REDWOOD TRUST INC
Form 10-Q
May 05, 2010

UNITED STATES OF AMERICA

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended: March 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 (Address of Principal Executive Offices)	94941 (Zip Code)

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 x No o

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

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.

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, $0.01 par value per share	77,897,360 shares outstanding as of May 4, 2010

TABLE OF CONTENTS

REDWOOD TRUST, INC.

2010 FORM 10-Q REPORT

TABLE OF CONTENTS

-
i

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	March 31, 2010	December 31, 2009
ASSETS		
Real estate loans	$3,662,283	$3,739,254
Real estate securities, at fair value:		
Trading securities	288,820	277,274
Available-for-sale securities	846,642	810,471
Total real estate securities	1,135,462	1,087,745
Other investments	10,762	20,371
Cash and cash equivalents	241,753	242,818
Total earning assets	5,050,260	5,090,188
Restricted cash	87,600	94,306
Accrued interest receivable	14,665	18,193
Derivative assets	5,520	12,372
Deferred tax asset	3,631	4,810
Deferred asset-backed securities issuance costs	6,014	6,639
Other assets	27,576	26,142
Total Assets(1)	$5,195,266	$5,252,650
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$	$
Accrued interest payable	5,390	5,968
Derivative liabilities	79,486	83,800
Accrued expenses and other liabilities	103,617	71,828
Dividends payable	19,438	19,434
Asset-backed securities issued Sequoia	3,557,669	3,644,933
Asset-backed securities issued Acacia	279,471	297,596
Long-term debt	140,000	140,000
Total liabilities(2)	4,185,071	4,263,559
Equity		
Common stock, par value $0.01 per share, 100,000,000 shares authorized; 77,750,697 and 77,737,130 issued and outstanding	778	777
Additional paid-in capital	1,680,565	1,674,367
Accumulated other comprehensive income	57,597	64,860
Cumulative earnings	411,731	364,888

Cumulative distributions to stockholders	(1,153,065)	(1,133,171)
Total stockholders equity	997,606	971,721
Noncontrolling interest	12,589	17,370
Total equity	1,010,195	989,091
Total Liabilities and Equity	$5,195,266	$5,252,650

(1) Assets in our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs. At March 31, 2010, these assets totaled $4,074,108.

(2) Liabilities in our consolidated balance sheets include liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At March 31, 2010, these liabilities totaled $3,981,885.

The accompanying notes are an integral part of these consolidated financial statements.

1

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended March 31, 2010	2009
Interest Income		
Real estate loans	$14,791	$33,969
Real estate securities	43,899	47,263
Other investments	9	76
Cash and cash equivalents	17	130
Total interest income	58,716	81,438
Interest Expense		
Short-term debt		
Asset-backed securities issued	(17,066)	(45,834)
Long-term debt	(1,116)	(1,808)
Total interest expense	(18,182)	(47,642)
Net Interest Income	40,534	33,796
Provision for loan losses	(9,475)	(16,032)
Market valuation adjustments on trading instruments	(9,291)	(14,207)
Other-than-temporary impairments[(1)]	(1,946)	(29,035)
Market valuation adjustments, net	(11,237)	(43,242)
Net Interest Income (Loss) After Provision and Market Valuation Adjustments	19,822	(25,478)
Operating expenses	(17,306)	(10,539)
Realized gains, net	44,338	462
Net income (loss) before provision for income taxes	46,854	(35,555)
Provision for income taxes	(26)	(105)
Net income (loss)	46,828	(35,660)
Less: Net loss attributable to noncontrolling interest	(15)	(716)
Net Income (Loss) Attributable to Redwood Trust, Inc.	$46,843	$(34,944)
Basic earnings (loss) per common share:	$0.59	$(0.65)
Diluted earnings (loss) per common share:	$0.58	$(0.65)
Regular dividends declared per common share	$0.25	$0.25
Special dividends declared per common share	$	$
Total dividends declared per common share	$0.25	$0.25
Basic weighted average shares outstanding	77,677,235	53,632,132
Diluted weighted average shares outstanding	78,542,299	53,632,132

(1) For the three months ended March 31, 2010, total other-than-temporary impairments were $3,615 of which $1,669 were recognized in Accumulated Other Comprehensive Income (Loss).

The accompanying notes are an integral part of these consolidated financial statements.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY AND COMPREHENSIVE INCOME (LOSS)

For the Three Months Ended March 31, 2010

For the Three Months Ended March 31, 2009

The accompanying notes are an integral part of these consolidated financial statements.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended March 31, 2010	2009
Cash Flows From Operating Activities:		
Net income (loss)	$46,843	$(34,944)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	(8,220)	2,965
Depreciation and amortization of non-financial assets	240	273
Provision for loan losses	9,475	16,032
Non-cash equity award compensation	6,086	1,794
Market valuation adjustments, net	11,237	43,242
Realized gains, net	(44,338)	(462)
Net change in:		
Accrued interest receivable	3,349	6,244
Deferred tax asset	1,179	869
Other assets	1,976	20,087
Accrued interest payable	2,026	(10,483)
Accrued expenses and other liabilities	31,789	(8,499)
Net cash provided by operating activities	61,642	37,118
Cash Flows From Investing Activities:		
Principal payments on real estate loans held-for-investment	65,647	83,866
Purchases of real estate securities available-for-sale	(162,772)	(97,551)
Proceeds from sales of real estate securities available-for-sale	134,025	711
Principal payments on real estate securities available-for-sale	33,458	18,588
Purchases of real estate securities trading	(17,137)	
Proceeds from sales of real estate securities trading	3,603	
Principal payments on real estate securities trading	14,290	28,571
Principal payments on other investments	3,766	3,942
Net decrease in restricted cash	6,706	2,237
Net cash provided by investing activities	81,586	40,364
Cash Flows From Financing Activities:		
Repurchase of asset-backed securities	(8,639)	
Repayments on asset-backed securities	(96,568)	(117,142)
Net settlements of derivatives	(12,390)	(7,223)
Net proceeds from issuance of common stock	113	282,765
Dividends paid	(19,890)	(26,639)
Change in noncontrolling interests	(6,919)	(2,570)
Net cash (used in) provided by financing activities	(144,293)	129,191
Net (decrease) increase in cash and cash equivalents	(1,065)	206,673

Cash and cash equivalents at beginning of period	$242,818	$126,480
Cash and cash equivalents at end of period	$241,753	$333,153
Supplemental Disclosures:		
Cash paid for interest	$16,156	$62,362
Cash paid (received) for taxes	$	$(806)
Dividends declared but not paid at end of period	$19,438	$15,057

The accompanying notes are an integral part of these consolidated financial statements.

4

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 1. Redwood Trust

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. For tax purposes, we are structured as a real estate investment trust (REIT).

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.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2010 and December 31, 2009, and for the three months ended March 31, 2010 and 2009. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States for interim financial information and with the Securities and Exchange Commission s (SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Results for the three months ended March 31, 2010, may not necessarily be indicative of the results for the year ending December 31, 2010. These unaudited interim consolidated financial statements should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2009. All amounts presented herein, except per share data, are shown in thousands.

We recognize the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162* (FAS 168), which establishes the Accounting Standards Codification (ASC) as the single source of authoritative GAAP in the United States.

Organization

Our consolidated financial statements include the accounts of Redwood, its direct and indirect wholly-owned subsidiaries, and other entities in which we have a controlling financial interest. All significant intercompany balances and transactions have been eliminated. A number of Redwood s consolidated subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We are the asset manager and an investor in the Redwood Opportunity Fund LP (the Fund) that we sponsor. The Fund primarily invests in mortgage-backed securities. We also sponsor two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the consolidated Sequoia securitization entities. Our Acacia program is used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all the consolidated Acacia securitization entities.

We do not service any assets, including assets owned by the Fund, Sequoia, or Acacia.

Principles of Consolidation

We apply ASC 860 and ASC 810-10 to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. These standards became effective for our interests in all VIEs as of January 1, 2010, except for the Fund, as a result of the FASB s decision to delay the applicability of ASC 810-10 for private equity funds. Our determination of whether we must consolidate the Fund was made in accordance with FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)); at the time we acquired our interests in the Fund.

5

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 2. Basis of Presentation (continued)

We currently consolidate the assets, liabilities, and noncontrolling interests of the Fund, as well as the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain continuing involvement. For financial reporting purposes, the real estate securities owned at the Fund are shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third parties is shown under noncontrolling interest. In our consolidated statements of income (loss), we record interest income on the securities owned at the Fund. Since the Fund is currently funded with equity, there is no associated interest expense. The underlying loans and securities owned at Sequoia and Acacia entities are shown on our consolidated balance sheets under real estate loans and real estate securities and the asset-back securities (ABS) issued to third parties are shown under ABS issued. In our consolidated statements of income (loss), we record interest income on the loans and securities owned by Sequoia and Acacia entities and interest expense on the ABS issued by these consolidated securitization entities.

See *Note 4* for further discussion on principles of consolidation.

Note 3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences could be material.

Fair Value Option

We have the option to measure eligible financial assets, financial liabilities, and commitments at fair value on an instrument-by-instrument basis. This option is available when we first recognize a financial asset or financial liability or enter into a firm commitment. Subsequent changes in the fair value of assets, liabilities, and commitments where we have elected the fair value option are recorded in the consolidated statements of income (loss).

Our decision to apply the fair value option for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally be accounted for as available-for-sale (AFS) securities. Securities that we anticipate funding with a combination of debt and equity or those financed through the issuance of asset-backed liabilities will generally be measured using the fair value option along with the corresponding liabilities. Additionally, we may elect the fair value option for nontraditional real estate investments or for a variety of other reasons.

See *Note 5* for further discussion on the fair value option.

