek to pay a regular common stock dividend rate that is sustainable, we may reduce our regular dividend rate in the future for a variety of reasons. We have paid special dividends in the past, but we may not do so in the future. We may not provide public warnings of such dividend reductions prior to their occurrence. Fluctuations in our current and prospective earnings, cash flows, and dividends, as well as many other factors such as perceptions, economic conditions, stock market conditions, and the like, can affect our stock price. Investors may experience volatile returns and material losses. In addition, liquidity in the trading of our stock may be insufficient to allow investors to sell their stock in a timely manner or at a reasonable price.

In November 2003, we declared a sizable special dividend, and this announcement, as well as the payment of the dividend, caused some stock price fluctuations. We have indicated that we may need to pay additional special dividends prior to October 2005 in the event that our REIT taxable income results remain strong. Speculation regarding the amount and timing of any special dividend payments may cause fluctuations in our stock price.

We currently expect that our earnings per share results (as measured before mark-to-market income and expense) may have peaked in the first half of 2004. We believe this measure, as well as other per share measures of our results including reported GAAP earnings per share, are more likely than not to decline over the next several quarters from results posted recently. This may have a negative effect on our stock price.

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USE OF PROCEEDS

The net proceeds that we will receive from the sale of 1,000,000 shares of our common stock in this offering are estimated to be approximately $56,056,000, after deducting underwriting discounts and commissions and estimated expenses, assuming the over-allotment option is not exercised by the underwriters, and $64,494,400 assuming the over-allotment option is exercised in full. We intend to use the net proceeds primarily to purchase new real estate assets for our permanent investment portfolio and secondarily to support our securitization activities and for general corporate purposes. Pending use of the net proceeds for these purposes, the net proceeds will be used to reduce short-term debt we typically use to finance on a temporary basis the assets that we are accumulating for sale into a securitization. This debt generally bears interest at rates that adjust based on the one-month or six-month LIBOR.

PRICE RANGE OF COMMON STOCK AND DIVIDENDS

The following table sets forth the high and low sales prices of our common stock as reported by the New York Stock Exchange as well as the cash dividends we declared on each share for the periods indicated through September 20, 2004.

	Price Range		Common Dividends Declared	
	High	Low	Per Share	Dividend Type
2002				
First quarter	$27.49	$23.76	$0.62	Regular
Second quarter	$31.50	$27.00	$0.63	Regular
			$0.125	Special
Third quarter	$31.45	$23.00	$0.63	Regular
			$0.125	Special
Fourth quarter	$28.20	$23.54	$0.63	Regular
			$0.125	Special
2003				
First quarter	$33.15	$27.25	$0.65	Regular
Second quarter	$42.75	$32.15	$0.65	Regular
Third quarter	$44.12	$34.70	$0.65	Regular
Fourth quarter	$58.25	$41.14	$0.65	Regular
			$4.75	Special
2004				
First quarter	$63.47	$47.72	$0.67	Regular
			$0.50	Special
Second quarter	$62.71	$42.73	$0.67	Regular
Third quarter (through September 20, 2004)	$61.00	$54.15	$0.67	Regular

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COMMON STOCK DIVIDEND POLICY AND DISTRIBUTIONS

We intend to distribute at least 90% of our REIT taxable income to our stockholders in order to comply with the REIT tax rules. Our taxable income does not equal net income as calculated for GAAP purposes. We do not currently intend to distribute as dividends the taxable income we earn in our non-REIT subsidiaries as such income is being invested in our business. We declare regular quarterly dividends. Our goal is to pay regular dividends on our common stock at a rate that is steady and sustainable given the level of cash flows we expect to generate from our operations over time. In August 2004, we declared a regular cash dividend of $0.67 per share, payable on October 21, 2004 to stockholders of record on September 30, 2004. Based upon our current outlook, we believe that our cash flows will be sufficient to sustain dividend payments at the rate of at least $0.67 per share per quarter for the reasonably foreseeable future. Please see Risk Factors for a discussion of some of the factors that could potentially lead to a lower regular dividend rate. We have increased our regular dividend rate over the last few years as our profits and cash flows have increased.

