

REDWOOD TRUST INC
Form 10-K
February 24, 2011

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

FORM 10-K

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

For the Fiscal Year Ended: December 31, 2010

OR

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

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

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

(Address of Principal Executive Offices) (Zip Code)

(415) 389-7373

(Registrant's Telephone Number, Including Area Code)

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

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

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

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

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

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

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

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

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

At June 30, 2010, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,125,366,435 based on the closing sale price as reported on the New York Stock Exchange.

The number of shares of the registrant's Common Stock outstanding on February 23, 2011 was 78,132,878.

DOCUMENTS INCORPORATED BY REFERENCE

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

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2010 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS

Introduction

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

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

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

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

Cautionary Statement

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

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

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Statements regarding the following subjects, among others, are forward-looking by their nature:

- (i) our competitive position and our ability to compete in the future, including our ability to effectively compete to acquire residential mortgage loans and our ability to compete to invest in commercial real estate loans;
- (ii) our future investment strategy and our ability to find attractive investments and future trends relating to our pace of acquiring or selling assets, including, without limitation, statements relating to our efforts to acquire residential mortgage loans and make commercial real estate investments;
- (iii) the \$119 million of loans that we have identified for purchase from originators through our conduit program and that we plan to subsequently acquire, references to future securitizations of loans we have acquired, which future securitizations may not be completed, and, more generally, statements regarding the likelihood and timing of, and our participation in, future securitization transactions and our ability to finance loan acquisitions through the execution of securitization transactions;
- (iv) that we plan to securitize residential mortgage loans we own and plan to acquire, our expectation that new Sequoia securitization entities will represent a larger portion of our balance sheet in the future, and our expectations that there will be an increase in types of commercial lending transaction on which we want to lend and that a significant portion of the capital we have to invest in 2011 will go into commercial assets, so that commercial assets could rise to account for 20% of, or a meaningful amount of, our invested capital in the next year or two;
- (v) that we do not anticipate a need to issue equity in the near term, our estimates of our short-term borrowing capacity and our short-term investment capacity, our statements regarding our ability to access additional short-term borrowings and capital, and our expectations regarding an increase in the balance of our outstanding short-term debt;
- (vi) the future returns we may earn on our investment portfolio, including future trends in interest income and interest expense, and our statements that in the near-term we expect interest income will be primarily derived from our residential securities and that in future periods we expect our residential and commercial loan businesses to contribute more significantly to interest income;
- (vii) future market and economic conditions, including, without limitation, future conditions in the residential and commercial real estate markets and related financing markets (including our statement that we believe there is an abundance of private sector money seeking investment in appropriately structured and originated mortgage-backed securities at attractive, risk-adjusted yields), and the related potential opportunities for our residential and commercial businesses;
- (viii) our beliefs about the future direction of housing market fundamentals, including, without limitation, home prices, demand for housing, delinquency rates, foreclosure rates, prepayment rates, inventory of homes for sale, and mortgage interest rates and their potential impact on our business and results of operations and our statements regarding how the historical relationship between income and home prices may imply that a significant double dip in housing prices is unlikely;
- (ix) our beliefs about the future direction of commercial real estate fundamentals, including, without limitation, vacancy rates, rental rates, default rates, and availability of financing;
- (x) the impact of recent and future legislative and regulatory changes that affect our business and the mortgage finance markets, the manner in which the reform of the GSEs, including Fannie Mae and Freddie Mac, may take place and the timeline for that reform, and our statements that if reform of the GSEs is implemented as set forth in the Treasury

Department's recent released plan it will be a positive long-term development and favorable for Redwood's business model and that we believe we are well positioned to take advantage of opportunities we expect will result from a meaningful reduction in the federal government's role in supporting mortgage finance and that any such advantage is more likely to begin to affect our results in 2012;

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- (xi) our expectations regarding credit reserves, credit losses and impairments on our investments (including as compared to our original expectations and credit reserve levels) and the timing of those losses and impairments, and our statement that the amount of credit reserves we designate may require changes in the future;
- (xii) future earnings, future earnings volatility, and future trends in operating expenses and the factors that may affect those trends;
- (xiii) our board of directors' intention to pay a regular dividend of \$0.25 per share per quarter in 2011; and
- (xiv) our expectations relating to tax accounting, including our anticipation of additional losses for tax accounting purposes, that we currently anticipate reporting a taxable loss for the full year 2011, and our expectations regarding taxable income for 2010 and the tax characterization of the 2010 dividends we paid.

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

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

Certifications

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated February 24, 2011, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to this Annual Report on Form 10-K. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on May 19, 2010 that he is unaware of any violations by Redwood Trust, Inc. of the NYSE's

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corporate governance listing standards in effect as of that date.

Employees

As of December 31, 2010, Redwood employed 67 people.

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ITEM 1A. RISK FACTORS

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

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

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

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

The economic downturn and the significant government interventions into the financial markets and fiscal stimulus spending over the last several years have contributed to significantly increased U.S. budget deficits. This upward pressure on U.S. budget deficits has the potential to put upward pressure on U.S. interest rates. It is possible we would not fully anticipate such a shift or all the negative consequences of such a shift in the interest rate environment. Thus, higher long-term interest rates could adversely affect our overall business, income, and our ability to pay dividends, as discussed further below under Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility in our earnings.

The Federal Reserve's aggressive easing program could have significant implications for financial asset pricing in general and for mortgage-related securities pricing, in particular. While market participants expect the Federal Reserve to abandon its low interest rate policy at some point, it is very difficult, if not impossible, to predict the timing or implications of the Federal Reserve's rate hikes. It is possible Redwood will not accurately anticipate the future interest rate environment; our business may be harmed by our inability to accurately anticipate the developments on the interest rate front.

Over the last several years, government intervention has been important to support real estate markets, the overall U.S. economy, capital markets, and mortgage markets. We expect the government will gradually withdraw this support,

although we remain uncertain about the timing, process, and implications of withdrawal. Until more information is available, it is difficult to accurately anticipate the timing of that withdrawal or anticipate the implications of that withdrawal. It is possible that our earnings, cash flows, dividends, and liquidity will be negatively affected by actions taken to implement this withdrawal.

Mortgage markets have received tremendous U.S. government support. In fact, the government's support of mortgage markets through its support of Fannie Mae and Freddie Mac expanded in late 2009, as the U.S. Treasury chose to backstop these government-sponsored enterprises for three years (2010–2012), without limit. This outsized support for these entities has caused Fannie Mae and Freddie Mac to continue to dominate mortgage and securitization activity, inhibiting the return of private mortgage securitization and this may continue for some time. This has potentially negative consequences to us, since we have traditionally taken an active role in assuming credit risk in the private sector mortgage market, often via securitization.

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

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

As an example, we believe that Fannie Mae, Freddie Mac, and the Federal Housing Administration accounted for approximately 90% of the financing for new residential mortgage loans in 2009 and 2010. These entities, in turn, currently receive much of their financing from the U.S. Treasury Department or the Federal Reserve System. As a result, most of the market for housing finance in the U.S. is controlled by the federal government and can be materially affected by decisions of federal policy makers, the President, and Congress, and they may establish or change existing laws, regulations, and policies to respond to political rather than market pressures. If the federal government determines to maintain or expand its current role in the markets for financing residential mortgage loans, it may adversely affect our business or our ability to effectively compete. Even if the federal government determines to decrease its role in the markets for financing residential mortgage loans, it may establish regulations for other market participants that have an adverse effect on our ability to effectively participate or compete or which may diminish or eliminate the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.

During the third quarter of 2008, the federal government commenced implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. In addition, certain mortgage lenders and servicers then voluntarily, or as part of settlements with law enforcement authorities, established loan modification programs relating to the mortgages they hold or service. Subsequently, in early 2009, the President announced administration plans aimed at reducing foreclosures through loan modification and refinancing programs. In addition, members of Congress have at times indicated support for additional legislative relief for homeowners, including a proposed amendment of the bankruptcy laws to permit the forgiveness of principal on first lien mortgage loans in bankruptcy proceedings. In 2010, numerous state attorneys general launched an investigation into the business practices of loan servicers and, in particular, into the propriety of many foreclosures that had recently taken place. These loan modification programs, as well as future law enforcement and legislative or regulatory actions, including possible amendments to the bankruptcy laws, may adversely affect the value of, and the returns on, the mortgage loans and the related mortgage securities we currently own or may acquire in the future.

The recent credit crisis, financial turmoil, and the economic recession that followed led to an unprecedented level of federal governmental intervention in the financial markets and into the affairs of particular financial institutions. These events revealed the extent to which the functioning of financial markets and the ability of particular

counterparties to perform can be affected by, and be dependent on, the policies and actions of the government. They also prompted the government to offer attractive financing to certain industry participants, through programs such as the Public-Private Investment Program and the Term Asset-Backed Securities Loan Facility, which arguably gave a competitive advantage to firms taking advantage of these programs. Similar types of governmental interventions could occur in the future, and they may not be predictable and may not benefit us and, therefore, could adversely affect our financial position and our ability to compete.

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

In addition, the Federal Reserve has taken certain actions (e.g., implementing a program to acquire agency mortgage securities) and may take other actions that could have significant implications for mortgage-related securities pricing and the returns we expect on our mortgage-related assets. Financial regulators globally have cooperated to implement capital regulations under the Basel III accord in an attempt to better coordinate and set capital standards for certain types of regulated financial institutions that appropriately account for risk. It is not yet possible to anticipate the consequences of Basel III, especially since new risk weightings have not yet been established.

Ultimately, we cannot assure you that governmental actions will directly benefit our business or otherwise have a lasting and beneficial impact on the financial markets and, in fact, they may adversely affect us, possibly materially. We cannot predict whether or when such actions may occur or what unintended or unanticipated impacts, if any, such actions could have on our business, results of operations, and financial condition. Even after governmental actions have been taken and we believe we understand the impacts of those actions, we may not be able to effectively respond to them so as to avoid a negative impact on our business or results of operations.