Fair Value Measurements

Our financial statements include assets and liabilities that are measured at their estimated fair values in accordance with GAAP. A fair value measurement represents the price at which an orderly transaction would occur between willing market participants at the measurement date. We develop fair values for financial assets or liabilities based on available inputs and pricing that is observed in the marketplace. Examples of market information that we attempt to obtain include the following:

Quoted prices for the same or similar securities;

6

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Relevant reports issued by analysts and rating agencies;
The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;
Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;
Indicative prices or yields from broker/dealers; and,
Other relevant observable inputs, including nonperformance risk and liquidity premiums.
After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value.

The markets for many of the real estate securities that we invest in and issue are generally illiquid. Establishing fair values for illiquid assets and liabilities is inherently subjective and is often dependent upon our estimates and modeling assumptions. If we determine that either the volume and/or level of trading activity for an asset or liability has significantly decreased from normal market conditions, or price quotations or observable inputs are not associated with orderly transactions, the market inputs that we obtain might not be relevant. For example, broker or pricing service quotes might not be relevant if an active market does not exist for the financial asset or liability. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) is also evaluated.

In circumstances where relevant market inputs cannot be obtained, increased analysis and management judgment are required to estimate fair value. This generally requires us to establish the use of our internal assumptions about future cash flows and appropriate risk-adjusted discount rates. Regardless of the valuation inputs we apply, the objective of fair value measurement is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

See *Note 6* for further discussion on fair value measurements.

Real Estate Loans

Residential and Commercial Real Estate Loans   Fair Value

Residential and commercial real estate loans at fair value are loans where we have elected the fair value option. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income (loss) in market valuation adjustments, net.

Residential and Commercial Real Estate Loans Held-for-Sale

Residential and commercial real estate loans held-for-sale are loans that we are marketing for sale to third parties. These loans are carried at the lower of their cost or fair value, as measured on an individual basis. If the fair value of a loan held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation adjustment through our consolidated statements of income (loss). Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Gains or losses on the sale of real estate loans are based on the specific identification method.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Residential and Commercial Real Estate Loans Held-for-Investment

Real estate loans held-for-investment include residential real estate loans owned and securitized at Sequoia entities and commercial real estate loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Interest previously accrued for loans that have become greater than 90 days past due is reserved for in the allowance for loan losses. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due is used to reduce the outstanding loan principal balance.

We use the interest method to determine an effective yield to amortize the premium or discount on real estate loans held-for-investment. For residential loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine periodic amortization. For residential loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to determine periodic amortization.

We reclassify loans held-for-investment to loans held-for-sale if we determine that these loans will be sold to third parties. This may occur, for example, if we exercise our right to call ABS issued by a Sequoia securitization trust and decide to subsequently sell the underlying loans to third parties.

Real Estate Loans Allowance for Loan Losses

For real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses based on our estimate of credit losses inherent in our loan portfolios at the reporting date. To calculate the allowance for loan losses, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each of the consolidated loans or pool of loans.

We consider the following factors in setting the allowance for loan losses:

Ongoing analyses of loans, including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, and other observable data;

Historical loss rates and past performance of similar loans;

Relevant environmental factors;

Relevant market research and publicly available third-party reference loss rates;

Trends in delinquencies and charge-offs;
Effects and changes in credit concentrations;
Information supporting a borrower s ability to meet obligations;
Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,
Discounted cash flow analyses.

Once we determine the amount of defaults, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each individual loan or pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an appropriate loss confirmation period. This period is defined as the range of time between the occurrence of a credit loss (such as the initial deterioration of the borrower s financial condition) and the confirmation of that loss (the actual impairment or

8

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our allowance for loan losses, since we believe these losses exist as of the reported date of the financial statements. We re-evaluate the adequacy of our allowance for loan losses at least quarterly.

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a growing number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings according to GAAP. If a loan is determined to be a troubled debt restructuring, it is removed from the general loan pools used for calculating allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in the consolidated statements of income (loss).

See *Note 8* for further discussion on the allowance for loan losses.

We do not currently maintain a loan repurchase reserve. We do not originate real estate loans and we believe that risk of loss due to loan repurchases (i.e., due to breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans and therefore would be covered by our recourse to those companies. In addition, management is not aware of any outstanding repurchase claims against Redwood that would require the establishment of a loan repurchase reserve.

Real Estate Securities, at Fair Value

Trading Securities

Trading securities include residential, commercial, and collateralized debt obligation (CDO) securities. Trading securities are carried at their estimated fair values. Coupon interest is recognized as interest income when earned and deemed collectible. All changes in fair value are reported through our consolidated statements of income (loss) in market valuation adjustments, net.

We primarily denote trading securities as those securities where we have adopted the fair value option. We currently account for certain securities at Redwood and all securities at Acacia entities as trading securities.

Available-for-Sale Securities

AFS securities include certain residential, commercial, and CDO securities. AFS securities are carried at their estimated fair values with cumulative unrealized gains and losses reported as a component of accumulated other comprehensive income (loss) in our consolidated statements of equity. Coupon interest is recognized as interest income when earned and deemed collectible, and the interest method is used to determine an effective yield to amortize purchase premiums, discounts, and fees associated with these securities into income over time. This requires us to project cash flows over the remaining life of each security and make assumptions with regards to interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

For an AFS security where its fair value has declined below its amortized cost basis, we evaluate the security for other-than-temporary impairment (OTTI). If we either (i) intend to sell the impaired security; (ii) will more likely than not be required to the sell the impaired security before it recovers in value; or, (iii) do not expect to recover the impaired security s amortized cost basis even if we do not intend to sell the security the impairment is deemed an OTTI and we record the entire difference between the security s fair value and its amortized cost in our consolidated statements of income (loss). Conversely, if none of these three conditions are met, we analyze the expected cash flows, or cost recovery of the security, to determine what, if any, OTTI is recognized through our consolidated statements of income (loss). This analysis includes an assessment of any changes in the regulatory and/or economic environment that might affect the performance of the security.

If we conclude through our analysis that there has been no significant adverse change in our cash flow assumptions for the security, then the impairment is deemed temporary in nature and the associated difference between the security s fair value and its amortized cost basis is recorded as an unrealized loss through accumulated other comprehensive income (loss), a component of stockholders equity. Alternatively, if we conclude that there has been a significant adverse change in our cash flow assumptions for the security, then the impairment is deemed an OTTI and we perform an additional analysis to determine what portion of OTTI, if any, should be recorded through our consolidated statements of income (loss). This analysis entails discounting the security s cash flows to a present value using the prior period yield for the security to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis of the security is deemed to be the credit component of the OTTI that is recorded in our consolidated statements of income (loss). The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between this expected recoverable value and the fair value is deemed to be the non-credit component of the OTTI that is recorded to accumulated other comprehensive income (loss). Future amortization and accretion for the security is computed based upon its new amortized cost basis.

In the second quarter of 2009, as part of our adoption of new authoritative GAAP guidance that we currently use to evaluate impairments on AFS securities, we evaluated $450 million of previously recorded OTTI on securities still held at April 1, 2009. We determined that $224 million of these OTTI related to securities where we either had the intent to sell or the OTTI did not include a non-credit component. The remaining $226 million of these OTTI related to securities that included a $165 million aggregate credit component and a $61 million aggregate non-credit component (of which, $60 million related to Redwood s interest and $1 million related to noncontrolling interest at the Fund). In accordance with the guidance, we recorded a $61 million one-time cumulative-effect adjustment, net of any related tax effects, to reclassify the non-credit component of these OTTI previously recorded through our consolidated statements of income (loss), as was prescribed under previous GAAP. This reclassification increased retained earnings and decreased other comprehensive income (OCI), resulting in zero net impact to reported stockholders equity and noncontrolling interest.

See *Note 9* for further discussion on real estate securities.

Other Investments

Other investments include a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statement purposes. We account for this investment under the fair value option. Changes in fair value are reported through our consolidated statements of income (loss) through market valuation adjustments, net. Interest income is reported through our consolidated statements of income (loss) through interest income, other investments.

See *Note 10* for further discussion on other investments.

10

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At March 31, 2010, we had minimal concentrations of credit risk arising from cash deposits as more than 98% of our cash and cash equivalents were invested in U.S. Government Treasury Bills or FDIC-insured bank products.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued consolidated securitization entities, and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization entities or in the Fund prior to the purchase of loans or securities, payments on or redemption of outstanding ABS issued, or distributions to limited partners. At March 31, 2010, we did not have any significant concentrations of credit risk arising from restricted cash deposits as more than 98% of our restricted cash was held in custodial accounts, invested in U.S. Government Treasury Bills, or held in FDIC-insured bank products.

Accrued Interest Receivable

Accrued interest receivable represents interest that is due and payable to us. Cash interest is generally received within thirty days of recording the receivable. For financial assets where we have elected the fair value option, the associated accrued interest on these assets is measured at fair value. For financial assets where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Derivative Financial Instruments

Derivative financial instruments include contractual interest rate agreements and credit default swaps. All derivative financial instruments are reported at fair value in accordance with derivative accounting guidance. Derivatives with a positive value to us are reported as an asset and derivatives with a negative value to us are reported as a liability. The changes in fair value of derivatives accounted for as trading instruments are reported in the consolidated statements of income (loss) through market valuation adjustments, net.

Interest Rate Agreements

We maintain an overall interest rate risk management strategy that incorporates the use of interest rate agreements. We enter into interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Interest rate agreements that we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases. We designate these interest rate agreements as either (i) a hedge of the fair market value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge); (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge); or, (iii) a trading instrument (no designation).

In 2010, we began using interest rate swaps to hedge our interest rate exposure related to our long-term debt. We account for these swaps as cash flow hedges, as we structured their critical terms to substantially match the payment terms of our floating-rate long-term debt. Specifically, (i) the swaps and long-term debt use the same interest rate index for variable cash flows, (ii) the interest rate resets for variable rate cash flows are the same for both the swaps and long-term debt, and (iii) the hedging relationship does not contain any other basis differences.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

We expect these cash flow hedges to be highly effective in reducing our exposure to changes in the benchmark LIBOR interest rates used to determine our quarterly interest payment obligations on long-term debt. We measure the effective portion of these cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the swaps with the change in fair value of the expected future variable cash flows of our long-term debt. To the extent these cash flow hedges are effective, we record interest income or expense as a component of net interest income and all other changes in fair value of the swaps are recorded in accumulated other comprehensive income (loss), a component of stockholders equity. We currently do not anticipate recording any ineffectiveness pertaining to these cash flow hedges and any unrealized gains or losses resulting from changes in the fair values of the swaps would only be reclassified into earnings to the extent the hedging relationships are terminated prior to the derivative contracts expiring.