In certain years, we may declare one or more special dividends in order to meet the annual minimum dividend distribution requirements necessary to comply with the REIT tax rules. In 2003, our Board of Directors authorized the declaration of a special cash dividend totaling $4.75 per share. In 2003, the total common stock dividends declared, including regular dividends and the special dividend, was $7.35. In March 2004, we declared another special cash dividend of $0.50 per share, which was paid on April 21, 2004 to stockholders of record on March 31, 2004.

If our REIT taxable income results continue to be strong in the second half of 2004, in order to meet our minimum dividend distribution requirements to maintain REIT status we will need to pay, prior to October 2005, a special cash dividend in addition to the current regular quarterly cash dividend of $0.67 per share payable on October 21, 2004. We do not anticipate that we will use the net proceeds from this offering to meet our dividend distribution requirements. At June 30, 2004, we had $57 million of unrestricted cash and $100 million of net liquidity (the total amount of unrestricted cash we would have had if all short-term funded assets for securitization were sold and short-term debt was repaid). We believe this liquidity, together with our cash flows and receipt of principal payments from our permanent investment portfolio, should be sufficient to meet our dividend distribution requirements. The primary purpose of this offering is to raise equity capital to purchase new real estate for our permanent investment portfolio, and secondarily to support our securitization activities and for general corporate purposes.

The dividend policy with respect to our common stock is subject to revision at the discretion of our Board of Directors. All decisions regarding distributions will be authorized by our Board of Directors and will depend on our REIT taxable income, maintaining our REIT status, GAAP earnings, cash flows, overall financial condition, and such other factors that our Board of Directors deems relevant.

Distributions to our stockholders generally will be subject to tax as ordinary income and generally will not be eligible for the lower tax rates that apply to certain dividends. Occasionally, a portion of our distributions may be designated by us as capital gain, as a tax-free return of capital, or (if we distribute earnings from our taxable subsidiaries) a distribution of profits that have already been taxed (and those distributions may be taxed at a lower rate than ordinary income). Our Board of Directors may elect to authorize payment of a steady regular dividend during periods of fluctuating taxable income. In such event, our Board of Directors may choose to authorize dividends that include a return of capital that was held at the REIT level or a distribution of retained earnings from our taxable subsidiaries. We will furnish to each stockholder an annual statement setting forth distributions paid during the preceding year and their characterization as ordinary income, capital gains, return of capital or other dividends that may be subject to a lower rate of tax. For a discussion of the federal income tax treatment of our distributions, see Federal Income Tax Considerations Taxation of Stockholders in this prospectus supplement.

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TAXABLE INCOME

Total taxable income is pre-tax income earned by our REIT and by our taxable subsidiaries. Pre-tax income earned by the REIT generally is not subject to corporate income tax to the extent it is distributed to stockholders as dividends.

For the first half of 2004, we estimate that our total taxable income was $114 million, or $5.52 per share (based on shares outstanding at period end). Taxable income at the REIT level was $5.09 per share for the first half of 2004.

Our REIT taxable income, which drives our minimum dividend distribution requirements under the REIT tax rules, differs from our GAAP income as set forth in the table below. For example, our GAAP income is reduced by credit provision expenses accrued in anticipation of credit losses while taxable income is reduced by credit losses only when they are realized. Additionally, unrealized market valuation adjustments for assets and hedges under GAAP are generally not included in taxable income, and certain compensation-related items are treated differently for GAAP and tax purposes (both in terms of timing and total expense recognition over time). Most of the securitizations we sponsor are treated as sales of the assets for tax purposes. This may create a realized gain or loss for tax purposes (which is a component of the taxable income we earn in our taxable subsidiaries). Conversely, most of our securitizations are accounted for on a fully consolidated basis for GAAP purposes, so no gain or loss is recognized.