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

Overview of credit risk

We assume credit risk through the ownership of securities backed by residential and commercial real estate loans and through direct investments in residential and commercial real estate loans. Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; increases in payments required to be made by borrowers; declines in the value of homes; earthquakes, the effects of global climate change (including flooding, drought, and severe weather) and other natural events; uninsured property loss; over-leveraging of the borrower; costs of remediation of environmental conditions, such as indoor mold; changes in zoning or building codes and the related costs of compliance; acts of war or terrorism; changes in legal protections for lenders and other changes in law or regulation; and personal events affecting borrowers, such as reduction in income, job loss, divorce, or health problems. In addition, the amount and timing of credit losses could be affected by loan modifications, delays in the liquidation process, documentation errors, and other action by servicers. If the U.S. economy or the housing market continues to weaken, our credit losses could increase beyond levels that we currently anticipate.

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

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

Commercial real estate loans are particularly sensitive to changes in the local economy, so even minor local adverse economic events may adversely affect the performance of commercial real estate assets. We expect much of our future exposure to credit risk associated with commercial loans to be in the form of subordinate financing (e.g., mezzanine loans, b-notes, preferred equity, subordinated interests in securitized pools). We directly originate commercial loans and may participate in loans originated by others (including through ownership of commercial mortgage-backed securities). Directly originating commercial loans exposes us to credit, legal, and other risks that may be greater than risks associated with loans we acquire or participate in that are originated by others. We may incur losses on commercial real estate loans and securities for reasons not necessarily related to an adverse change in the performance of the property. This includes bankruptcy by the owner of the property, issues regarding the form of ownership of the property, poor property management, origination errors, inaccurate appraisals, fraud, and non-timely actions by servicers. If and when these problems become apparent, we may have little or no recourse to the borrower, issuer of the securities, or seller of the loan and we may incur credit losses as a result.

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

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

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

For loans we own directly (not through a securitization structure), we will most likely be in a position to incur credit losses should they occur only after losses are borne by the owner of the property (e.g., by a reduction in the owner's equity stake in the property). We may take actions available to us in an attempt to protect our position and mitigate the amount of credit losses, but these actions may not prove to be successful and could result in our increasing the amount of credit losses we ultimately incur on a loan.

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

For certain types of loans underlying our securities the loan rate or borrower payment rate may increase over time, increasing the potential for default. For example, a portion of the securities we acquire, or have an indirect interest in through our investment in the Acacia entities we sponsor, are backed by residential real estate loans that have negative amortization features. The rate at which interest accrues on these loans may change more frequently or to a greater extent than payment adjustments on an adjustable-rate loan, and adjustments of monthly payments may be subject to limitations or may be limited by the borrower's option to pay less than the full accrual rate. As a result, the amount of interest accruing on the remaining principal balance of the loans at the applicable adjustable mortgage loan rate may exceed the amount of the monthly payment. This is particularly a risk in a rising interest rate environment. Negative amortization occurs when

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

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

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

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

A significant number of residential real estate loans that underlie the securities we own are secured by property in California, and thus, we have a higher concentration of credit risk within California than in other states. Additional states where we maintain concentrations of residential loan credit risk include Florida and New York. Balances on commercial loans we originate or otherwise acquire are larger than residential loans and we will likely have a geographically concentrated commercial loan portfolio until our portfolio increases in size. While we intend to originate commercial loans throughout the country, we will likely have a portfolio that is concentrated in or near selected major metropolitan areas. Additional information on geographic distribution is set forth in Note 6 to the Financial Statements.

The timing of credit losses can harm our economic returns.

The timing of credit losses can be a material factor in our economic returns from residential and commercial loans and securities. If unanticipated losses occur within the first few years after a loan is originated or a securitization is completed, those losses could have a greater negative impact on our investment returns than unanticipated losses on more seasoned loans or securities. In addition, higher levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of the principal and interest that is due to us under the terms of the securities backed by that pool. This would also lower our economic returns. The timing of credit losses could be

We have concentrated credit risk in certain geographical regions and may be disproportionately affected by an economic

affected by the creditworthiness of the borrower, the borrower's willingness and ability to continue to make payments, and new legislation, legal actions, or programs that allow for the modification of loans or ability for borrowers to get relief through bankruptcy or other avenues.

Our efforts to manage credit risks may fail.

We attempt to manage risks of credit losses by continually evaluating our investments for impairment indicators and establishing reserves under GAAP for credit and other risks based upon our assessment of these risks. We cannot establish credit reserves for tax accounting purposes. The amount of capital and cash reserves

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that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility and liquidity issues. If these increased credit losses are greater than we anticipated and we need to increase our credit reserves, our GAAP earnings might be reduced. In the event that assets that have declined in value are deemed to be other-than-temporarily impaired, our GAAP earnings might be reduced. Increased credit losses may also adversely affect our cash flows, our ability to invest, dividend distribution requirements and payments, asset fair values, access to short-term borrowings, and our ability to securitize assets.

Despite our efforts to manage credit risk, there are many aspects of credit risk that we cannot control. Our quality control and loss mitigation policies and procedures may not be successful in limiting future delinquencies, defaults, and losses, or they may not be cost effective. Our underwriting reviews may not be effective. The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies and other counterparties. Loan servicing companies may not cooperate with our loss mitigation efforts or those efforts may be ineffective. Service providers to securitizations, such as trustees, loans servicers, bond insurance providers, and custodians, may not perform in a manner that promotes our interests. The delay of residential foreclosures that may result from an attempt to fix procedural problems could delay resolution and increase ultimate loss rates, as a result.

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

Changes in consumer behavior, bankruptcy laws, tax laws, regulation of the mortgage industry, and other laws may exacerbate loan losses. Changes in rules that would cause loans owned by a securitization entity to be modified may not be beneficial to our interests if the modifications reduce the interest we earn and increase the eventual severity of a loss. In some states and circumstances, the securitizations in which we invest have recourse as owner of the loan against the borrower's other assets and income in the event of loan default. However, in most cases, the value of the underlying property will be the sole effective source of funds for any recoveries. Other changes or actions by judges or legislators regarding mortgage loans and contracts, including the voiding of certain portions of these agreements, may reduce our earnings, impair our ability to mitigate losses, or increase the probability and severity of losses. Any expansion of our loss mitigation efforts as we grow our portfolio could increase our operating costs and the expanded loss mitigation efforts may not reduce our future credit losses.

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

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

We note that the assignment of an investment grade rating to a security by a rating agency does not mean that there is

not credit risk associated with the security or that the risk of a credit loss with respect to such security is necessarily remote. Securities we own do have credit ratings and, to the extent we securitize loans and securities, we expect to rely on credit rating agencies to provide ratings on the securities created by these securitization entities (as we have in the past).

Rating agencies rate debt securities based upon their assessment of the safety of the receipt of principal and interest payments. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of debt securities and, therefore, the assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to credit ratings based on available data or changes in economic outlook or may otherwise fail to make changes

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in credit ratings in response to subsequent events, so that our investments may be better or worse than the ratings indicate. Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities. These changes may occur quickly and often. The market's ability to understand and absorb these changes, and the impact to the securitization market in general, are difficult to predict. Such changes may have an impact on the amount of investment-grade and non-investment-grade securities that are created or placed on the market in the future.

Downgrades to the ratings of securities could have an adverse effect on the value of some of our investments and our cash flows from those investments. For example, the underlying documents of some of our equity investments in asset-backed securities state that certain average rating levels must be met on the securities held by the entity. If these average rating levels are not met, then cash that would otherwise be distributed to the equity holders or the lower-rated debt holders would instead be distributed to the more senior debt holders. Our equity and lower-rated security investments in these securitizations have failed this average rating test, which, in turn, has adversely affected our cash flows from these investments.

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

Some of the loans held by our Sequoia securitization entities are insured in part by mortgage insurers. Mortgage insurance protects the lender or other holder of a loan up to a specified amount, in the event the borrower defaults on the loan. Mortgage insurance generally is required only when the principal amount of the loan at the time of origination is greater than 80% of the value of the property (loan-to-value). Any inability of the mortgage insurers to pay in full the insured portion of the loans that we hold would adversely affect the value of the securities we own that are backed by these loans, which could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business.

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

The economic returns we earn from most of the residential real estate securities and loans we own (directly or indirectly) are affected by the rate of prepayment of the underlying residential real estate loans. Prepayments are unpredictable and adverse changes in the rate of prepayment could reduce our cash flows, earnings, and dividends. Adverse changes in cash flows would likely reduce an asset's fair value, which could reduce our ability to borrow against that asset and may cause a market valuation adjustment for GAAP purposes, which could reduce our reported earnings. While we estimate prepayment rates to determine the effective yield of our assets and valuations, these estimates are not precise, and prepayment rates do not necessarily change in a predictable manner as a function of interest rate changes. Prepayment rates can change rapidly. As a result, changes can cause volatility in our financial results, affect our ability to securitize assets, affect our ability to fund acquisitions, and have other negative impacts on our ability to grow and generate earnings.

We own a number of securities backed by residential loans that are particularly sensitive to changes in prepayments rates. These securities include interest-only securities (IOs) that we acquire from third parties and from our Sequoia

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

entities. Faster prepayments than we anticipated on the underlying loans backing these IOs will have an adverse effect on our returns on these investments.

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

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

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

With the exception of our adjustable-rate assets, higher interest rates generally reduce the fair value of most of our assets. This may affect our earnings results, reduce our ability to re-securitize or sell our assets, or reduce our liquidity. Higher interest rates could reduce the ability of borrowers to make interest payments or to refinance their loans. Higher interest rates could reduce property values and increased credit losses could result. Higher interest rates could reduce mortgage originations, thus reducing our opportunities to acquire new assets.

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

When short-term interest rates vary, our premium amortization expense on loans acquired by Sequoia entities prior to July 2004 may significantly increase or decrease from one period to the next. Under the applicable GAAP accounting elections, the amortization expense for the current period is a function of actual and projected prepayments and the current London Interbank Offered Rate (LIBOR) interest rate. During a period when rates change dramatically, the effect that the interest rate has on the amortization expense may become the more significant factor (over prepayments) and may alter the amount of premium amortized thereby creating volatility in our reported income for that period, all other factors being equal. We have significant investment and reinvestment risks.

We have significant investment and reinvestment risks.

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

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

backed by newly-originated loans, as well as new acquisitions that are backed by more seasoned loans.