We will discontinue cash flow hedge accounting if (i) we determine that the derivative is no longer expected to be effective in offsetting changes in the cash flows of the designated hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) the derivative is de-designated as a cash flow hedge; or (iv) it is probable that a forecasted transaction will not occur by the end of the originally specified time period. To the extent we de-designate cash flow hedges but the associated hedged items continue to exist, the fair value of cash flow hedges at the time of de-designation remains in accumulated other comprehensive income (loss) and is amortized using the straight-line method through interest expense over the remaining lives of the hedged Acacia ABS issued. Net purchases and proceeds from interest rate agreements are included in net settlements of derivatives, which are classified as financing activities within our consolidated statements of cash flows.

Credit Derivatives

A credit default swap (CDS) is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us to synthetically assume the credit risk of a reference security or index of securities. All of our existing CDS contracts were initiated during 2007 by one of the Acacia entities that we consolidate for financial reporting purposes. Net purchases and proceeds from CDS are included in net settlements of derivatives, which are classified as financing activities within our consolidated statements of cash flows.

See *Note 11* for further discussion on derivative financial instruments.

Deferred Tax Assets

Our deferred tax assets are generated by differences in GAAP and taxable income at our taxable subsidiaries. Income and expense recognition for GAAP and tax differ in material respects. These differences generally reflect differing accounting treatments for tax and GAAP, such as accounting for discount and premium amortization, credit losses, equity awards, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset and an associated deferred tax benefit for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is recognized as an expense.

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are expenses associated with the issuance of ABS from the Sequoia securitization entities we sponsor. These expenses typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities accounted for under the fair value option are expensed as incurred. ABS issuance costs associated with liabilities reported at cost are deferred. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges and are amortized as an adjustment

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related ABS issued under the principle guidance for interest on receivables and payables.

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair value. Subsequent declines in the value of an REO property are recorded in our consolidated statements of income (loss) as a component of market valuation adjustments, net. All other assets are reported at cost.

See *Note 12* for further discussion on other assets.

Short-Term Debt

Short-term debt can include master repurchase agreements, bank borrowings, and other forms of collateralized borrowings with various commercial banks and investment banks that expire within one year. These facilities may be unsecured or collateralized by loans or securities. Since November 2008, we have had no short-term debt outstanding.

Accrued Interest Payable

Accrued interest payable represents interest that is due and payable to third parties. Interest is generally paid within one to three months of recording the payable, based upon our remittance requirements. For borrowings where we have elected the fair value option, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Asset Backed Securities Issued   Sequoia and Acacia

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. Sequoia and Acacia assets are held in the custody of trustees. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors. ABS obligations are payable solely from the assets of these entities and are not obligations of Redwood.

Sequoia ABS Issued

Sequoia ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

Acacia ABS Issued

Acacia ABS issued are accounted for under the fair value option and carried at their estimated fair values. Changes in fair value (gains or losses) are reported in our consolidated statements of income (loss) through market valuation adjustments, net.

See *Note 13* for further discussion on ABS issued.

Long-Term Debt

Long-term debt includes trust preferred securities and subordinated notes at Redwood and is carried at its unpaid principal balance. Both are unsecured debt, requiring quarterly interest payments at a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until they are redeemed in whole or mature at a future date.

See *Note 14* for further discussion on long-term debt.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Equity

Earnings (Loss) Per Common Share

Basic earnings (loss) per share (EPS) is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS is computed by dividing net income (loss) by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period. In accordance with earnings per common share guidance, if there is a loss from continuing operations, the common stock equivalents are deemed antidilutive and diluted income (loss) per share is calculated in the same manner as basic income (loss) per share.

Effective January 1, 2009, the authoritative GAAP states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities and therefore should be included in computing EPS using the two-class method. Our adoption of this guidance required us to recast previously reported EPS and did not have a significant impact on EPS.

Other Comprehensive Income (Loss)

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements previously designated as cash flow hedges under derivative accounting literature are reported as components of other comprehensive income (loss) on our consolidated statements of equity and comprehensive income (loss). Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income (loss) are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership interests in the Fund held by third parties. In accordance with FASB noncontrolling interest guidance, the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income (loss) allocable to third parties is shown as net income (loss) attributable to noncontrolling interest in our consolidated statements of income (loss). A reconciliation of equity attributable to noncontrolling interest is disclosed in our consolidated statements of equity and comprehensive income (loss).

Equity Compensation Plans

Incentive Plan

In May 2008, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

The cost of equity awards is determined in accordance with share-based payment accounting guidance and amortized over the vesting term using an accelerated method for equity awards granted prior to December 1, 2008. For equity awards granted after December 1, 2008, the cost of the awards is amortized over the vesting period on a straight-line basis. Timing differences between the accelerated and straight-line method of amortization were determined to not be material to our financial statements.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Employee Stock Purchase Plan

In May 2009, our stockholders approved an amendment to our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

Executive Deferred Compensation Plan

In May 2002, our Board of Directors approved our 2002 Executive Deferred Compensation Plan (EDCP). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. Redwood matches some deferrals. Compensation deferred under the EDCP is an asset of Redwood and subject to the claims of the general creditors of Redwood. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

See *Note 17* for further discussion on equity compensation plans.

Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. To qualify as a REIT we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We assess our tax positions for all open tax years and determine whether we have any material unrecognized liabilities in accordance with FASB guidance on accounting for uncertainty in income taxes. We record these liabilities to the extent we deem them incurred. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income (loss).

See *Note 19* for further discussion on taxes.

Recent Accounting Pronouncements

In March 2010, the FASB issued Accounting Standards Update (ASU) 2010-11, *Scope Exception Related to Embedded Credit Derivatives*, to address questions that have been raised in practice about the intended breadth of the embedded credit derivative scope exception in ASC 815, *Derivatives and Hedging*. The amended guidance clarifies that the scope exception applies to contracts that contain an embedded credit derivative that is *only* in the form of subordination of one financial instrument to another. The amended guidance is effective at the beginning of an entity s first fiscal quarter beginning after June 15, 2010, although early adoption is permitted as of the first day of an entity s first fiscal quarter beginning after the ASU s issuance date of March 5, 2010. Upon adoption of the amended guidance, entities are permitted to elect the fair value option for beneficial interests in securitized financial assets on an instrument-by-instrument basis. Entities that elect the fair value option must prepare supporting documentation by the beginning of the period of adoption, and perform impairment analyses of applicable investments before adoption. We are currently evaluating the impact of ASU 2010-11 on our financial statements.

On February 26, 2010, the FASB issued Accounting Standards Update (ASU) 2010-10, *Amendments for Certain Investment Funds*. The ASU defers the effective date of Statement 167, *Amendments to FASB Interpretation 46(R)* (included in ASC 810-10) for a reporting enterprise s interest in certain entities and for certain money market mutual funds. It addresses concerns that the joint consolidation model under

15

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

development by the FASB and the International Accounting Standards Board (IASB) may result in a different consolidation conclusion for asset managers and that an asset manager consolidating certain funds would not provide useful information to investors. The ASU also amends certain provisions of current guidance to change how a decision maker or service provider determines whether its fee is a variable interest. The amended guidance in ASU 2010-10 is effective for fiscal years beginning after November 15, 2009, and for interim periods within those years. The adoption of ASU 2010-10 did not impact our financial statements.

Note 4. Principles of Consolidation

We apply ASC 860 and ASC 810-10 to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. ASC 860 considers whether securitizations and other transfers of financial assets are treated as sales or financings. Additionally, ASC 810-10 addresses whether VIEs (e.g., certain legal entities often used in securitization and other structured finance transactions) should be included in the consolidated financial statements of any particular interested party. These standards became effective for our interests in all VIEs as of January 1, 2010, except for the Fund, as a result of the FASB s decision to delay the applicability of ASC 810-10 for private equity funds. Our determination of whether we must consolidate the Fund was performed in accordance with FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)) at the time we acquired our interests in the Fund.

To provide information on the application of these principles, we provide our analysis of consolidated and unconsolidated VIEs below. We also note that these principles of consolidation require reassessment every quarter. Our future assessments of whether we are required to consolidate a VIE may change based upon the facts and circumstances pertaining to each VIE. This could result in a material impact to our financial statements during subsequent reporting periods.

Analysis of Consolidated VIEs

The VIEs we are required to consolidate include the Fund, certain Sequoia securitization entities, and the Acacia entities. The following table presents a summary of the assets and liabilities of these VIEs.

Assets and Liabilities of Consolidated VIEs at March 31, 2010

(In Thousands, Except VIE Data)	The Fund	Sequoia Entities	Acacia Entities	Total
Real estate loans	$	$ 3,643,143	$ 16,670	$ 3,659,813
Real estate securities	26,969		268,830	295,799
Other investments			10,762	10,762
Other assets	2,779	24,588	94,540	121,907
Total Assets	29,748	3,667,731	390,802	4,088,281
Asset-backed securities		3,557,669	279,471	3,837,140
Other liabilities	1,331	2,064	141,350	144,745
Total Liabilities	1,331	3,559,733	420,821	3,981,885
Noncontrolling interest	12,589			12,589
Number of VIEs	1	36	10	47

16

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 4. Principles of Consolidation (continued)

As noted above, we looked to FIN 46(R) to determine whether to consolidate the assets, liabilities, and noncontrolling interest of the Fund. We determined that we are the primary beneficiary of the Fund as our ongoing asset management responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of the Fund, and our significant general and limited partnership interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

Pursuant to the guidance in ASC 860, we consolidate the assets and liabilities of certain Sequoia securitization entities, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Had we not been the transferor and depositor of these securitizations; however, we would likely not have consolidated them as we determined that we are not the primary beneficiary of these entities in accordance with ASC 810-10. We note that future securitizations will be analyzed under these provisions and, although it is generally our intent to consolidate sponsored securitizations, the determination will be on a case by case basis.