(all dollars in thousands except per share data)	For the Year Ended December 31, 2003	For the Six Months Ended June 30, 2004
GAAP net income	$131,713	$105,879
Amortization and credit provision expenses	39,643	22,910
Operating expenses	9,989	6,141
Stock options exercised	(4,011)	(12,337)
Provision for excise tax	1,203	490
Provision for income tax	4,840	
Deferred tax benefit		(5,180)
Asset valuation adjustments	(7,126)	(3,486)
Total taxable income (estimated for June 30, 2004)	176,251	114,417
(Earnings)/losses from taxable subsidiaries	(7,861)	(9,043)
REIT taxable income	$168,390	$105,374
GAAP income per share based on average diluted shares during period	$ 7.09	$ 5.08
Total taxable income per share based on shares outstanding at period end	$ 9.65	$ 5.52
REIT taxable income per share based on shares outstanding at period end	$ 9.21	$ 5.09

Estimated total taxable income and estimated REIT taxable income are not GAAP performance measures; however, they are important measures as they are the basis of our required minimum dividend distributions to stockholders.

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The following table shows the components of estimated REIT taxable income and the amounts related to calls, sales of assets, and stock option exercise deductions:

(all dollars in thousands except per share data)	For the Year Ended December 31, 2003	Per Share	For the Six Months Ended June 30, 2004	Per Share
REIT taxable income before calls, sales, and stock options exercised	$124,150	$ 6.88	$ 88,781	$ 4.30
REIT taxable gains on calls	45,666	2.41	21,678	1.05
REIT taxable gains on sales of assets	2,585	0.14	7,252	0.36
REIT stock option exercise deductions	(4,011)	(0.21)	(12,337)	(0.62)
REIT taxable income	168,390	9.22	105,374	5.09
Pre-tax income at taxable subsidiaries	7,861	0.43	9,043	0.43
Total taxable income	$176,251	$ 9.65	$114,417	$ 5.52

We retained $20 million of taxable income earned in 2003 (before applicable federal and state income taxes of $6 million) and redeployed such income in our business.

Based on our 2003 REIT taxable income, we entered 2004 with $53 million of undistributed REIT taxable income. We expect to distribute this income as regular and special dividends to our stockholders during 2004. Based on estimates, we believe we finished the second quarter of 2004 with $121 million ($5.63 per share outstanding at that time) of undistributed REIT taxable income (after deducting the second quarter dividend of $0.67 per share paid to stockholders of record as of June 30, 2004). This amount includes $16 million of undistributed REIT taxable income carried over from 2003. Our estimates of taxable income are subject to change.

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CAPITALIZATION

The following table sets forth our capitalization as of June 30, 2004 (i) on an actual GAAP basis and (ii) as adjusted for the issuance of 1,000,000 shares of our common stock in this offering. The capitalization information set forth in the table below is qualified by the more detailed Consolidated Financial Statements and Notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2003 and our Form 10-Q for the quarter ended June 30, 2004.

	June 30, 2004	
	Actual(1)(2)	As Adjusted(3)
	unaudited (in thousands)	
Stockholders Equity:		
Common Stock, par value $0.01 per share; 50,000,000 shares authorized; 21,510,801 issued and outstanding, actual; 22,510,801 shares issued and outstanding, as adjusted(3)	$ 215	$ 225
Additional paid-in capital	625,151	681,197
Accumulated other comprehensive income	111,221	111,221
Cumulative earnings	354,851	354,851
Cumulative distributions to stockholders	(333,498)	(333,498)
Total stockholders equity	$ 757,940	$ 813,996

(1) Excludes as of June 30, 2004 (i) 1,656,998 shares of our common stock issuable upon exercise of outstanding options at a weighted average exercise price of $28.71 per share and (ii) an aggregate of 840,603 shares of Common Stock available for future issuance under our 2002 Redwood Trust, Inc. Incentive Stock Plan.

(2) At June 30, 2004, we also utilized borrowings of $270 million of short-term debt. In addition, we included on our GAAP consolidated balance sheet $20.9 billion of asset-backed securities issued by securitization trusts sponsored by us.