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

If the assets we acquire in the future earn lower GAAP yields than the assets we currently own, our reported earnings per share could well decline over time as the older assets are paid down, are called, or are

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sold, assuming comparable expenses, credit costs, and market valuation adjustments. Under the effective yield method of accounting that we use for GAAP accounting purposes for some of our assets, we recognize yields on assets based on our assumptions regarding future cash flows. A portion of the cash flows we receive may be used to reduce our basis in these assets. As a result of these various factors, our basis for GAAP amortization purposes may be lower than their current fair values. Assets with a lower GAAP basis than current fair values generate higher GAAP yields, yields that are not necessarily available on newly acquired assets. Economic conditions, including credit results, prepayment patterns, and interest rate trends in the future are difficult to project with accuracy over the life of the assets we acquire, so there will be volatility in the reported returns over time.

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

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

We do not originate residential loans; rather, we rely on the origination market to supply the types of loans we wish to credit enhance. At times, due to heightened credit concerns, strengthened underwriting standards, or concerns about economic growth or housing values, the volume of originations may decrease significantly. In 2008 through 2010, the volume of loan originations was lower than in prior years, and the volume may not return to previous levels in the foreseeable future. This reduced volume may make it difficult for us to acquire loans and securities.

We originate commercial loans, but we may not be willing to provide the level of proceeds or the coupon rate on loans that the borrower finds acceptable or that matches our competitors. While the volume of commercial real estate assets is increasing from recent levels, it is not at the volume experienced in the past. And, the high-quality commercial assets we seek to originate loans on are highly-sought after by numerous lenders.

The supply of new non-agency securitized assets available for purchase could continue to be adversely affected if the economics and/or form of the securitization continue to be challenging. A key factor in the economics of securitization is a highly liquid market for triple-A rated securities. The events beginning in late 2007 and continuing through 2010 revealed that the liquidity of this market may be severely disrupted at times. Losses experienced by holders of triple-A securities in non-agency mortgage-backed securities have dampened the demand for investment grade securities backed by real estate loans and securities. Investor demand in the foreseeable future for these securities may not reach previous levels. Without a robust market for triple-A rated securities, the supply of real estate credit enhancement securities could be significantly diminished. In addition, the risks associated with the acquisition of loans for the purpose of securitization may increase significantly and we may reduce our loan acquisitions or choose not to acquire any loans during these periods.

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

We have invested in and may in the future invest in a variety of real estate and non-real estate related assets that may not be closely related to our current core business. Additionally, we may enter various securitizations, services, and other operating businesses that may not be closely related to our current business. Any of these actions may expose us to new, different, or increased investment, operational, financial, or management risks. We may invest various types of non-real estate assets. We may invest directly or indirectly in real property. We may invest in non-real estate asset-backed securities (ABS), corporate debt, or equity. We have invested in diverse types of IOs from residential and

commercial securitizations sponsored by us or by others. The higher credit and prepayment risks associated with these types of investments may increase our exposure to losses. We may invest in non-U.S. assets that may expose us to currency risks (which we may choose not to hedge) and different types of credit, prepayment, hedging, interest rate, liquidity, legal, and other risks. We may originate first mortgage commercial loans primarily for the sale to others (while retaining a

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subordinate interest in these loans or retaining subordinate financing for the same property) and this would expose us to certain representation and warranty, aggregation, market value, and other risks on loan balances in excess of our potential investments.

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

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

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

We actively manage the risks associated with acquiring, originating, holding, and managing real estate loans and securities. No amount of risk management or mitigation, however, can change the variable nature of the cash flows, fair values of, and financial results generated by these loans and securities. Changes in the credit performance of or the prepayments on these real estate loans and the loans underlying these securities and changes in interest rates impact the cash flows on these securities, and the impact could be significant for our securities with concentrated risks.

Changes in cash flows lead to changes in our return on investment and also to potential variability in and level of reported income. The revenue recognized on most of our assets is based on an estimate of the yield over the remaining life of the asset. Thus, changes in our estimates of expected cash flow from an asset will result in changes in our reported earnings on that asset in the current reporting period. We may be forced to recognize adverse changes in expected future cash flows as a current expense, further adding to earnings volatility.

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

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

Fair values for our assets, liabilities, and derivatives can be volatile. The fair values can change rapidly and significantly and changes can result from changes in interest rates, perceived risk, supply, demand, and actual and

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

projected cash flows, prepayments, and credit performance. A decrease in fair value may not necessarily be the result of deterioration in future cash flows. Fair values for illiquid assets can be difficult to estimate, which may lead to volatility and uncertainty of earnings.

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

A decrease in the fair value of the securities we own may result in a reduction in our book value due to the accounting standards we are required to apply. Reporting a low book value could have adverse effects even if that book value is not indicative of the actual value of our net investments in assets and securitization

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entities. The adverse effects could include the inability to meet or agree upon covenants with counterparties, to enter into derivative contracts, or a reduction in the market price of our common stock.

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

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

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

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

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

Many of our investments have limited liquidity.

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

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

Our calculations of the fair value of the securities we own or consolidate are based upon assumptions that are inher

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

We fund our residential loans we acquire in anticipation of a securitization with a combination of equity and short-term debt. In addition, we have in the past and may again in the future make investments in securities and loans financed with short-term debt. By incurring this leverage we expect to generate more attractive returns on our equity invested in these assets. However, as a result of leverage (whether for the accumulation of loans or as part of a longer-term investment), we could also incur significant losses if our borrowing costs increase relative to the earnings on our assets and hedges. Financing facilities may also force us to sell assets under adverse market conditions to meet lenders' margin calls, for example, in the event of a decrease in the fair values of the assets pledged as collateral.

Liquidation of the collateral could create negative tax consequences and raise REIT qualification issues.

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

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The use of short-term financial leverage is critical to certain aspects of our business and we may expand our dependence on short-term debt in the future. The inability to access financial leverage through warehouse and repurchase facilities, credit facilities, commercial paper, or other forms of debt financing may inhibit our ability to execute our business plan. In that case, our inability to access funding could have a material adverse effect on our results of operations, financial condition, and business.

Our ability to fund our business or our investment strategy depends to some extent on our securing warehouse, repurchase, credit, or other forms of debt financing (or leverage) on acceptable terms. For example, pending the securitization of a pool of mortgage loans we may fund the acquisition of mortgage loans through borrowings from warehouse, repurchase, and credit facilities, and other forms of short-term financing. We can provide no assurance that we would be successful in establishing sufficient sources of short-term debt. In addition, because of the short-term nature, the lenders may decline to renew them upon maturity or expiration, and it may be difficult for us to obtain continued short-term financing. During certain periods of the credit cycle, lenders may curtail their willingness to provide financing. To the extent our business or investment strategy calls for us to access financing and counterparties are unable or unwilling to lend to us, then our business and results of operations will be adversely affected. Furthermore, to the extent we do employ leverage and subsequently default or are unable to renew the facilities when they mature, we may suffer adverse consequences. In addition, it is possible that lenders who provide us with committed financing could experience changes in their ability to advance funds to us, independent of our performance or the performance of our investments, in which case funds we had planned to be able to access may not be available to us.

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

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

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

The use of short-term financial leverage is critical to certain aspects of our business and we may expand our dependen

We also may hedge by taking short, forward, or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. We may take both long and short positions in credit derivative transactions linked to real estate assets.

These derivatives may have additional risks to us, such as special liquidity, basis, and counterparty risks.

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

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

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

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

The markets for these types of investments have, in some cases, only existed for relatively few years and may not be liquid. Many of these investments incorporate pay as you go credit events. The terms of certain types of investments could make it more difficult to assign such an instrument or determine the loss pursuant to the underlying agreement.

In a credit default swap, the party wishing to buy protection will pay a premium. When interest rates change, the spreads change, or the prevailing credit premiums on credit default swaps change, the amount of the termination payment due could change by a substantial amount. In an illiquid market, the determination of this change could be difficult to ascertain and, as a result, we may not achieve the desired benefit of entering into this contractual relationship.

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

Our results could be adversely affected by counterparty credit risk.

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

We may enter into derivative contracts that expose us to contingent liabilities and those contingent liabilities may not

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

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investment-grade credit ratings; however, we may not always be able to do so. Our counterparty risk management strategy may prove ineffective and, accordingly, our earnings and cash flows could be adversely affected.

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

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

Widening ABS interest rate spreads, rising ABS yields, incorrect estimation of rating agency securitization requirements, poor hedging practices or results, changes in applicable law and regulations, and other factors could result in a securitization execution that is less favorable to us than initially assumed, which would typically result in a loss.

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

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

Our business may also include originating or acquiring commercial real estate loans and selling them to third parties (which third parties would be expected to, in turn, securitize these loan assets). When selling loans to third parties, we

Through certain of our wholly-owned subsidiaries, we have in the past engaged in securitization transactions relating

typically make representations and warranties to the purchasers of those loans regarding, among other things, certain characteristics of those loans. If our representations and warranties are inaccurate with respect to any loan, we may be obligated to repurchase that loan, which may result in a loss.

Loans and other assets that are held by securitization entities are serviced by third-party loan servicers. Should a servicer experience financial or operational difficulties, it may not be able to perform these obligations or these obligations may be limited in nature, including any obligation to advance payments of amounts due from delinquent loan obligors. For example, typically a servicer's obligation to make advances on behalf of a delinquent loan obligor is limited to the extent that it does not expect to recover the advances from the ultimate disposition of the collateral pledged to secure the loan.

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In addition, as with any external service provider, we are subject to the risks associated with inadequate or untimely services for other reasons such as fraud, negligence, errors, miscalculations, or other reasons. In the current economic environment, many loan servicers are experiencing higher volumes of delinquent loans than they have in the past and, as a result, there is a risk that their operational infrastructures cannot properly process this increased volume. For example, many loan servicers have been accused of improprieties in the handling of the foreclosure process with respect to residential mortgage loans that have gone into default. To the extent a third party loan servicer fails to fully and properly perform its obligations, ABS that we hold as investments may experience losses and securitizations that we have sponsored may experience poor performance, and our ability to engage in future securitization transactions could be harmed.

There has also recently been debate as to whether there are defects in the legal process and legal documents governing transactions in which securitization trusts and other secondary purchasers take legal ownership of residential mortgage debt and establish their rights as first priority lien holders on underlying mortgaged property. To the extent there are problems with the manner in which title and lien priority rights were established or transferred, ABS that we hold as investments may experience losses and securitizations that we have sponsored may experience poor performance, which could expose us to losses and could damage our ability to engage in future securitization transactions could be harmed.