We consolidate the assets and liabilities of the Acacia securitization entities, as we met the criteria for consolidation in both ASC 860 and ASC 810-10. That is, we determined that (i) we did not meet the sale criteria at the time we transferred financial assets to these entities; and (ii) we are the primary beneficiary of Acacia VIEs. Our ongoing asset management responsibilities and call options provide us with the power to direct the activities that most significantly impact the economic performance of these individual entities, and our equity investments in each entity provide us with the obligation to absorb losses or the right to receive benefits that are significant.

Analysis of Non-Consolidated VIEs

Third party VIEs are securitization entities that Redwood did not sponsor. We may own several securities from a third party VIE, and in those cases, the analysis is done in consideration of all of our interests in that VIE. In accordance with ASC 810-10, we determined that we are not the primary beneficiary of any third-party residential, commercial, re-REMIC, or CDO entities in any third party VIEs, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these VIEs we only account for our specific interests in each.

The following table presents a summary of Redwood s interest in third party VIEs at March 31, 2010, grouped by collateral type and ownership interest.

VIE Summary

March 31, 2010 (In Thousands, Except VIE Data)	Fair Value	Number of VIEs
Real estate securities at Redwood		
Residential		
Senior	$ 739,512	110
Re-REMIC	66,913	10
Subordinate	23,140	209
Commercial	8,876	15
CDO	1,222	10
Total third-party real estate securities	$ 839,663	354

17

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2010
(Unaudited)

Note 5. Fair Value Option

The fair value option gives us the option of electing to measure eligible financial assets, financial liabilities, and commitments at fair value on an instrument-by-instrument basis. This election is available when we first recognize a financial asset or financial liability or enter into a firm commitment. Subsequent changes in the fair value of these assets, liabilities, and commitments are recorded in the consolidated statements of income (loss).

Our decision to elect the fair value option for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally be accounted for as AFS. Securities and loans that we anticipate funding with a combination of debt and equity or financed through securitization liabilities will generally be accounted for at cost or fair value and the corresponding liabilities will generally be accounted for in a similar manner. Additionally, we may elect to apply the fair value option for financial instruments that may not perform similarly to our traditional real estate investments or are particularly volatile or complex.

As of March 31, 2010, the loans at Acacia had an aggregate fair value of $17 million and an unpaid principal balance of $23 million, the securities had an aggregate fair value of $269 million and an unpaid principal balance of $2.0 billion, and asset-backed securities issued at Acacia had an aggregate fair value of $279 million and an unpaid principal balance of $3.0 billion.

We elected the fair value option for certain ABS issued by Sequoia and acquired by Acacia as a result of the deconsolidation of certain Sequoia entities during the fourth quarter of 2008 and second quarter of 2009. These ABS issued had been previously eliminated as intercompany assets for financial reporting purposes. During the first quarter of 2010, we elected the fair value option for $13 million of residential senior securities that we acquired.

Note 6. Fair Value of Financial Instruments

The FASB fair value guidance defines fair value, establishes a hierarchy of information used in measuring fair value, and enhances the disclosure of information about fair value measurements. Further, it provides that the exit price should be used to value an asset or liability, which is the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale at the measurement date. Additionally, relevant market data, to the extent available, and not internally generated or entity specific information should be used to determine fair value. The financial impact on Redwood from the adoption of this guidance was not significant since our valuation methodology used in prior periods did not need to be revised to comply with the new standard.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 6. Fair Value of Financial Instruments (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value as of March 31, 2010 and December 31, 2009.

	March 31, 2010		December 31, 2009	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Real estate loans (held-for-investment)	$ 3,643,386	$ 2,958,370	$ 3,724,791	$ 3,000,496
Real estate loans (held-for-sale)	2,227	2,227	2,374	2,374
Real estate loans (fair value)	16,670	16,670	12,089	12,089
Trading securities	288,820	288,820	277,274	277,274
Available-for-sale securities	846,642	846,642	810,471	810,471
Other investments	10,762	10,762	20,371	20,371
Cash and equivalents	241,753	241,753	242,818	242,818
Derivative assets	5,520	5,520	12,372	12,372
Restricted cash	87,600	87,600	94,306	94,306
Accrued interest receivable	14,665	14,665	18,193	18,193
REO (included in other assets)	14,289	14,289	17,421	17,421
Liabilities				
Derivative liabilities	79,486	79,486	83,800	83,800
Accrued interest payable	5,390	5,390	5,968	5,968
ABS Issued				
ABS issued Sequoia	3,557,669	2,912,559	3,644,933	2,909,032
ABS issued Acacia	279,471	279,471	297,596	297,596
Total ABS issued	3,837,140	3,192,030	3,942,529	3,206,628
Long-term debt	140,000	72,800	140,000	68,600

For financial reporting purposes, we follow a fair value hierarchy established under GAAP that is used to measure the fair value of the assets and liabilities in the table above. This hierarchy prioritizes relevant market inputs in order to determine an exit price , or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale at the date of measurement. Level 1 inputs are observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability being measured at fair value.

In certain cases, inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2010
(Unaudited)

Note 6. Fair Value of Financial Instruments (continued)

The following table presents assets and liabilities recorded at fair value on our consolidated balance sheet on a recurring basis and indicates the fair value hierarchy of the valuation techniques used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of March 31, 2010

(In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Real estate loans	$ 16,670	$	$	$ 16,670
Trading securities	288,820			288,820
Available-for-sale securities	846,642			846,642
Other investments	10,762		10,762	
Derivative assets	5,520		5,498	22
Liabilities				
ABS issued Acacia	279,471			279,471
Derivative liabilities	79,486		68,763	10,723

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2009

(In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Real estate loans	$ 12,089	$	$	$ 12,089
Trading securities	277,274			277,274
Available-for-sale securities	810,471			810,471
Other investments	20,371		20,371	
Derivative assets	12,372		12,326	46
Liabilities				
ABS issued Acacia	297,596			297,596

Derivative liabilities	83,800	63,499	20,301

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 6. Fair Value of Financial Instruments (continued)

The following table presents additional information about Level 3 assets and liabilities during the three months ended March 31, 2010.

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(In Thousands)	Assets				Liabilities	
	Real Estate Loans	Trading Securities	AFS Securities	Derivative Assets	ABS Issued Acacia	Derivative Liabilities
Beginning balance December 31, 2009	$12,089	$277,274	$810,471	$ 46	$297,596	$20,301
Principal paydowns	215	(14,290)	(33,458)		(25,982)	
Gains / losses in net income, net	4,366	12,149	8,684	(20)	5,253	(186)
Gains / losses in OCI, net			(5,207)			
Acquisitions		17,137	162,772			
Sales		(3,603)	(96,646)			
Other settlements, net		153	26	(4)	2,604	(9,392)
Ending Balance March 31, 2010	$16,670	$288,820	$846,642	$ 22	$279,471	$10,723

The following table presents the portion of gains or losses included in our consolidated statement of income (loss) that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at March 31, 2010 and 2009. Gains or losses incurred on assets or liabilities sold or otherwise disposed of during the three months ended March 31, 2010 and 2009 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2010 and 2009 Included in Net Income (Loss)

	Included in Net Income (Loss) Three Months Ended March 31,	
(In Thousands)	2010	2009

Assets		
Real estate loans	$ 4,366	$ (2,246)
Trading securities	12,281	(46,471)
Available-for-sale securities	(1,946)	(29,035)
Derivative assets	(20)	160
Liabilities		
ABS issued Acacia	(5,253)	31,689
Derivative liabilities	186	271

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 6. Fair Value of Financial Instruments (continued)

The following table presents information on assets and liabilities recorded at fair value on a non-recurring basis at March 31, 2010 and December 31, 2009.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of March 31, 2010

(In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3	Gain (Loss) Three Months Ended March 31, 2010
Assets					
Real estate loans (held-for-sale)	$ 2,227	$	$	$ 2,227	$ (120)
REO	14,289			14,289	(74)

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of December 31, 2009

(In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3	Gain (Loss) Three Months Ended March 31, 2009
Assets					
Real estate loans (held-for-sale)	$ 2,374	$	$	$ 2,374	$ (21)
REO	17,421			17,421	(765)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income (loss) for the three months ended March 31, 2010 and 2009.

Market Valuation Adjustments, Net

	Three Months Ended March 31,	
(In Thousands)	2010	2009
Assets		
Real estate loans (fair value)	$ 4,366	$ (2,246)
Real estate loans (held-for-sale)	(120)	(21)
REO	(74)	(765)
Trading securities	12,149	(46,425)
Impairments on AFS securities	(1,946)	(29,035)
Liabilities		
ABS issued Acacia	(5,253)	31,689
Derivative instruments, net	(20,359)	3,561
Market Valuation Adjustments, Net	$ (11,237)	$ (43,242)

A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed below.

Real estate loans

Residential real estate loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3).

Commercial real estate loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3).

22

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 6. Fair Value of Financial Instruments (continued)

Real estate securities

Real estate securities are residential, commercial, CDO, and other asset-backed securities that are illiquid in nature and trade infrequently. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. Relevant market indicators that are factored in the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. The availability of third-party marks continues to decline, in part because some dealers no longer exist and others have ceased providing client valuation services. For March 31, 2010, we received dealer marks on 81% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were 4% lower (i.e., more conservative) than the aggregate dealer marks.

Other investments

Other investments currently include a GIC. Management considers the GIC s fair value to approximate its contract value, as the GIC earns a variable interest rate of LIBOR less 5 basis points and resets on a monthly basis (Level 2).

Derivative assets and liabilities

Our derivative instruments include interest rate agreements and credit default swaps. Fair values of derivative instruments are determined using valuation models and are verified by valuations provided by dealers active in derivative markets. Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2). For other derivatives, such as certain CDS, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market evidence. In the absence of such evidence, management s best estimate is used (Level 3).