(3) Adjusted for the issuance of 1,000,000 shares contemplated to be issued in this offering, with net proceeds of approximately $56,056,000 after underwriting discounts, commissions and other estimated expenses. Assumes no exercise of the underwriters over-allotment option.

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COMPANY BUSINESS AND STRATEGY

General

Our business model and principal strategy are based on our belief that an efficiently structured financial institution can achieve an attractive level of profitability though investing in, credit-enhancing, and securitizing residential and commercial real estate loans and securities in a disciplined manner. Our primary financial goal is to generate steady regular dividends for our stockholders.

Securitization of Jumbo Residential Loans

Our primary product/market focus is investing in, credit-enhancing, and securitizing high-quality jumbo residential real estate loans and related securities. Our permanent investment portfolio consists primarily of credit-enhancement securities, or CES, and interest-only securities, or IOS, that were created through the securitization of high-quality jumbo residential real estate loans. These loans have coupon rates that are fixed, adjustable or hybrid (a fixed rate period that is followed by an adjustable rate period). Our securitization activities focus primarily on adjustable-rate jumbo residential loan products.

According to industry sources, approximately $7.6 trillion of residential real estate loans were outstanding in the United States as of June 30, 2004. The amount outstanding has grown at an average rate of 9% per year for approximately 20 years as home ownership and housing values have generally increased. New originations of residential real estate loans have ranged from $1.0 trillion to $3.8 trillion per year over the last five years. Originations generally increase in years when refinancing activity is stronger due to declines in long-term interest and mortgage rates.

The U.S. government-sponsored residential real estate loan investment companies, Fannie Mae and Freddie Mac, are prohibited from owning and credit-enhancing real estate loans with balances over certain limits (the limit for single-family real estate loans originated within the continental United States is currently $333,700). Loans with balances larger than this limit are commonly referred to as jumbo loans. We estimate that over the past five years, new originations of jumbo residential real estate loans have ranged between $200 billion and $700 billion per year making up between 18% and 22% of total new residential loan originations. We believe that outstanding U.S. jumbo residential real estate loans total nearly $1.4 trillion as of June 30, 2004. We also believe that the outstanding balance of jumbo residential real estate loans will continue to grow at the same rate as the residential loan market as a whole (between 4% and 12% per year).

Each year the amount of jumbo loans that are available for securitization consists of new originations (plus seasoned loans) that are securitized directly by or sold into the secondary mortgage market by financial institutions. When banks and thrifts (and, to a lesser degree, other financial institutions) acquire loans (or retain newly originated loans) to maintain or increase the size of their loan portfolios, these loans are generally not available for securitization. The amount of jumbo loans available for securitization each year depends on the economic conditions and other factors that determine the level of new loan originations and the relative attractiveness to financial institutions of selling versus buying or retaining loans for portfolio.

We estimate that the share of jumbo residential real estate loans outstanding that have been securitized has been increasing steadily from approximately 10% in 1990 to over 50% in 2003. Strong demand for portfolio assets from banks and thrifts in recent years has slowed, and to some extent reversed, the trend towards a greater market share for securitization. As a result of continued bank demand and also reduced originations, we expect that the supply of new jumbo loan securitizations may be somewhat reduced in the next few years. Nevertheless, we do expect that there will continue to be a large amount of CES and IOS available for sale, relative to our desired purchase rate.

Securitizations of jumbo residential real estate loans are generally sponsored by financial institutions, including Wall Street firms and mortgage conduits that acquire loans for securitization and also banks, loan origination companies, and REITs (that generally securitize their own origination). We acquire CES (and, to a lesser degree, IOS) for our permanent investment portfolio from a variety of securitization sponsors. Our Sequoia securitization program competes with these other companies in the securitization business. Our Sequoia program focuses primarily on acquiring and securitizing LIBOR-indexed adjustable-rate high-quality jumbo residential real estate loans (and recently, on a much smaller scale, high-quality home equity lines of credit, or HELOCs). While origination of jumbo adjustable-rate residential loans has increased over the last two years, we believe competition to acquire and securitize these loans has also increased significantly. Additional new