We also rely on corporate trustees to act on behalf of us and other holders of ABS in enforcing our rights as security holders. Under the terms of most ABS we hold, we do not have the right to directly enforce remedies against the issuer of the security, but instead must rely on a trustee to act on behalf of us and other security holders. Should a trustee not be required to take action under the terms of the securities, or fail to take action, we could experience losses.

Our ability to execute future securitizations of residential mortgage loans could be delayed, limited, or precluded by legislative and regulatory reforms applicable to asset-backed securities and the institutions that sponsor, service, rate, or otherwise participate in, or contribute to, the successful execution of a securitization transaction. Other factors could also limit, delay, or preclude our ability to execute securitization transactions. These legislative, regulatory, and other factors could also reduce the returns we would otherwise expect to earn in connection with executing securitization transactions.

In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Provisions of the Dodd-Frank Act require, among other things, significant revisions to the legal and regulatory framework within which ABS, including residential mortgage-backed securities (RMBS), are issued through the execution of securitization transactions. Some of the provisions of the Dodd-Frank Act have become effective or been implemented, while others are in the process of being implemented or will become effective soon. In addition, prior to the passage of the Dodd-Frank Act, the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC) had already published proposed regulations relating to the issuance of ABS, including RMBS and the FDIC's proposed regulations have subsequently become effective. In addition to those described above, additional federal or state laws and regulations that could affect our ability to execute future securitization transactions could be proposed, enacted, or implemented.

Our ability to execute future securitizations of residential mortgage loans could be delayed, limited, or precluded by

It is difficult to predict with certainty how the Dodd-Frank Act and the other regulations that have been proposed will affect our future ability to successfully execute securitizations of residential mortgage loans, due to, among other things, the fact that federal agencies have not yet finalized all of the regulations implementing the Dodd-Frank Act.

These laws and regulations could effectively preclude us from executing securitization transactions, delay our execution of these types of transactions, or reduce the returns we would otherwise expect to earn from executing securitization transactions.

Rating agencies can affect our ability to execute a securitization transaction, or reduce the returns we would otherwise expect to earn from executing securitization transactions, not only by deciding not to publish ratings for our securitization transaction (or deciding not to consent to the inclusion of those ratings in the prospectuses we file with the SEC relating to securitization transactions), but also by altering the criteria and process they follow in publishing ratings. Rating agencies could alter their ratings processes or criteria after

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we have accumulated loans for securitization in a manner that effectively reduces the value of those previously acquired loans or requires that we incur additional costs to comply with those processes and criteria.

Furthermore, other matters, such as (i) accounting standards applicable to securitization transactions and (ii) capital and leverage requirements applicable to banks and other regulated financial institutions holdings of ABS, could result in less investor demand for securities issued through securitization transactions we execute or increased competition from other institutions that execute securitization transactions.

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

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

We are not directly liable for any of the ABS issued by these entities. Nonetheless, third parties who hold the ABS issued by these entities may try to hold us liable for any losses they experience, including through claims under federal and state securities laws or claims for breaches of representations and warranties we made in connection with engaging in these securitization transactions.

For example, as discussed below in Part I, Item 3 of this Annual Report on Form 10-K, on December 23, 2009, the Federal Home Loan Bank of Seattle filed a claim in Superior Court for the State of Washington against us and our subsidiary, Sequoia Residential Funding, Inc. The complaint relates in part to RMBS that were issued by a Sequoia securitization entity and alleges that, at the time of issuance, we, Sequoia Residential Funding, Inc. and the underwriters made various misstatements and omissions about these RMBS in violation of Washington state law. We have also been named in other similar lawsuits. A further discussion of these lawsuits is set forth in Note 14 to the Financial Statements. Defending a lawsuit can consume significant resources and may divert management's attention from our operations. To the extent we are unsuccessful in our defense of any lawsuit, we could suffer losses, which could be material.

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

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

Our sources of cash flow are primarily the principal and interest payments on the loans and securities we own. In addition, we may generate cash flow from the sales or calls of assets, issuing debt, or raising equity. Our sources of

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

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

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

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

In addition, there are significant competitive threats to our business from governmental actions and initiatives that have already been undertaken or which may be undertaken in the future. Sustained competition from governmental actions and initiatives could have a material adverse effect on us. For example, Fannie Mae and Freddie Mac are, among other things, engaged in the business of acquiring loans and engaging in securitizations transactions. Until 2008, competition from Fannie Mae and Freddie Mac was limited to some extent due to the fact that they were statutorily prohibited from purchasing loans for single unit residences in the continental United States with a principal amount in excess of \$417,000, while much of our business had historically focused on acquiring residential loans with a principal amount in excess of \$417,000. In February 2008, Congress passed an economic stimulus package that temporarily increased the size of certain loans these entities could purchase to up to \$729,750, if the loans were made to secure real estate purchases in certain high-cost areas, and these increases have been extended through September 2011 and may be extended further. In addition, in September 2008, Fannie Mae and Freddie Mac were placed into conservatorship and have become, in effect, instruments of the U.S. federal government. As long as there is continuing governmental support for these entities to continue to operate and provide financing to a significant portion of the mortgage finance market, they will represent significant business competition due to, among other things, their large size and low cost of funding. To the extent that laws, regulations, or policies governing the business activities of Fannie Mae and Freddie Mac are not changed to limit their role in housing finance (such as a change in these loan size limits), the competition from these two governmental entities will remain significant. In addition, to the extent that property values decline while these loan size limits remain the same, it may have the same effect as an increase in this limit, as a greater percentage of loans would likely be within the size limit. Any increase in the loan size limit, or in the overall percentage of loans that are within the limit, allows Fannie Mae and Freddie Mac to compete against us to a greater extent than they had been able to compete previously and our business could be adversely affected.

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

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

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

Due to the recent credit crisis and downturn in the U.S. housing markets and the economy, the mortgage industry and the related capital markets are undergoing significant changes, including due to the significant governmental interventions in these areas and changes to the laws and regulations that govern the banking and mortgage finance industry. Our methods of, and model for, doing business and financing our investments are changing and if we fail to develop, enhance, and implement strategies to adapt to changing conditions in the

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mortgage industry and capital markets, our financial condition and earnings may be adversely affected. Furthermore, changes we make to our business to respond to changing circumstances may expose us to new or different risks than we were previously exposed to and we may not effectively identify or manage those risks.

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

We have historically depended upon the issuance of mortgage-backed securities by the securitization entities we sponsor as a funding source for our residential real estate-related business. However, due to market conditions, we did not engage in residential mortgage securitization transactions in 2008 or 2009 and we only engaged in one mortgage securitization transaction in 2010. We do not know when, or if, market conditions will allow us to more regularly engage in securitization transactions and the continued disruption of this market may adversely affect our earnings and growth. If more regular residential mortgage securitization activity does resume among market participants other than government sponsored entities, we do not know if it will be on terms and conditions that will permit us to participate or be favorable to us. Even if conditions are favorable to us, we may not be able to return to the volume of securitization activity we previously conducted.

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

Initiating new business activities or significantly expanding existing business activities are two ways to grow our business and respond to changing circumstances in our industry, however, they may expose us to new risks and regulatory compliance requirements. We cannot be certain that we will be able to manage these risks and compliance requirements effectively. Furthermore our efforts may not succeed and any revenues we earn from any new or expanded business initiative may not be sufficient to offset the initial and ongoing costs of that initiative, which would result in a loss with respect to that initiative. For example, efforts we are making to significantly expand our investing activity in commercial real-estate related assets and to develop new methods for acquiring residential real estate-related investment assets may expose us to new risks, may not succeed, and may not generate sufficient revenue to offset our related costs. As another example, we have a subsidiary, Redwood Asset Management, Inc., that engages in the investment advisory business. Asset management activities may increase our exposure to litigation, fiduciary responsibilities, conflicts of interest arising from our investment activities and the activities of the entities we manage, and other risks.

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

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

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

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The purchase of residential mortgage loans in the secondary market may, in some circumstances, require us to maintain various state licenses. Acquiring the right to service residential mortgage loans may also, in some circumstances, require us to maintain various state licenses even though we currently do not expect to engage in loan servicing ourselves. Similarly, certain commercial real estate lending activities that we may engage in may also require us to obtain various state licenses. There is no assurance we will be able to obtain or maintain those licenses and we may fail to comply with various state and federal laws and regulations relating to these activities.

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

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

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

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

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

Our risk management efforts may not be effective.

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

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

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

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

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

We could be harmed by misconduct or fraud that is difficult to detect.

We are exposed to risks relating to misconduct by our employees, contractors we use, or other third parties with whom we have relationships. For example, our employees could execute unauthorized transactions; use our assets improperly or without authorization; perform improper activities; use confidential information for improper purposes; or mis-record or otherwise try to hide improper activities from us. This type of misconduct could also relate to assets we manage for others through our investment advisory subsidiary. This type of misconduct can be difficult to detect and if not prevented or detected could result in claims or enforcement actions against us or losses. Accordingly, misconduct by employees, contractors or others could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Our controls may not be effective in detecting this type of activity.

Inadvertent errors could subject us to financial loss, litigation, or regulatory action.

Our employees, contractors we use, or other third parties with whom we have relationships may make inadvertent errors that could subject us to financial losses, claims, or enforcement actions. These types of errors could include, but are not limited to, mistakes in executing, recording, or reporting transactions we enter into for ourselves or with respect to assets we manage for others. Inadvertent errors expose us to the risk of material losses until the errors are detected and remedied prior to the incurrence of any loss. The risk of errors may be greater for business activities that are new for us or have non-standardized terms.

Our business may be adversely affected if our reputation is harmed.

Our business is subject to significant reputational risks. If we fail, or appear to fail, to address various issues that may affect our reputation, our business could be harmed. Issues could include real or perceived legal or regulatory violations or be the result of a failure in governance, risk-management, technology, or operations. Similarly, market rumors and actual or perceived association with counterparties whose own reputation is under question could harm our business. Claims of employee misconduct, wrongful termination, adverse publicity, conflict of interests, ethical issues, or failure to protect private information could also cause significant reputational damages. Such reputational damage could result not only in an immediate financial loss, but could also result in a loss of business relationships, the ability to raise capital, and the ability to access liquidity through borrowing facilities.