Cash and cash equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values.

Restricted cash

Restricted cash primarily includes interest-earning cash balances in ABS entities and the Fund for the purpose of distribution to bondholders or limited partners, and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values.

Accrued interest receivable and payable

Accrued interest receivable and payable includes interest due on our assets and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values.

23

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2010
(Unaudited)

Note 6. Fair Value of Financial Instruments (continued)

Short-term debt

Short-term debt includes our credit facilities that mature within one year. Short-term debt is generally at an adjustable rate. Fair values approximate carrying values.

ABS issued

ABS issued includes asset-backed securities issued through our Sequoia and Acacia programs. These instruments are illiquid in nature and trade infrequently, if at all. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Relevant market indicators factored into the analyses include dealer price indications to the extent available, bid/ask spreads, external spreads, collateral credit losses, interest rates and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. The availability of third-party marks continues to decline, in part because some dealers no longer exist and others have ceased providing client valuation services. For March 31, 2010, we received dealer marks on 92% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 9% higher (i.e., more conservative) than the aggregate dealer marks.

Long-term debt

Long-term debt includes our subordinated notes and trust preferred securities. Fair values are determined using comparable market indicators of current pricing. Significant inputs in the valuation analysis are predominantly Level 3 due to the nature of these instruments and the lack of readily available market quotes. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

Real Estate Owned (REO)

REO includes properties owned in satisfaction of foreclosed loans. Fair values are determined using available market quotes, appraisals, broker price opinions, comparable properties, or other indications of value (Level 3).

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 7. Real Estate Loans

We invest in residential and commercial real estate loans that we acquire from third party originators. We finance these loans through the Sequoia and Acacia entities that we sponsor or with equity or long-term debt.

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans recorded on our consolidated balance sheets at March 31, 2010 and December 31, 2009.

(In Thousands)	March 31, 2010	December 31, 2009
Residential real estate loans (held-for-sale)	$ 2,227	$ 2,374
Residential real estate loans (held-for-investment)	3,643,143	3,724,546
Commercial real estate loans (fair value)	16,670	12,089
Commercial real estate loans (held-for-investment)	243	245
Total Real Estate Loans	$ 3,662,283	$ 3,739,254

Residential Real Estate Loans Held-for-Sale

Residential real estate loans held-for-sale are owned at Redwood and financed with equity. At both March 31, 2010 and December 31, 2009, there were 14 residential loans held-for-sale with $4 million in outstanding principal value and a lower of cost or fair value of $2 million.

Residential Real Estate Loans Held-for-Investment

Residential real estate loans held-for-investment are owned at the consolidated Sequoia securitization entities. The following table provides additional information on residential real estate loans held-for-investment at March 31, 2010 and December 31, 2009.

(In Thousands)	March 31, 2010	December 31, 2009
Principal value	$ 3,656,655	$ 3,728,738
Unamortized premium, net	47,657	50,028
Allowance for loan losses	(61,169)	(54,220)
Carrying Value	$ 3,643,143	$ 3,724,546

Of the $3.7 billion of principal face and $48 million of unamortized premium on these loans at March 31, 2010, $1.8 billion of principal face and $31 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the first quarter of 2010, 2% of these residential loans prepaid and we amortized 6% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal face was $1.9 billion and the unamortized premium was $17 million at March 31, 2010. During the first quarter of 2010, 2% of these residential loans prepaid and we amortized 3% of the premium.

Of the $3.7 billion of principal face and $50 million of unamortized premium on these loans at December 31, 2009, $1.8 billion of principal face and $33 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the fourth quarter of 2009, 2% of these residential loans prepaid and we amortized 7% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal face was $1.9 billion and the unamortized premium was $17 million at December 31, 2009. During the fourth quarter of 2009, 2% of these residential loans prepaid and we amortized 4% of the premium.

Commercial Real Estate Loans

Commercial real estate loans at fair value are owned at the consolidated Acacia securitization entities. At March 31, 2010, there were four commercial loans at fair value with an aggregate outstanding principal value

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 7. Real Estate Loans (continued)

of $23 million and an aggregate fair value of $17 million, one of which has been delinquent since May 2009 with an outstanding principal balance of $4 million and a fair value of $3 million. At December 31, 2009, there were four commercial loans at fair value, with an outstanding principal of $23 million and a fair value of $12 million. The fair value of our commercial loans increased by $5 million during the first quarter as there was increased clarity regarding a bankruptcy and the resumption of payments in the near future.

At March 31, 2010, there was one commercial loan held-for-investment with $0.5 million in outstanding principal value and a carrying value of $0.2 million. During the first quarter of 2010, we charged off a $10 million commercial mezzanine loan with no impact to our consolidated statements of income (loss), as we had fully reserved for this loan in 2007. At December 31, 2009, there were two commercial loans held-for-investment with $11 million in outstanding principal value and a carrying value of $0.2 million.

Note 8. Allowance for Loan Losses

We establish an allowance for loan losses on our residential and commercial loans held-for-investment based on our estimate of losses incurred in these loan portfolios.

Activity in the Allowance for Losses on Residential Loans

At March 31, 2010 and December 31, 2009, all residential loans classified as held-for-investment were owned by Sequoia entities. The following table summarizes the activity in the allowance for loan losses on residential loans for the three months ended March 31, 2010 and 2009.

	Three Months Ended March 31,	
(In Thousands)	2010	2009
Balance at Beginning of Period	$ 54,220	$ 35,713
Charge-offs, net	(2,526)	(3,798)
Provision for loan losses	9,475	16,032
Balance at End of Period	$ 61,169	$ 47,947

Serious delinquencies on consolidated Sequoia loans were $158 million and $155 million as of March 31, 2010 and 2009, respectively. Serious delinquencies include loans delinquent more than 90 days and in foreclosure. As a percentage of current loan balances, serious delinquencies were 4.32% and 3.43% at March 31, 2010 and 2009, respectively.

When we pursue foreclosure in full satisfaction for a defaulted loan, we estimate the specific loan loss, if any, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs), and charge this specific estimated loss against the allowance for loan losses. During the first quarter of 2010, there were $3 million of charge-offs that reduced our allowance for loan losses. These charge-offs arose from $9 million of defaulted loan principal. Foreclosed property is subsequently recorded as REO, a component of other assets.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2010
(Unaudited)

Note 9. Real Estate Securities

We invest in third party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity as of March 31, 2010 and December 31, 2009.

March 31, 2010 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 829,565	$ 22,874	$ 201,388	$ 1,053,827
Commercial	8,876		54,542	63,418
CDO	1,222	4,095	12,900	18,217
Total Real Estate Securities	$ 839,663	$ 26,969	$ 268,830	$ 1,135,462

December 31, 2009 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 770,916	$ 32,884	$ 201,367	$ 1,005,167
Commercial	9,200		54,206	63,406
CDO	1,247	4,067	13,858	19,172
Total Real Estate Securities	$ 781,363	$ 36,951	$ 269,431	$ 1,087,745

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 9. Real Estate Securities (continued)

The following table presents our securities by trading and AFS, collateral type, and entity as of March 31, 2010 and December 31, 2009.

March 31, 2010	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 5,031	$ 5,031	$ 372,140	$	$ 372,140
Residential non-prime	18,231	102,491	120,722	349,141	16,560	365,701
Commercial		10,220	10,220			
Total Senior Securities	18,231	117,742	135,973	721,281	16,560	737,841
Re-REMIC Securities				66,913		66,913
Subordinate Securities						
Residential prime	346	24,642	24,988	16,250		16,250
Residential non-prime	191	69,224	69,415	6,353	6,314	12,667
Commercial		44,322	44,322	8,876		8,876
CDO	1,222	12,900	14,122		4,095	4,095
Total Subordinate Securities	1,759	151,088	152,847	31,479	10,409	41,888
Total Real Estate Securities	$ 19,990	$ 268,830	$ 288,820	$ 819,673	$ 26,969	$ 846,642

December 31, 2009	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 4,826	$ 4,826	$ 329,208	$	$ 329,208
Residential non-prime	6,084	100,397	106,481	308,868	26,735	335,603
Commercial		9,508	9,508			
Total Senior Securities	6,084	114,731	120,815	638,076	26,735	664,811
Re-REMIC Securities				105,951		105,951
Subordinate Securities						
Residential prime	319	27,380	27,699	19,191		19,191
Residential non-prime	218	68,764	68,982	1,077	6,149	7,226
Commercial		44,698	44,698	9,200		9,200
CDO	1,222	13,858	15,080	25	4,067	4,092
Total Subordinate Securities	1,759	154,700	156,459	29,493	10,216	39,709

Total Real Estate Securities	$ 7,843	$ 269,431	$ 277,274	$ 773,520	$ 36,951	$ 810,471

Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests. Prime residential securities are securities backed by prime residential loans that generally have low loan-to-value ratios (typically 75% LTV or less), are made to borrowers who have high FICO scores (typically 700 or higher), and typically have low concentrations of investor properties. Non-prime residential securities are generally backed by loans that have higher loan-to-value ratios, are made to borrowers who have lower credit scores or impaired credit histories (but exhibit the ability to repay their loans), and may have

28

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 9. Real Estate Securities (continued)

higher concentrations of investor properties. At March 31, 2010, all of our real estate securities had contractual maturities over ten years, except for less than $1 million of residential securities that had contractual maturities greater than five years but less than ten years.

AFS Securities

We generally purchase AFS securities at a discount. To the extent we purchase an AFS security that has a likelihood of incurring credit loss, we generally will not amortize into income the portion of the purchase discount that, although we are entitled to earn, we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion of our investment in the security to the extent we believe that principal losses will exceed the purchase discount. We designate the amount of principal face that we do not expect to receive and will not amortize into income as a credit reserve on the security, with any remaining net unamortized discounts or premiums amortized into income over time using the interest method.

The following table presents the components of carrying value (which equals fair value) of AFS securities as of March 31, 2010 and December 31, 2009.