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competition seems likely, particularly from Wall Street firms entering or expanding in the conduit (loan accumulation and securitization) business and potentially from new and expanding mortgage REITs. As a result of this increased competition, our economic profits from our most recent Sequoia securitizations have been less than they have been in the past (i.e., the proceeds Sequoia receives from selling asset-backed securities including its sales to our permanent investment portfolio have only marginally exceeded the cost of the securitized loans). Our Sequoia program is a good source of very high-quality assets for our permanent investment portfolio; therefore, we may continue to sponsor the securitization of loans even if there is little net securitization gain. We generally do not intend to continue to securitize loans if we have to do so at a projected economic loss. If we slow or halt our securitization business, we will still have the opportunity to acquire permanent portfolio assets from securitizations sponsored by others. However, securitization gains from prior quarters (that are effectively imbedded in our portfolio as a lower basis of net assets for GAAP purposes) are an important part of earnings over the next few years from our current permanent investment portfolio. If economic gains from future securitizations remain at reduced levels, or we end up acquiring all of our assets from securitizations sponsored by others, we believe the new assets we acquire are likely to earn lower rates of return for GAAP purposes than our current assets.

Residential Credit-Enhancement Securities

We have been investing in residential CES for our permanent investment portfolio since our founding in 1994. We started our residential loan securitization program in 1997 to provide an additional source of high-quality residential CES for our permanent investment portfolio.

In a securitization, asset-backed securities are sold by a securitization entity to capital markets investors. Most of the demand for asset-backed securities is for AAA and other investment-grade rated securities. In order to create AAA and other highly rated asset-backed securities from a pool of residential real estate loans, a form of credit-enhancement is necessary in order to reduce the risk of credit loss to the investment-grade securities that could come from the underlying loans. A pool of residential real estate loans can be credit-enhanced through a number of different methods. The senior/ subordinated structure is currently the most prevalent method for credit-enhancement of jumbo residential real estate loans. This structure establishes a set of senior security interests in the pool of real estate loans and a set of subordinated security interests in the pool. The subordinated interests are acquired by one or more entities that, through the purchase of these interests, provide credit-enhancement to the underlying real estate loans and the more senior asset-backed securities. Under the terms of the securitization, credit losses in the loan pool reduce the principal of the subordinated interests first, thus providing some credit protection to the senior asset-backed securities that allows them to be rated investment-grade. Other forms of credit-enhancement, such as pool insurance provided by mortgage insurance companies, bond insurance provided by bond insurance companies, and corporate guarantees, are often less efficient than the senior/subordinated structure due to regulation and rating agency requirements, among other factors.

Companies that credit-enhance jumbo residential real estate loan securitizations profit from cash flows generated from the ownership of the subordinated CES. The amount and timing of credit losses in the underlying loan pools affect the yields generated by these assets. These interests are generally purchased at a discount to the principal value of the interest, and much of the potential return to the subordinated investor is generated through the ultimate return of the principal that remains after realized credit losses are deducted. To the extent that the remaining principal (after credit losses) is returned to the owner of the CES more quickly than expected due to faster-than-expected prepayment rates, the investor in this security will benefit. In addition, par (100% of principal) value calls of these securities (which generally may occur when the current balance of loans is less than 10% of the original balance of loans securitized) benefit the owner of the CES.

We believe that the business of acquiring and owning residential CES is highly fragmented. Companies that credit-enhance jumbo residential loan securitizations include banks and thrifts (generally credit-enhancing their own loan originations), insurance companies, Wall Street broker-dealers, hedge funds, private investment firms, mortgage REITs, and others.

The liquidity crisis in the financial markets in 1998 caused many of the participants in this market to withdraw. With reduced demand stemming from reduced competition, and increased supply of securitized product as a result of increased new originations as well as sales of seasoned loan portfolios, prices of residential credit-enhancement intere