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

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

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

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

Since inception, we have distributed over \$1.2 billion in dividends and this exceeds our retained GAAP earnings of \$0.5 billion. One should not expect that our retained GAAP earnings will equal cumulative distributions as the Board of Directors' dividend distribution decisions, permanent differences in GAAP and tax accounting, and even temporary differences will result in material differences in these balances.

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

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

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

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

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

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

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

If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a dealer, and thus subject to 100% prohibited transaction taxes or other entity-level taxes on income from such transactions. Compliance with the REIT income and asset rules may limit the type or extent of financing or hedging that we can undertake.

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

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

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

A REIT is limited in its ability to earn income that is treated as compensation for services.

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

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

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

The requirements for maintaining REIT status or the taxation of REITs could change in a manner adverse to our operations. Rules regarding the taxation of dividends are enacted from time to time and future legislative or regulatory changes may limit the tax benefits accorded to REITs, either of which may reduce some of a REIT's competitive edge relative to non-REIT corporations. For example, federal legislation enacted in 2003 generally reduced the maximum federal tax rate for dividends payable to domestic stockholders that are individuals, trusts, and estates to 15% (extended through 2012), however, this legislation did not, as a general matter, reduce tax rates on dividends paid by REITs. Any future adverse changes could negatively affect our business and reduce the value of our common stock.

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The application of the tax code to our business is complicated and we may not interpret and apply some of the rules and regulations correctly. In addition, we may not make all available elections, which could result in our not being able to fully benefit from available deductions or benefits. Furthermore, the elections, interpretations and applications we do make could be deemed by the Internal Revenue Service (IRS) to be incorrect, and such rulings could have adverse impacts on our GAAP earnings and potentially on our REIT status.

The IRS tax code may change and/or the interpretation of the rules and regulations by the IRS may change. In circumstances where the application of these rules and regulations affecting our business is not clear, we may have to interpret them and their application to us, we seek the advice of outside tax advisors in arriving at these interpretations, but our interpretations may prove to be wrong, which could have adverse consequences.

Our dividend distributions and tax payments are based in large part on our estimate of taxable income which includes the application and interpretation of a variety of tax rules and regulations. While there are some relief provisions should we incorrectly interpret certain rules and regulations, we may not be able to fully take advantage of these provisions and this could have an effect on our REIT status. In addition, our GAAP earnings include tax provisions and benefits based on our estimates of taxable income and should our estimates prove to be wrong, we would have to make an adjustment to our taxable provisions and this adjustment could be material.

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

As a REIT we are required to distribute at least 90% of our REIT taxable income. Thus, we do not generally have the ability to retain earnings and we rely on our ability to raise capital to grow. We may raise capital through the issuance of new shares of our common stock, either through our direct stock purchase and dividend reinvestment plan or through secondary offerings. We may also raise capital by issuing other types of securities, such as preferred stock or convertible subordinated notes, or by taking on short-term or long-term debt. We have less than 22 million additional shares authorized for issuance under our charter, which will limit the amount of capital we can raise through issuances of common stock unless we seek and receive approval from our stockholders to increase the authorized number of our shares in our charter. Also, certain stock change of ownership tests, which could impact our future use of tax losses, may limit our ability to raise significant amounts of equity capital.

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

The application of the tax code to our business is complicated and we may not interpret and apply some of the rules

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

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

Under the Investment Company Act, as amended, an investment company is required to register with the SEC and is subject to extensive restrictive and potentially adverse regulations relating to, among other things, operating methods, management, capital structure, dividends, and transactions with affiliates. However, companies primarily engaged in the business of acquiring mortgages and other liens on and interests in real

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estate are exempt from the requirements of the Investment Company Act. We believe that we have conducted our business so that we are exempt from the Investment Company Act, however, in order to continue to do so we must, among other things, maintain at least 55% of our assets in certain qualifying real estate assets (the 55% Requirement) and are also required to maintain an additional 25% of our assets in such qualifying real estate assets or certain other types of real estate-related assets (the 25% Requirement). Rapid changes in the values of assets we own, however, can disrupt prior efforts to conduct our business to meet these requirements. Our efforts to comply with the 55% Requirement and the 25% Requirement may reduce our flexibility and could limit our ability to pursue certain opportunities.

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

If we were deemed an unregistered investment company, we could be subject to monetary penalties and injunctive relief and we could be unable to enforce contracts with third parties and third parties could seek to obtain rescission of transactions undertaken during the period we were deemed an unregistered investment company, unless the court found that under the circumstances, enforcement (or denial of rescission) would produce a more equitable result than no enforcement (or grant of rescission) and would not be inconsistent with the Investment Company Act.

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

In order to maintain our qualifications as a REIT, not more than 50% in value of our outstanding capital stock may be owned, actually or constructively, by five or fewer individuals (defined in the Internal Revenue Code to include certain entities). In order to protect us against risk of losing our status as a REIT due to concentration of ownership among our stockholders and for other reasons, our charter generally prohibits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of the outstanding shares of any class of our stock, unless our board of directors waives or modifies this ownership limit. This limitation may have the effect of precluding an acquisition of control of us by a third party without the consent of our board of directors. As of February 23, 2011, our board of directors has granted a waiver to one institutional shareholder to own shares in excess of this 9.8% limit, which waiver is subject to certain terms and conditions including the execution of a voting agreement. This voting agreement applies to the shares owned in excess of 9.8% and states that the excess shares shall be voted on matters in the same proportion as all other shares are voted (exclusive of the 9.8% block voted by the party to the voting agreement). Our board of directors may amend this existing waiver to permit additional share ownership or may grant waivers to additional stockholders at any time.

Certain other provisions contained in our charter and bylaws and in the Maryland General Corporation Law (MGCL) may have the effect of discouraging a third-party from making an acquisition proposal for us and may therefore inhibit a change in control. For example, our charter includes provisions granting our board of directors the authority to issue preferred stock from time to time and to establish the terms, preferences, and rights of the preferred stock without the approval of our stockholders. In addition, provisions in our charter and the MGCL restrict our stockholders' ability to remove directors and fill vacancies on our board of directors and restrict unsolicited share acquisitions. Our charter

provides that our board of directors is divided into three classes serving staggered terms of office of three years each, and thus at least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of our directors. These provisions and others may deter offers to acquire our stock or large blocks of our stock upon terms attractive to our stockholders, thereby limiting the opportunity for stockholders to receive a premium for their shares over then-prevailing market prices.

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

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

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

An investment in our common stock may involve a high degree of risk, particularly when compared to other types of investments. Risks related to the economy, the financial markets, our industry, our investing activity, our other business activities, our financial results, the amount of dividends we distribute, the manner in which we conduct our business, and the way we have structured and limited our operations could result in a reduction in, or the elimination of, the value of our common stock. The level of risk associated with an investment in our common stock may not be suitable for the risk tolerance of many investors. Investors may experience volatile returns and material losses. In addition, the trading volume of our common stock (*i.e.*, its liquidity) may be insufficient to allow investors to sell their common stock when they want to or at a price they consider reasonable.

Our earnings, cash flows, book value, and dividends can be volatile and difficult to predict. Investors in our common stock should not rely on our estimates, projections, or predictions, or on management's beliefs about future events. In particular, the sustainability of our earnings and our cash flows will depend on numerous factors, including our level of investment activity, the returns we earn, the amount and timing of credit losses, prepayments, the expense of running our business, and other factors, including risk factors described herein. As a consequence, although we seek to pay a regular common stock dividend rate that is sustainable, we may reduce our regular dividend rate, or stop paying dividends, in the future for a variety of reasons. We may not provide public warnings of dividend reductions prior to their occurrence. Although we have paid special dividends in the past, we have not paid a special dividend since 2007 and we may not do so in the future. Changes to the amount of dividends we distribute may result in a reduction in the value of our common stock.

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

As of February 23, 2011, we believe that three institutional shareholders each owned in excess of 5% of our outstanding common stock and that, overall, 15 institutional shareholders owned, in the aggregate, approximately 50%

The ability to take action against our directors and officers is limited by our charter and bylaws and provisions of Ma

of our outstanding common stock. Furthermore, one or more of these investors or other investors could significantly increase their ownership of our common stock. Significant ownership stakes held by these individual institutions or other investors could have adverse consequences for other stockholders because each of these stockholders will have a significant influence over the outcome of matters submitted to a vote of our stockholders, including the election of our directors and transactions involving a change in control. In addition, should any of these significant shareholders determine to liquidate all or a significant portion of their holdings of our common stock, it could have an adverse effect on the market price of our common stock.

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

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

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

Our current directors and executive officers beneficially own, in the aggregate, approximately 1.3% of our common stock. Sales of shares of our common stock by certain of these individuals are required to be publicly reported and are tracked by many market participants as a factor in making their own investment decisions. As a result, future sales by these individuals could negatively affect the market price of our common stock.

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

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

For 2010, we maintained our regular dividend at a rate of \$0.25 per share per quarter and in November 2010 our Board of Directors announced its intention to continue to pay regular dividends during 2011 at a rate of \$0.25 per share per quarter. Our ability to pay a dividend of \$0.25 per share per quarter in 2011 may be adversely affected by a number of factors, including the risk factors described herein. These same factors may affect our ability to pay other

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

future dividends. In addition, to the extent we determine that future dividends would represent a return of capital to investors, rather than the distribution of income, we may determine to discontinue dividend payments until such time that dividends would again represent a distribution of income. Any reduction or elimination of our payment of dividend distributions would not only reduce the amount of dividends you would receive as a holder of our common stock, but could also have the effect of reducing the market price of our common stock. In addition, the characterization of our dividend — be it ordinary income, capital gains, or a return of capital — could have an impact on the market price of our common stock.

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

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

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

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

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

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

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

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

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

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ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Redwood has two leases for its principal executive and administrative offices located at One Belvedere Place, Mill Valley, California 94941. One lease expires in 2013 and the second lease expires in 2018. The 2011 rent obligation for these leases is \$1.9 million. Additionally, Redwood has one lease for administrative offices at 245 Park Ave., New York, NY 10167, which expires in 2011. As of December 31, 2010, the rent obligation for this lease was \$0.1 million.