March 31, 2010 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$ 1,495,304	$ 152,408	$ 89,397	$ 1,737,109
Credit reserve	(388,078)	(139,320)	(87,103)	(614,501)
Net unamortized (discount) premium	(355,194)	(5,660)	9,379	(351,475)
Amortized cost	752,032	7,428	11,673	771,133
Gross unrealized gains	114,580	1,886		116,466
Gross unrealized losses	(32,941)	(438)	(7,578)	(40,957)
Carrying Value	$ 833,671	$ 8,876	$ 4,095	$ 846,642

December 31, 2009 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$ 1,581,692	$ 158,997	$ 89,371	$ 1,830,060
Credit reserve	(469,273)	(146,018)	(87,017)	(702,308)
Net unamortized (discount) premium	(401,808)	(5,130)	8,941	(397,997)
Amortized cost	710,611	7,849	11,295	729,755

Gross unrealized gains	130,914	1,422	25	132,361
Gross unrealized losses	(44,346)	(71)	(7,228)	(51,645)
Carrying Value	$ 797,179	$ 9,200	$ 4,092	$ 810,471

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 9. Real Estate Securities (continued)

The following table presents the changes for the three months ended March 31, 2010 of the unamortized discount and designated credit reserves on AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

	Residential		Commercial		CDO	
(In Thousands)	Credit Reserve	Unamortized Discount Net	Credit Reserve	Unamortized Discount Net	Credit Reserve	Unamortized Discount Net
Beginning balance December 31, 2009	$469,273	$401,808	$146,018	$5,130	$87,017	$(8,941)
Amortization of net discount		(10,596)		319		(352)
Realized credit losses	(43,194)		(6,590)			
Acquisitions	8,966	43,388				
Sales, calls, other	(52,335)	(75,881)				
Impairments	1,843		103			
Transfers to (release of) credit reserves	3,525	(3,525)	(211)	211	86	(86)
Ending Balance March 31, 2010	$388,078	$355,194	$139,320	$5,660	$87,103	$(9,379)

The loans underlying our residential subordinate securities totaled $64 billion at March 31, 2010. These loans are located nationwide with a large concentration in California (47%). Serious delinquencies (90+ days, in foreclosure or REO) at March 31, 2010 were 7.69% of current principal balances. The loans underlying our commercial subordinate securities totaled $25 billion at March 31, 2010, and consist primarily of office (37%), retail (33%), and multifamily (13%) loans. These loans are located nationwide with the highest concentration in California (13%). Serious delinquencies (60+ days, in foreclosure or REO) at March 31, 2010 were 3.70% of current principal balances.

AFS Securities with Unrealized Losses

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position as of March 31, 2010 and December, 31 2009.

March 31, 2010 (In Thousands)	Less Than 12 Consecutive Months Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	12 Consecutive Months or Longer Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$146,464	$(3,977)	$142,487	$66,296	$(28,964)	$37,331
Commercial	2,909	(438)	2,471			
CDO	4,264	(2,309)	1,955	7,409	(5,269)	2,141
Total Securities	$153,637	$(6,724)	$146,913	$73,705	$(34,233)	$39,472

December 31, 2009 (In Thousands)	Less Than 12 Consecutive Months Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	12 Consecutive Months or Longer Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$73,075	$(30,520)	$42,555	$42,368	$(13,826)	$28,542
Commercial	2,719	(71)	2,648			
CDO	4,091	(2,136)	1,955	7,204	(5,092)	2,112
Total Securities	$79,885	$(32,727)	$47,158	$49,572	$(18,918)	$30,654

30

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2010
(Unaudited)

Note 9. Real Estate Securities (continued)

At March 31, 2010, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 552 AFS securities, of which 189 were in an unrealized loss position, of which 105 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2009, our consolidated balance sheet included 554 AFS securities, of which 220 were in a continuous unrealized loss position and 72 were in a continuous unrealized loss position for twelve months or longer.

Of the total unrealized losses at March 31, 2010 and December 31, 2009, $10 million and $14 million, respectively, relate to securities owned at the Fund. The remaining unrealized losses relate to securities owned at Redwood.

Evaluating AFS Securities for Other-than-Temporary Impairments

When the fair value of an AFS security is below our cost basis, we evaluate the security for OTTI. Part of this evaluation is based upon significant adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities as of March 31, 2010.

Significant Valuation Assumptions

	Range for Securities		
March 31, 2010	Prime	Non-prime	Commercial
Prepayment rates	2 15 %	1 12 %	N/A
Loss severity[(1)]	13 64 %	21 63 %	34 50 %
Projected losses[(1)]	0 20 %	1 55 %	2 11 %

(1) Projected losses and severities are generally vintage specific, with the 2005 and later vintage securities having higher projected losses and severities and the 2004 and earlier vintages having the lower projected losses and severities.

During the three months ended March 31, 2010, we determined that $4 million of OTTI existed, of which $2 million was recognized in our consolidated statement of income (loss). We determined that $1 million of this $2 million related to securities with only credit-related OTTI and no corresponding non-credit component. The remaining $1 million was the aggregate credit component of OTTI for securities that also had an aggregate non-credit component of $2 million that was not recognized in our consolidated statements of income (loss).

The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at March 31, 2010.

Activity of Credit Component of Other-than-Temporary Impairments

(In Thousands)	Three Months Ended March 31, 2010
Balance at beginning of period	$ 181,913
Current period activity:	
Additions related to AFS securities that were not previously impaired	90
Additions related to AFS securities that were previously impaired	1,296
Balance at End of Period	$ 183,299

31

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2010
(Unaudited)

Note 9. Real Estate Securities (continued)

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income (loss). The following table presents the gross realized gains and losses on sales of AFS securities for the three months ended March 31, 2010 and 2009.

	Three Months Ended March 31,	
(In Thousands)	2010	2009
Gross realized gains sales	$ 38,854	$ 337
Gross realized losses sales	(1,475)	
Total Realized Gains on Sales of AFS Securities, net	$ 37,379	$ 337

Note 10. Other Investments

Other investments include a GIC owned by an Acacia securitization entity and recorded on our consolidated balance sheets at its estimated fair value. This GIC represents a deposit certificate issued by a rated investment bank and serves as collateral to cover realized losses on CDS entered into by this same Acacia entity. The CDS reference residential mortgage-backed securities issued in 2006 that were initially A and BBB-rated and have subsequently been downgraded. The fair value of the GIC was $11 million as of March 31, 2010, which is equal to its carrying value. The GIC has been drawn down by $69 million since its acquisition to cover credit losses and principal reductions on the referenced securities.

Note 11. Derivative Financial Instruments

We report our derivative financial instruments at fair value as determined using third-party models and confirmed by broker/dealers that make markets in these instruments. Derivatives with a positive fair value are accounted for as assets while derivatives with a negative fair value are accounted for as liabilities. Redwood and the consolidated Acacia entities held derivative positions at March 31, 2010. Acacia s derivative financial instruments are owned by Acacia securitization entities and are not the obligations of Redwood.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 11. Derivative Financial Instruments (continued)

The following table shows the aggregate fair value and notional amount by entity of our derivative financial instruments as of March 31, 2010 and December 31, 2009.

March 31, 2010 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Accounted for as Cash Flow Hedges						
Interest rate swaps	$281	$60,000	$	$	$281	$60,000
Assets Accounted for as Trading Instruments						
Interest rate swaps			757	73,536	757	73,536
Interest rate caps purchased			4,482	711,800	4,482	711,800
Total Assets	281	60,000	5,239	785,336	5,520	845,336
Liabilities Accounted for as Cash Flow Hedges						
Interest rate swaps	(693)	80,000			(693)	80,000
Liabilities Accounted for as Trading Instruments						
Interest rate swaps	(1,984)	14,100	(66,086)	770,995	(68,070)	785,095
Credit default swaps			(10,723)	10,723	(10,723)	10,723
Total Liabilities	(2,677)	94,100	(76,809)	781,718	(79,486)	875,818
Total Derivative Financial Instruments, net	$(2,396)	$154,100	$(71,570)	$1,567,054	$(73,966)	$1,721,154

December 31, 2009 (In Thousands)	Redwood Fair Value	Notional Amount	Acacia Fair Value	Notional Amount	Total Fair Value	Notional Amount
Assets Accounted for as Trading Instruments						
Interest rate swaps	$	$	$738	$73,563	$738	$73,563
Interest rate caps purchased			11,634	711,800	11,634	711,800
Total Assets			12,372	785,363	12,372	785,363

Liabilities Accounted for as Trading Instruments						
Interest rate swaps	(1,597)	14,100	(61,902)	784,856	(63,499)	798,956
Credit default swaps			(20,301)	20,301	(20,301)	20,301
Total Liabilities	(1,597)	14,100	(82,203)	805,157	(83,800)	819,257
Total Derivative Financial Instruments, net	$(1,597)	$14,100	$(69,831)	$1,590,520	$(71,428)	$1,604,620

Interest Rate Agreements

We currently account for our interest rate agreements as trading instruments or as cash flow hedges. For interest rate agreements accounted for as trading instruments, changes in the fair value and all associated income and expenses are reported in our consolidated statements of income (loss) as a component of market valuation adjustments, net. We had net valuation adjustments on interest rate agreements accounted for as trading instruments of negative $21 million and positive $3 million for the three months ended March 31, 2010 and 2009, respectively.

33

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 11. Derivative Financial Instruments (continued)

To hedge the variability in our long-term debt interest expense, we entered into interest rate swaps with an aggregate notional balance of $140 million during the three months ended March 31, 2010, which we designated as cash flow hedges and record all interest income or expense as a component of net interest income and other valuation changes (excluding amounts deemed ineffective) are recorded as a component of equity. To the extent the derivatives are deemed ineffective, that portion is included as a component of net interest income. For the three months ended March 31, 2010, these hedges did not have any interest income or expense, decreased in value by less than $1 million, and had no ineffectiveness. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income (loss) was negative $22 million at March 31, 2010, and December 31, 2009. We reclassified less than $1 million and $1 million of unrealized losses on derivatives previously designated as cash flow hedges to interest expense for the three months ended March 31, 2010 and 2009, respectively.