ITEM 3. LEGAL PROCEEDINGS

As previously disclosed during 2010, on December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, *et seq.*) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS) issued through our Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction and purchased by the FHLB-Seattle. The FHLB-Seattle seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys' fees and costs. On October 18, 2010, the FHLB-Seattle Defendants filed motions to dismiss the FHLB-Seattle's complaint, which motions are pending. The FHLB-Seattle alleges that the FHLB-Seattle Defendants' offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the credit quality of the mortgage loans that backed it. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. The Sequoia RMBS that is the subject of the FHLB-Seattle's claim was issued with an original principal amount of approximately \$133 million and, as of December 31, 2010, had a remaining outstanding principal balance of approximately \$30 million. We believe that this claim is without merit and we intend to defend the action vigorously.

As previously disclosed during 2010, on August 18, 2010, Redwood Trust, Inc.'s subsidiary, SRF, received service of process with respect to a claim filed on July 15, 2010 in Superior Court for the State of California in San Francisco (case number CGC-10-501610) by The Charles Schwab Corporation (Schwab). In the claim, Schwab is suing SRF and 26 other named defendants (collectively, the Schwab Defendants) in relation to RMBS sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges a claim of negligent misrepresentation under California state law and seeks unspecified damages and attorneys' fees and costs with respect to a RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction (which is the same securitization transaction at issue in the litigation initiated by the FHLB-Seattle described in the preceding paragraph). Among other things, Schwab alleges that the offering materials for this Sequoia RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. On September 8, 2010, the matter was

removed to the United States District Court for the Northern District of California, Case No. C 10-04030SI. On October 1, 2010, Schwab filed a motion to remand the matter to state court, which motion is pending. The Sequoia RMBS that is the subject of Schwab's claim was issued with an original principal amount of approximately \$14.8 million and, as of December 31, 2010, had a remaining outstanding principal balance of approximately \$3.3 million.

We believe that this claim is without merit and we intend to defend the action vigorously.

As previously disclosed during 2010, on July 12, 2010, two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law (815 ILCS Section 5/13(A)) were received from the Federal

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Home Loan Bank of Chicago (FHLB-Chicago). In the notices, the FHLB-Chicago sought to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Redwood Trust, Inc.'s subsidiary, SRF, was the depositor. Subsequently, on October 15, 2010, the FHLB-Chicago filed a claim in the Circuit Court of Cook County, Illinois (case number 10CH450B03) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants) in relation to RMBS sold or issued by the FHLB-Chicago Defendants or by entities controlled by the FHLB-Chicago Defendants. With respect to SRF, the FHLB-Chicago alleges that the offering materials for two RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2006-1 securitization transaction contained untrue and misleading statements and material representations in violation of Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)), and alleges claims of negligent misrepresentations under Illinois common law. On some of the claims, the FHLB-Chicago seeks to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory interest rate of 10% per annum from the date of original purchase (net of interest received). On one claim, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys' fees and costs. Among other things, the FHLB-Chicago alleges that the offering materials for this RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, (4) ratings assigned to this RMBS, and (5) due diligence performed on these mortgage loans. The first of these two Sequoia RMBS was issued with an original principal amount of approximately \$105 million and, as of December 31, 2010, had a remaining outstanding principal balance of approximately \$51 million. The second of these two Sequoia RMBS was issued with an original principal amount of approximately \$379 million and, as of December 31, 2010, had a remaining outstanding principal balance of approximately \$178 million. SRF has not yet responded to the complaint. We believe that these claims are without merit, and we intend to defend the action vigorously.

As previously disclosed during 2010, in May 2010, we received an Order from the SEC, pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC's Order required us to provide information regarding, among other things, our trading practices and valuation policies relating to our business of sponsoring and managing collateralized debt obligation (CDO) issuers. We have responded to the Order. The Order from the SEC indicates that it should not be construed as an indication by the SEC or its staff that any violations of law have occurred. The SEC could, however, as a result of our response to this Order or otherwise, allege that we violated applicable law or regulation in the conduct of our CDO business.

As previously disclosed during 2010, in November 2009, we received a subpoena from the National Credit Union Administration (NCUA), which is the federal agency that charters and supervises federal credit unions, as part of its investigation of the circumstances relating to the U.S. Central Federal Credit Union being placed into conservatorship in March 2009, including the U.S. Central Federal Credit Union's investment in various RMBS. The NCUA requested information relating to, among other things, two RMBS (i) issued by a securitization trust with respect to which SRF was the depositor and (ii) purchased at the time of issuance by the U.S. Central Federal Credit Union. We have responded to the subpoena. The subpoena from the NCUA states that it should not be construed as an indication by the NCUA or its staff that any violation of law has occurred. The NCUA could, however, as a result of our response to this subpoena or otherwise, allege that we did violate applicable law or regulation in the conduct of our securitization business.

Other than as disclosed in the preceding paragraphs of this Item 3, there are no material pending legal proceedings, or material changes with respect to pending legal proceedings, in each case, to which we or any of our subsidiaries is a party or of which our property is the subject.

ITEM 4. (Removed and Reserved)

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

Our common stock is listed and traded on the NYSE under the symbol RWT. As of February 23, 2011, our common stock was held by approximately 1,149 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 30,779 as of February 4, 2011. As of February 23, 2011, there were 78,132,878 shares of common stock outstanding.

The closing, high, and low sales prices of shares of our common stock, as reported by the Bloomberg Financial Markets service, and the cash dividends declared on our common stock for each full quarterly period during 2010 and 2009 were as follows:

	Stock Prices		Common Dividends Declared			
	High	Low	Record Date	Payable Date	Per Share	Dividend Type
<u>Year Ended December 31, 2010</u>						
Fourth Quarter	\$ 15.41	\$ 13.83	12/31/2010	1/21/2011	\$ 0.25	Regular
Third Quarter	\$ 15.99	\$ 13.75	9/30/2010	10/21/2010	\$ 0.25	Regular
Second Quarter	\$ 17.17	\$ 14.17	6/30/2010	7/21/2010	\$ 0.25	Regular
First Quarter	\$ 15.46	\$ 13.34	3/31/2010	4/21/2010	\$ 0.25	Regular
<u>Year Ended December 31, 2009</u>						
Fourth Quarter	\$ 15.94	\$ 13.40	12/31/2009	1/21/2010	\$ 0.25	Regular
Third Quarter	\$ 18.48	\$ 14.25	9/30/2009	10/21/2009	\$ 0.25	Regular
Second Quarter	\$ 18.54	\$ 13.84	6/30/2009	7/21/2009	\$ 0.25	Regular
First Quarter	\$ 17.80	\$ 10.76	3/31/2009	4/21/2009	\$ 0.25	Regular

All dividend distributions are made with the authorization of the board of directors at its discretion and will depend on such items as our REIT taxable earnings, financial condition, maintenance of REIT status, and other factors that the board of directors may deem relevant from time to time. The holders of our common stock share proportionally on a per share basis in all declared dividends on common stock. We intend to distribute to our stockholders as dividends at least 90% of our REIT taxable income. For 2010, we estimate a taxable loss and, therefore, we expect to have no dividend distribution requirement for the 2010 year. As reported, for dividend distributions made in 2010 in excess of our minimum requirement, we expect that 62% will be characterized as ordinary income and 38% will be characterized as a return of capital.

We announced a stock repurchase plan on November 5, 2007, for the repurchase of up to a total of 5,000,000 shares. This plan replaced all previous share repurchase plans and has no expiration date. The following table contains information on the shares of our common stock that we purchased during the year ended December 31, 2010.

Total Number of	Average Price	Total Number of Shares	Maximum Number (or
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	Shares Purchased	per Share Paid	Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value) of Shares that May Yet be Purchased Under the Plans or Programs
January 1, 2010 - January 31, 2010	4,923	(1) \$ 14.46		4,658,071
February 1, 2010 - June 30, 2010				4,658,071
July 1, 2010 - July 30, 2010	123	(1) 14.64		4,658,071
August 1, 2010 - December 31, 2010				4,658,071
Total	5,046	\$ 14.46		4,658,071

(1) The 4,923 and 123 shares repurchased in January and July 2010 represent shares reacquired from directors, officers and employees to satisfy tax withholding requirements on the vesting of restricted shares.

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The following table provides information, as of December 31, 2010, with respect to compensation plans under which equity securities of the registrant are authorized for issuance.

Plan Category	Plan Name	Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights ⁽¹⁾	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights ⁽²⁾	Number of Securities Remaining Available for Future Issuance ⁽³⁾
Equity compensation plan approved by security holders	2002 Incentive Plan	2,810,919	\$ 53.13	1,052,826
Equity compensation plan approved by security holders	2002 Employee Stock Purchase Plan			78,357
Total		2,810,919	\$ 53.13	1,131,183

As of December 31, 2010, 2,351,804 shares of common stock may be issued pursuant to outstanding deferred stock (1) units and 459,115 shares of common stock may be issued pursuant to outstanding options to purchase common stock.

(2) As of December 31, 2010, the weighted-average exercise price of outstanding options to purchase common stock was \$53.13. Under our 2002 Incentive Plan no exercise price is applicable to deferred stock units.

Number of securities remaining available for future issuance does not reflect the awards made under the 2002 (3) Incentive Plan since December 31, 2010 and does not include issuance of shares of common stock under the 2002 Employee Stock Purchase Plan since December 31, 2010.

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The following graph presents a cumulative total return comparison of our common stock, over the last five years, to the S&P Composite-500 Stock Index and the National Association of Real Estate Investment Trusts, Inc. (NAREIT) Mortgage REIT index. The total returns reflect stock price appreciation and the reinvestment of dividends for our common stock and for each of the comparative indices, assuming that \$100 was invested in each on December 31, 2005. The information has been obtained from sources believed to be reliable; but neither its accuracy nor its completeness is guaranteed. The total return performance shown on the graph is not necessarily indicative of future performance of our common stock.

Five Year Cumulative Total Return Comparison December 31, 2005 through December 31, 2010

	2005	2006	2007	2008	2009	2010
Redwood Trust, Inc	100.00	156.93	105.94	52.72	54.55	60.21
NAREIT Mortgage REIT Index	100.00	116.30	67.54	46.33	57.76	70.80
S&P Composite-500 Index	100.00	115.79	122.16	76.96	97.33	111.99

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The following selected financial data is qualified in its entirety by, and should be read in conjunction with, the more detailed information contained in the Consolidated Financial Statements and Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K and in our Annual Reports on Form 10-K for each of the years ended December 31, 2010, 2009, 2008, 2007 and 2006. Certain amounts for prior periods have been reclassified to conform to the 2010 presentation.

(In Thousands, Except Per Share Data)	2010	2009	2008	2007	2006
Selected Statement of Operations Data:					
Interest income	\$230,054	\$287,877	\$567,545	\$868,348	\$884,801
Interest expense	(84,664)	(132,003)	(416,669)	(651,762)	(701,704)
Net interest income	145,390	155,874	150,876	216,586	183,097
(Provision for) reversal of loan losses	(24,135)	(49,573)	(55,111)	(12,808)	359
Market valuation adjustments, net	(19,554)	(87,628)	(492,902)	(1,261,449)	(12,586)
Net interest income (loss) after provision and market valuation adjustments	101,701	18,673	(397,137)	(1,057,671)	170,870
Operating expenses	(53,715)	(46,995)	(60,906)	(58,555)	(55,925)
Realized gains on sales and calls, net	63,496	63,166	8,511	12,781	22,557
(Provision for) benefit from income taxes	(280)	4,268	3,210	(5,192)	(9,970)
Net income (loss)	111,202	39,112	(446,322)	(1,108,637)	127,532
Less: Net income (loss) attributable to noncontrolling interest	1,150	(83)	(1,936)		
Net Income (Loss) Attributable to Redwood Trust, Inc.	\$110,052	\$39,195	\$(444,386)	\$(1,108,637)	\$127,532
Average common shares basic	77,841,634	68,458,009	33,022,622	27,928,234	25,718,435
Earnings (loss) per share basic	\$1.37	\$0.56	\$(13.46)	\$(39.70)	\$4.96
Average common shares diluted	78,810,949	68,990,891	33,022,622	27,928,234	26,313,826
Earnings (loss) per share diluted	\$1.36	\$0.55	\$(13.46)	\$(39.70)	\$4.85
Regular dividends declared per common share	\$1.00	\$1.00	\$3.00	\$3.00	\$2.80
Special dividends declared per common share	\$	\$	\$	\$2.00	\$3.00
Total dividends declared per common share	\$1.00	\$1.00	\$3.00	\$5.00	\$5.80
Selected Balance Sheet Data:					
Earning assets	\$5,049,254	\$5,090,188	\$5,436,184	\$9,695,240	\$12,752,890
Total assets	\$5,143,688	\$5,252,650	\$5,581,749	\$9,938,472	\$13,030,473
Short-term debt	\$44,137	\$	\$	\$7,561	\$1,856,208
Asset-backed securities issued Sequoia	\$3,458,501	\$3,644,933	\$4,508,127	\$6,946,166	\$7,669,551
Asset-backed securities issued Acacia	\$303,077	\$297,596	\$346,931	\$3,383,113	\$2,309,673

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Long-term debt	\$ 139,500	\$ 140,000	\$ 150,000	\$ 150,000	\$ 100,000
Total liabilities	\$4,068,096	\$4,263,559	\$5,257,286	\$10,656,751	\$12,027,783
Noncontrolling interest	\$10,839	\$17,370	\$22,611	\$	\$
Total stockholders' equity (deficit)	\$1,064,753	\$971,721	\$301,852	\$(718,279)	\$1,002,690
Number of common shares outstanding	78,124,668	77,737,130	33,470,557	32,385,073	26,733,460
Book value per common share	\$13.63	\$12.50	\$9.02	\$(22.18)	\$37.51
Other Selected Data:					
Average assets	\$5,196,092	\$5,329,461	\$8,026,050	\$12,177,451	\$14,123,151
Average debt and ABS issued outstanding	\$4,011,855	\$4,461,745	\$7,386,690	\$11,322,898	\$12,996,244
Average stockholders' equity	\$1,008,126	\$729,032	\$556,354	\$723,807	\$988,495
Net income/average stockholders' equity	10.9	% 5.4	% (79.9))% (153.2))% 12.9

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

Our Business

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time.

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

Our investments include residential and commercial real estate loans and securities backed by residential and commercial loans. The securities include both senior securities and subordinate securities. Senior securities (often investment-grade) are those interests in a securitization that have the first right to cash flows and are last to absorb losses. Subordinate securities (often below investment-grade) are those interests in a securitization that have the last right to cash flows and are first in line to absorb losses. We may also invest in re-REMIC securities, or securities that were created through the resecuritization of certain senior interests in residential mortgage securitizations to provide additional credit support to those interests.

Residential securities we invest in are generally acquired by us from third parties or by retaining mortgage-backed securities issued by Sequoia securitization trusts, which are securitization entities we sponsor. The process of sponsoring a Sequoia securitization includes the acquisition of residential loans, which we generally fund with equity and short-term debt during the accumulation period, the transfer of a pool of those loans to a Sequoia securitization entity, and the structuring and issuance by the Sequoia securitization entity of mortgage-backed securities collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities are generally issued to third parties, while the subordinate securities issued by these entities are generally retained by us.

Historically, we have also sponsored other entities: a private limited partnership fund that we manage, the Redwood Opportunity Fund, LP (the Fund), and Acacia securitization entities that we also manage. The Fund and the Acacia securitization entities generally invested in a variety of real estate related assets. Our investments in these entities are currently financed with equity and long-term debt. We are not currently seeking to sponsor other entities like the Fund and the Acacia securitization entities.

Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not obligations of Redwood, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. For financial reporting purposes, we are required to consolidate the assets and liabilities of the Fund and the assets and liabilities of many of the Sequoia and Acacia securitization entities we have sponsored.

The commercial real estate loans we invest in are primarily originated by us and any commercial mortgage-backed securities we invest in are acquired from third parties. Our commercial investments are currently financed with equity and long-term debt.

For tax purposes, we are structured as a real estate investment trust (REIT). As a REIT, we are able to pass through substantially all of our earnings to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries.

Business Update Fourth Quarter 2010

A year ago, we observed that new private securitization was within sight (but hurdles remained), commercial investment opportunities were near, and we liked our competitive position. At the time, we had not completed a residential mortgage-backed securitization since August 2007 in the wake of the financial crisis. Our commercial team was in a formative stage and we had just recently hired the head of that team.

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Residential Mortgage Loan Business

In April 2010, we completed the first non-agency residential mortgage-backed securitization backed by newly originated loans since mid-2008. Going into 2010, we had plans to complete additional mortgage securitizations, but we had no assurances that we could do so. In fact, investors in residential mortgage-backed securities (RMBS) were still aggressively buying seasoned senior RMBS at yields well above jumbo mortgage rates, making the securitization economics unattractive at that time.

We accomplished most of our residential business plans in 2010. After completing the securitization in April 2010, we launched our residential mortgage conduit program for acquiring loans from originators. By the end of 2010, we had acquired \$253 million of residential loans and had a pipeline of \$119 million of additional loans from conduit program originators identified for subsequent acquisition. We submitted our Government Sponsored Enterprises (GSE) reform plan to regulators in July and published the Redwood Guide to Restoring Private-Sector Residential Mortgage Securitization in November. We had several opportunities to discuss both of these documents with federal regulators and policy makers.

In late 2009, we started rebuilding our Sequoia securitization platform. We did so based on our beliefs that the government's role in backing roughly 90% of annual mortgage originations was unsustainable; private securitization would return; we had several competitive advantages in private securitization; building a better jumbo mortgage conduit would likely and ultimately benefit our shareholders; and Redwood should take a leading role in restarting private securitization.

Taking a longer view, we believe we are well positioned to take advantage of opportunities we expect to result from a meaningful reduction in the federal government's role in supporting mortgage finance. This will take time and may not begin to significantly affect our results until 2012. We would, of course, prefer more immediate loan volume for our residential mortgage conduit to make the activity more efficient, profitable, and beneficial for shareholders.

Residential Portfolio Business

While the 10-year Treasury yield increased in the fourth quarter by 76 basis points, the overall decline for 2010 of 55 basis points to a 3.30% level kept investors searching for yield in the secondary market for seasoned private-label RMBS. Against this backdrop, our investment activity in RMBS remained subdued in the fourth quarter as credit spreads continued to grind tighter.

The following chart shows market prices for senior RMBS securities since October 2008.

Senior RMBS Prices

Source: JPMorgan Chase

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During the fourth quarter, our investment portfolio increased by \$26 million to \$823 million at December 31, 2010. The increase was driven by \$26 million in acquisitions and \$29 million in price appreciation, offset by \$29 million in pay downs. We had no sales in the fourth quarter.

We will continue to manage our mortgage securities with an eye to protect credit and enhance returns, as possible. While we do not anticipate significant further price appreciation, we will stay vigilant for opportunities that result from uncertainty and changes in perceptions in the market. For example, negative headlines on housing could help create investment opportunities in select RMBS. We view volatility that often comes with uncertainty as potentially a good source of opportunities. On the margin, we expect to continue to manage the risk/reward of our portfolio.

Commercial Loan Business

The progress and results for our commercial loan business have been promising. Our commercial business is actively engaged as an originator and underwriter of commercial mezzanine loans on high quality, stabilized assets. We invested \$30 million in the fourth quarter through our funding of three new mezzanine loans. In February 2011, we originated another \$6 million mezzanine loan. Our team is in place, we have built processes and strengthened relationships, and our lending opportunities are expanding. We currently expect a significant portion of the capital we invest in 2011 to go into commercial assets, and our commercial investments could rise to become 20% of our invested capital over the next year or two.

The commercial real estate market is experiencing a significant increase in the volume of financing transactions as liquidity has increasingly returned in earnest for stabilized commercial assets. Fundamentals appear to have at least stabilized in select metropolitan markets, especially for multifamily properties, strong anchored retail space, and class-A office space in central business districts.

The increased capital flows to commercial real estate can be seen in the recent resurgence in the commercial mortgage-backed securities (CMBS) market. Issuance velocity for CMBS backed by high quality commercial loans is increasing. Investor demand is strong, triple-A credit spreads to Treasury yields continue to tighten, and borrowers are able to refinance at attractive rates and on easing credit terms. Furthermore, many banks and Wall Street firms are building CMBS platforms that will likely increase future originations. Last year, CMBS issuance totaled roughly \$10 billion excluding agency originations. Some market observers expect CMBS issuance of approximately \$40 to \$50 billion for 2011.