Credit Derivatives

All of our existing CDS contracts were initiated during 2007 by an Acacia securitization entity that we have consolidated for financial reporting purposes. As the seller of these contracts we receive a fixed-rate premium and have assumed the credit risk of the reference securities.

These CDS are accounted for as trading instruments. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a specific credit event, the market perception of default risk and counterparty risk, and supply and demand changes. A qualifying credit event, defined as an interest shortfall, a failure to pay principal, or a distressed rating downgrade, may trigger Acacia as the seller of protection to compensate the counterparty (which it does so by drawing down on the GIC it owns). During the three months ended March 31, 2010 and 2009, the reference securities underlying our CDS experienced principal losses resulting in a $10 million and $17 million obligation, respectively. During the three months ended March 31, 2010 and 2009, the fair value of these CDS increased less than $1 million.

At March 31, 2010, our CDS had a fair value of negative $11 million and a notional amount of $11 million. At December 31, 2009, our CDS had a fair value of negative $20 million and a notional amount of $20 million. At both March 31, 2010 and December, 31 2009, all of our CDS had expiration dates of greater than 15 years and the credit ratings of the reference securities were CCC or lower.

Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. To mitigate this risk, we enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the Federal Reserve Bank of New York as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated A or higher. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

As of March 31, 2010, Redwood had outstanding derivative agreements with three bank counterparties and Acacia entities had outstanding derivative agreements with seven bank counterparties. As of March 31, 2010, both Redwood and Acacia entities were in compliance with International Swaps and Derivatives Association (ISDA) agreements governing these open derivative positions.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 12. Other Assets

Other assets as of March 31, 2010 and December 31, 2009, are summarized in the following table.

Other Assets

(In Thousands)	March 31, 2010	December 31, 2009
Real estate owned (REO)	$ 14,289	$ 17,421
Fixed assets and leasehold improvements	3,914	3,630
Derivative margin receivables	5,237	1,830
Investment receivable	1,256	667
Income tax receivables	1,244	65
Prepaid expenses	1,478	2,180
Other	158	349
Total Other Assets	$ 27,576	$ 26,142

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at March 31, 2010, was $14 million, of which $4 million related to transfers into REO during the first quarter of 2010, offset by $6 million of REO liquidations, and $1 million of negative market valuation adjustments. The carrying value of REO as of December 31, 2009, was $17 million, of which $29 million related to transfers into REO during 2009, offset by $24 million of REO liquidations, $3 million of negative valuation changes, and $4 million of REO derecognized as a result of our deconsolidation of certain Sequoia entities.

At March 31, 2010, there were 61 REO properties recorded on our balance sheet, of which 60 were owned at Sequoia and one was owned at Redwood. At December 31, 2009, there were 79 REO properties recorded on our balance sheet, of which 78 were owned at Sequoia and one was owned at Redwood. Properties located in California, Ohio, Georgia, and Michigan accounted for 46% of our REO outstanding at March 31, 2010.

Note 13. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities that we sponsor issue ABS to acquire assets from us and from third parties. Each series of ABS issued consists of various classes that pay interest on a monthly or quarterly basis. Substantially all ABS issued pay variable rates of interest, which are indexed to one, three, or six-month LIBOR. Some ABS issued pay fixed rates of interest or pay hybrid rates, which are fixed rates that subsequently adjust to variable rates. ABS issued also include some interest-only classes with coupons set at a fixed-rate or a fixed spread, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 13. Asset-Backed Securities Issued (continued)

The components of ABS issued by consolidated securitization entities we sponsor as of March 31, 2010 and December 31, 2009, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	March 31, 2010			December 31, 2009		
(In Thousands)	Sequoia	Acacia	Total	Sequoia	Acacia	Total
Certificates with principal value	$3,542,070	$3,002,299	$6,544,369	$3,627,952	$3,026,307	$6,654,259
Interest-only certificates	18,016		18,016	19,190		19,190
Unamortized premium	2,192		2,192	2,371		2,371
Unamortized discount	(4,609)		(4,609)	(4,580)		(4,580)
Fair value adjustment, net		(2,722,828)	(2,722,828)		(2,728,711)	(2,728,711)
Total ABS Issued	$3,557,669	$279,471	$3,837,140	$3,644,933	$297,596	$3,942,529
Range of weighted average interest rates, by series	0.42% to 4.53%	0.71% to 1.10%		0.44% to 4.69%	0.70% to 1.13%	
Stated maturities	2024 2047	2039 2052		2024 2047	2039 2052	
Number of series	36	10		36	10	

The maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of ABS issued will often occur earlier than its stated maturity. As of March 31, 2010, all of the $3.8 billion reported value of ABS issued ($6.5 billion principal value) had contractual maturities of over five years. Amortization of deferred ABS issuance costs was less than $1 million for each of the three months ended March 31, 2010 and 2009.

The following table summarizes the accrued interest payable on ABS issued as of March 31, 2010 and December 31, 2009. Interest due on Sequoia ABS issued is settled monthly and interest due on Acacia ABS issued is settled quarterly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	March 31, 2010	December 31, 2009
Sequoia	$ 2,060	$ 2,356
Acacia	2,747	3,002
Total Accrued Interest Payable on ABS Issued	$ 4,807	$ 5,358

36

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 13. Asset-Backed Securities Issued (continued)

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding as of March 31, 2010 and December 31, 2009.

Collateral for Asset-Backed Securities Issued

	March 31, 2010			December 31, 2009		
(In Thousands)	Sequoia	Acacia	Total	Sequoia	Acacia	Total
Real estate loans	$3,643,143	$16,670	$3,659,813	$3,724,546	$12,090	$3,736,636
Real estate securities		300,325	300,325		303,852	303,852
Other investments		10,762	10,762		20,371	20,371
Real estate owned (REO)	13,967		13,967	17,087		17,087
Restricted cash	284	84,627	84,911	310	89,057	89,367
Accrued interest receivable	6,033	4,035	10,068	6,931	4,731	11,662
Total Collateral for ABS Issued	$3,663,427	$416,419	$4,079,846	$3,748,874	$430,101	$4,178,975

Note 14. Long-Term Debt

In 2006, we issued $100 million of trust preferred securities through Redwood Capital Trust I, a wholly-owned Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than January 30, 2037. The weighted average interest rate on our trust preferred securities was 3.23% and 4.91%, for the three months ended March 31, 2010 and 2009, respectively. The earliest optional redemption date without penalty is January 30, 2012.

In 2007, we issued an additional $50 million of subordinated notes, which require quarterly distributions at a floating interest rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole, which will be no later than July 30, 2037. The weighted average interest rate on our subordinated notes was 3.23% and 4.91%, for the three months ended March 31, 2010 and 2009, respectively. The earliest optional redemption date without a penalty is July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt for $3.4 million and recorded a $6.6 million gain on extinguishment of debt in realized gains, net, on our consolidated statements of income (loss).

At both March 31, 2010 and December 31, 2009, the accrued interest payable balance on long-term Redwood debt was less than $1 million. There are no financial covenants associated with our long-term debt.

Note 15. Commitments and Contingencies

Lease Commitments

As of March 31, 2010, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $12 million. The majority of the future lease obligations relates to a ten-year operating lease for our executive office that expires in 2013 and a lease for additional space that expires in 2018. The total payments required under these leases are recognized as office rent expense on a straight-line basis over the lease terms. Operating lease expense was less than $1 million for each of the three months ended March 31, 2010 and 2009.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 15. Commitments and Contingencies (continued)

The following table presents our future lease commitments as of March 31, 2010.

Future Lease Commitments by Year

(In Thousands)	March 31, 2010
2010 (nine months)	$ 1,326
2011	1,831
2012	1,882
2013	1,439
2014	1,132
2015 and thereafter	4,120
Total	$ 11,730

Leasehold improvements for our offices are amortized into expense over the ten-year lease term, expiring in 2013. The unamortized leasehold improvement balance was $3 million at both March 31, 2010 and December 31, 2009.

Loss Contingencies Litigation

On December 23, 2009, the Federal Home Loan Bank of Seattle filed a claim in Superior Court for the State of Washington against us, our subsidiary, Sequoia Residential Funding, Inc., Morgan Stanley & Co., and Morgan Stanley Capital, Inc. The complaint relates in part to residential mortgage-backed securities (RMBS) with a rate of LIBOR plus 0.22% that were issued in 2005 by a securitization trust with respect to which Sequoia Residential Funding, Inc. was the depositor and purchased at the time of issuance by the Federal Home Loan Bank of Seattle. The Federal Home Loan Bank of Seattle alleges that, at the time of issuance, we, Sequoia Residential Funding, and the underwriters of the Sequoia Mortgage Trust 2005-4 securitization made various misstatements and omissions about these RMBS in violation of Washington state law. The Federal Home Loan Bank of Seattle seeks, under Washington law, to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys fees and costs.

In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due.

We believe that this claim is without merit and we intend to defend the action vigorously. However, the outcome of this matter cannot be determined at this time, and the results cannot be predicted with certainty; there can be no assurance that this matter will not have a material adverse effect on our results of operations in any future period, and any loss and expense related to this litigation could have a material adverse impact on our consolidated financial statements.

38

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 16. Equity

The following table provides a summary of changes to stockholders equity for the three months ended March 31, 2010.

Stockholders Equity

(In Thousands)	Three Months Ended March 31, 2010
Beginning Stockholders Equity	$ 971,721
Issuance of new equity capital, net	6,199
Unrealized losses on securities and derivatives, net	(7,263)
Distributions to shareholders	(19,894)
Net income	46,843
Ending Stockholders Equity	$ 997,606

Earnings Per Common Share

The following table provides the basic and diluted earnings (loss) per common share computations for the three months ended March 31, 2010 and 2009.