The environment for building our commercial business and making investments is favorable, particularly since we expect an increase in the flow of the types of lending opportunities we want for our business. At this point, there are no meaningful regulatory challenges to commercial real estate finance. As is the case with all of our investment activities, we are focused on getting credit right. We believe we have built the in-house expertise, platform, market recognition, and relationships to allow us to prosper over time.

It is our objective to be well positioned to originate attractive risk-adjusted commercial investments on a sustainable basis, as market conditions ebb and flow. Currently, we are focused on providing long-term solutions to meet the challenge of financing the gap between the amount of equity a borrower will invest into a property and the amount of financing available from the senior lender. Our balance sheet is well suited for retaining this type of long-term credit risk. Our capital and origination process provide reliability, flexibility, and advantages to borrowers, including the advantage of permanent funding of longer-term assets.

Housing Finance Reform

Over the past year, participants in the origination and securitization process have seen numerous regulatory proposals and, of course, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) put forth various ideas and frameworks for reforming the regulatory regime that governs residential mortgage securitization.

Uncertainty about where all of these proposals will settle has been a clear headwind for private mortgage securitization participants. We expect greater certainty as crucial implementation details for Dodd-Frank and related regulations emerge, particularly as they relate to how qualified residential mortgages will be defined and what risk retention will look like. Once the rules of the road are known, market participants throughout the mortgage chain can begin to adjust their policies,

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practices, and operations. In reality, it will only be after participants in this market begin to function under new rules that we will have the best empirical evidence of whether the regulatory framework needs further reform in one direction or another.

As a significant step in this process, in February 2011, the Obama Administration made recommendations to Congress pertaining to the mortgage industry through a Department of Treasury white paper titled, *Reforming America's Housing Finance Market*. As specifically cited in Treasury's paper, the reform plan is designed to pave the way for a robust private mortgage market by reducing government support for housing and winding down Fannie Mae and Freddie Mac on a responsible timeline. Although implementation of reforms will take time, if reform is implemented as set forth in the plan, it will be a positive long-term development for private residential mortgage investors such as us.

During the financial crisis that began in 2008, government intervention into the mortgage market through Fannie Mae and Freddie Mac, as well as through the Federal Housing Administration (FHA), was essential to maintaining the flow of mortgage liquidity to support housing. Private mortgage financing through securitization had ceased and banks were unable to fill the void as their balance sheets were generally under pressure.

More recently, we have observed the resurgence of other private asset-backed securities (ABS) markets (e.g., credit cards, auto loans, and now CMBS) which are now up and functioning while RMBS issuance has barely budged. Many have asked, *Why?* To us, there are several contributing factors, but none more relevant than the historically high level of attractive government financing that is currently crowding out traditional private market participants.

Major banks are benefiting from government involvement by selling about 90% of their mortgage originations to GSEs such as Fannie Mae and Freddie Mac. Further, banks currently have low funding costs and ample balance sheet capacity to retain the remaining jumbo mortgage loans that do not conform to government loan limits or product standards. As a result, there is little financial motivation for banks to securitize loans or sell loans to third parties such as Redwood for private securitization. However, we believe that the Obama Administration's recommendations, if enacted, would significantly change this market dynamic.

We acknowledge concerns expressed by some market participants that any reduction to the current level of government support for housing at a time when the private markets are not fully functioning could cause credit to become scarcer and mortgage rates to increase. On the other hand, many believe that the excessive government support is the biggest reason for the dearth of private securitizations. To strike the right balance, we believe the status quo is an unsustainable burden on taxpayers and needs to be tested through a gradual, well-planned process that has safeguards at each incremental phase to ensure that the private sector is ready to step up and offer attractive mortgage financing as the government steps back.

Regardless of where housing finance reform takes us, we are encouraged to see dialogue and debate of the issues rather than just postponing discussion of reform to the future. Meanwhile, we believe temporary loan limits for high cost areas will likely be allowed to expire on September 30, 2011. Lowering loan limits which help determine how big a role the GSEs play in housing finance is an easy way to effectively make a first step in GSE reform. Lowering loan limits makes sense in the context of home price declines, it limits the additional burden to the taxpayer, and it opens a door for the private sector to return to financing mortgages in a more significant way.

Outlook

We are building for the future, which requires patience by management and especially by shareholders. We continue to expect our residential portfolio business to generate the majority of our interest income in 2011, and we expect yields on these securities to remain relatively stable over time. However, we have laid a strong foundation for our commercial and residential loan businesses and expect an increasing amount of our earnings to come from these businesses over time.

TABLE OF CONTENTS**Summary of Results of Operations****Net Income**

Our reported GAAP net income was \$15 million (\$0.18 per share) for the fourth quarter of 2010, as compared to \$40 million (\$0.51 per share) for the fourth quarter of 2009. Our reported GAAP net income was \$110 million (\$1.36 per share) for 2010, as compared to \$39 million (\$0.55 per share) for 2009. We declared regular quarterly dividends of \$0.25 per share for all four quarters of 2010 and 2009.

The following table presents the components of our GAAP net income (loss) for the three and twelve months ended December 31, 2010 and 2009.

Table 1 Net Income

(In Thousands, Except Share Data)	Three Months Ended		Years Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Interest income	\$55,753	\$61,796	\$230,054	\$287,877
Interest expense	(21,624)	(20,524)	(84,664)	(132,003)
Net interest income	34,129	41,272	145,390	155,874
Provision for loan losses	(7,902)	(8,997)	(24,135)	(49,573)
Market valuation adjustments, net	380	(4,191)	(19,554)	(87,628)
Net interest income after provision and market valuation adjustments	26,607	28,084	101,701	18,673
Operating expenses	(12,937)	(10,880)	(53,715)	(46,995)
Realized gains on sales and calls, net	1,512	19,618	63,496	63,166
(Provision for) benefit from income taxes	(26)	3,613	(280)	4,268
Less: Net income (loss) attributable to noncontrolling interest	447	143	1,150	(83)
Net Income	\$14,709	\$40,292	\$110,052	\$39,195
Diluted weighted average common shares outstanding	78,944,301	78,101,232	78,810,949	68,990,891
Net earnings per share	\$0.18	\$0.51	\$1.36	\$0.55

Net Interest Income after Provision and Market Valuation Adjustments (MVA)

Net interest income after provision and MVA was \$27 million for the fourth quarter of 2010, as compared to \$28 million for the fourth quarter of 2009, a decrease of \$1 million. Net interest income after provision and MVA was \$102 million for the year ended December 31, 2010, as compared to \$19 million for the year ended December 31, 2009, an increase of \$83 million. These results reflect a decline in net interest income due to lower principal balances on securities and loans at consolidating entities. The decline was more than offset by a significantly reduced provision for loan losses for the Sequoia entities due to a deceleration in borrower defaults, as well as a significant reduction in negative market valuation adjustments.

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The following table details the components of market valuation adjustments for the three and twelve months ended December 31, 2010 and 2009.

Table 2 Components of MVA

(In Thousands)	Three Months Ended		Years Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Commercial real estate loans (fair value)	\$ 631	\$ 9,330	\$ 7,979	\$ 3,611
Residential real estate loans (held-for-sale)	127	105	462	19
Trading securities	36,758	15,095	102,612	22,176
Impairment on AFS securities	(1,144)	(2,288)	(9,887)	(73,758)
REO	(639)	461	(2,617)	(2,036)
Risk management derivatives	16,643	5,586	(46,408)	18,598
ABS issued Acacia	(51,996)	(32,479)	(71,695)	(56,238)
Total Market Valuation Adjustments, Net	\$ 380	\$ (4,190)	\$ (19,554)	\$ (87,628)

Market valuation adjustments, net, was positive \$380 thousand for the fourth quarter of 2010, as compared to negative \$4 million for the fourth quarter of 2009, an increase of \$4 million. This increase was primarily a result of increased valuations and balances of risk management derivatives and fewer impairments on AFS securities, partially offset by stabilizing valuations of commercial loans. Negative market valuation adjustments, net, decreased \$68 million from \$88 million in 2009 to \$20 million in 2010. This decrease in negative market valuations was primarily a result of fewer impairments on AFS securities and increasing valuations of commercial loans, partially offset by declining valuations on risk management derivatives.

Operating Expenses

Operating expenses were \$13 million and \$11 million for the fourth quarters of 2010 and 2009, respectively. This \$2 million increase was predominantly due to differences in the timing of the recognition of variable compensation expenses. Operating expenses were \$54 million and \$47 million for 2010 and 2009, respectively. This increase was largely due to a \$4 million non-recurring equity compensation expense related to the accelerated vesting of equity awards from the announced retirement of our former Chief Executive Officer. The remaining increase was primarily the result of a rise in our operating expenses associated with the expansion of our residential and commercial businesses. Another factor contributing to the increase in operating expenses in 2010, as compared to 2009 was an increase in legal expenses.

The following table presents the components of operating expenses for the three and twelve months ended December 31, 2010 and 2009.

Table 3 Operating Expenses

(In Thousands)	Three Months Ended		Years Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Fixed compensation expense	\$ 3,402	\$ 3,262	\$ 14,487	\$ 14,526
Variable compensation expense	2,152	566	7,542	7,470

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Equity compensation expense	1,710	1,554	11,353	6,105
Severance expense			358	486
Total compensation expense	7,264	5,382	33,740	28,587
Systems	2,127	2,285	7,658	7,012
Office costs	1,689	1,930	7,027	7,047
Accounting and legal	1,504	1,028	3,866	2,904
Other operating expenses	352	255	1,424	1,445
Total Operating Expenses	\$ 12,936	\$ 10,880	\$ 53,715	\$ 46,995

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

TABLE OF CONTENTS**Realized Gains on Sales and Calls, Net**

The following table details the components of realized gains on sales and calls, net, for the three and twelve months ended December 31, 2010 and 2009.

Table 4 Realized Gains on Sales and Calls, Net

(In Thousands)	Three Months Ended		Years Ended	
	December 31,		December 31,	
	2010	2009	2010	2009
Net gains on sales of real estate securities	\$ 437	\$ 19,618	\$ 53,649	\$ 37,752
Net gains on repurchase of Sequoia ABS	119		7,078	
Net gains on extinguishment of debt	230		547	6,843
Net gains on calls	726		2,220	