Basic and Diluted Earnings (Loss) Per Common Share

(In Thousands, Except Share Data)	Three Months Ended March 31, 2010	2009
Basic Earnings (Loss) Per Common Share:		
Net income (loss) attributable to Redwood Trust, Inc.	$46,843	$(34,944)
Less: Dividends and undistributed earnings allocated to participating securities	1,298	
Net income (loss) allocated to common shareholders	$45,545	$(34,944)
Basic weighted average common shares outstanding	77,677,235	53,632,132
Basic Earnings (Loss) Per Common Share	$0.59	$(0.65)

Diluted Earnings (Loss) Per Common Share:		
Net income (loss) attributable to Redwood Trust, Inc.	$46,843	$(34,944)
Less: Dividends and undistributed earnings allocated to participating securities	1,012	
Net income (loss) allocated to common shareholders	$45,831	$(34,944)
Basic weighted average common shares outstanding	77,677,235	53,632,132
Net effect of dilutive equity awards	865,064	
Diluted weighted average common shares outstanding	78,542,299	53,632,132
Diluted Earnings (Loss) Per Common Share	$0.58	$(0.65)

We determine earnings per common share under the two-class method prescribed by GAAP. The two-class method is an earnings allocation formula that determines earnings per common share for each share of common stock and participating securities. All outstanding unvested equity awards that have nonforfeitable rights to dividends or dividend equivalents are defined as participating securities. Under the two-class method, earnings (both distributed and undistributed) are allocated to common shares and participating securities based

39

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 16. Equity (continued)

upon their respective rights to receive dividends. Earnings per common share are calculated by dividing earnings allocated to common shareholders by the weighted-average number of common shares outstanding during the period.

For the three months ended March 31, 2010, there were 865,064 dilutive equity awards under the two-class method. Participating securities were included in the calculation of diluted earnings per common share using the two-class method for the three months ended March 31, 2010, as this computation was more dilutive than using the treasury stock method. For the three months ended March 31, 2009, there were no dilutive equity awards based on our reported net loss for this period. For the three months ended March 31, 2010 and 2009, the number of outstanding equity awards that were antidilutive totaled 496,767 and 1,009,291, respectively. There were no other participating securities during these periods.

Stock Repurchases

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the three months ended March 31, 2010 and 2009, there were no shares acquired under the plan. As of March 31, 2010, there remained 4,658,071 shares available for repurchase under this plan.

Accumulated Other Comprehensive Income

The following table provides a summary of the components of accumulated other comprehensive income as of March 31, 2010 and December 31, 2009.

(In Thousands)	March 31, 2010	December 31, 2009
Net unrealized gains on real estate securities	$75,509	$80,716
Less: Unrealized losses attributable to noncontrolling interest	(4,477)	(6,614)
Net unrealized gains on real estate securities recognized in equity	79,986	87,330
Net unrealized losses on interest rate agreements accounted for as cash flow hedges	(22,389)	(22,470)
Total Accumulated Other Comprehensive Income	$57,597	$64,860

At March 31, 2010, the net unrealized gains on AFS securities were $76 million, a $5 million decrease from the net unrealized gains of $81 million at December 31, 2009. During the first three months of 2010, $2 million of net unrealized losses were reclassified to earnings upon recognition of OTTI, a $24 million decrease in unrealized gains was recognized on the sale of securities, and $17 million of fair value increases in securities were recognized in net unrealized gains. A portion of these net unrealized losses, $4 million at March 31, 2010 and $7 million at December 31, 2009, were attributable to the noncontrolling interest on AFS securities owned by the Fund.

At March 31, 2010, interest rate agreements, previously or currently accounted for as cash flow hedges, had an unrealized loss of $22 million, which will be expensed through our consolidated statements of income (loss) over the remaining lives of previously designated hedged items (See *Note 11*), which will generally be $1 million per quarter.

Noncontrolling Interest

Of the total equity on our balance sheet at March 31, 2010, $13 million is noncontrolling interest. Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third parties. As of March 31, 2010, the noncontrolling interest represents a 48% third-party interest in the Fund. Income allocated to the noncontrolling interest is based on the third party LP ownership percentage. The

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 16. Equity (continued)

ownership percentage is determined by dividing the number of units held by third party LP investors by the total units outstanding. Subsequent changes, if any, in our ownership percentage would be treated as equity transactions and result in a reallocation between shareholders equity and noncontrolling interest in our consolidated balance sheets.

Note 17. Equity Compensation Plans

As of March 31, 2010 and December 31, 2009, 445,471 and 783,911 shares of common stock, respectively, were available for grant under Redwood s Incentive Plan. The unamortized compensation cost under the Incentive Plan and the Employee Stock Purchase Plan totaled $14 million at March 31, 2010, as shown in the following table.

	Three Months Ended March 31, 2010				
(In Thousands)	Stock Options	Restricted Stock	Deferred Stock Units	Employee Stock Purchase Plan	Total
Unrecognized compensation cost at beginning of period	$	$ 879	$ 16,081	$	$ 16,960
Equity grants		7	2,646	177	2,830
Equity compensation cost		(86)	(5,917)	(56)	(6,059)
Unrecognized Compensation Cost at End of Period	$	$ 800	$ 12,810	$ 121	$ 13,731

The weighted average amortization period remaining for all of our equity awards was one year at March 31, 2010.

Stock Options

At both March 31, 2010 and December 31, 2009, there were 500,073 of stock options outstanding. All of the outstanding stock options were fully vested as of March 31, 2010. The aggregate intrinsic value of the options outstanding and options currently exercisable was less than $1 million at both March 31, 2010 and December 31, 2009.

There were no stock options exercised for the three months ended March 31, 2010. There were 6,500 stock options exercised for the three months ended March 31, 2009. None of these stock option exercises were by executive officers. The total intrinsic value or gain (fair market value less exercise price) for options exercised was less than $1 million for the three months ended March 31, 2009.

Restricted Stock

As of March 31, 2010 and December 31, 2009, there were 62,951 and 75,645 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through January 2014. There were no restricted stock awards granted during the three months ended March 31, 2010.

Deferred Stock Units

As of March 31, 2010 and December 31, 2009, there were 2,048,762 and 1,708,326, respectively, of DSUs outstanding, of which 502,218 and 294,430, respectively, had vested. There were 358,227 DSUs granted during the three months ended March 31, 2010 which will vest over the next two to four years. There were no DSUs granted during the three months ended March 31, 2009. During the three months ended March 31, 2009, the number of DSUs distributed to participants in the Executive Deferred Compensation Plan (EDCP) totaled 248,794. Cash distributions to EDCP participants of some of their previously deferred compensation and vested matching totaled $7 million during the three months ended March 31, 2009. There were no cash or DSU distributions to EDCP participants during the three months ended March 31, 2010.

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 17. Equity Compensation Plans (continued)

In March 2010, vesting of 376,564 DSUs previously awarded to Mr. George E. Bull, III, was accelerated to June 1, 2010, in connection with the announcement that he would retire from serving as Chief Executive Officer in the second quarter of 2010. We recorded a $4 million equity compensation expense during the three months ended March, 31, 2010 related to the modification of these DSUs. No such equity award modifications occurred during the three months ended March 31, 2009.

Employee Stock Purchase Plan

The ESPP allows a maximum of 200,000 shares of common stock to be purchased in aggregate for all employees. As of March 31, 2010 and December 31, 2009, 99,355 and 92,479 shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

Note 18. Operating Expenses

Components of our operating expenses for the three months ended March 31, 2010 and 2009 are presented in the following table.

Operating Expenses

	Three Months Ended March 31,	
(In Thousands)	2010	2009
Fixed compensation expense	$ 4,109	$ 4,028
Variable compensation expense	1,880	556
Equity compensation expense	6,059	1,795
Severance expense	81	28
Total compensation expense	12,129	6,407
Systems	1,577	1,594
Office costs	1,765	1,750
Accounting and legal	1,466	559
Other operating expenses	369	229
Total Operating Expenses	$ 17,306	$ 10,539

Note 19. Taxes

For each of the three months ended March 31, 2010 and 2009, we recognized a provision for income taxes of less than $1 million. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at March 31, 2010 and 2009.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	March 31,	
	2010	2009
Federal statutory rate	34.0 %	34.0 %
State statutory rate, net of Federal tax effect	7.2 %	7.2 %
Differences in taxable (loss) income from GAAP income (loss)	(41.1)%	(41.5)%
Effective Tax Rate	0.1 %	(0.3)%

In November 2009, our Board of Directors announced its intention to pay a regular quarterly dividend to shareholders during 2010 of $0.25 per share. The first quarter of 2010 regular dividend has been declared and paid.

42

TABLE OF CONTENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2010 (Unaudited)

Note 19. Taxes (continued)

We assessed our tax positions for all open tax years (Federal years 2006 to 2008, State years 2005 to 2008) and concluded as of March 31, 2010 and December 31, 2009, that we have no material unrecognized liabilities.

Note 20. Subsequent Events

During April 2010, we acquired and transferred $238 million of recently originated, first-lien, residential mortgage loans into Sequoia Mortgage Trust 2010-H1, a Sequoia securitization entity sponsored by us. We anticipate consolidating this entity for financial reporting purposes, pending our final interpretation of applicable GAAP pertaining to the transfer of financial assets and consolidation of VIEs. We acquired certain securities issued by this securitization entity for an aggregate investment of $28 million.

TABLE OF CONTENTS

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Introduction

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

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidat 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 the notes thereto, and the supplemental financial information, which is included in Part I, Items 1 and 2 of this Quarterly Report on Form 10-Q.

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-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 Quarterly Report on Form 10-Q.

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 Quarterly Report on Form 10-Q 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 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 our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected 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.

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

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

45

TABLE OF CONTENTS

This Quarterly Report on Form 10-Q 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.

Our Business

Redwood is a financial institution focused on investing in, financing, and managing residential and commercial real estate loans and securities. Our primary source of income is typically net interest income, which consists of the interest income we earn from our investments less the interest expenses we incur on our borrowed funds and other liabilities. We assume a range of risks in our investments and the level of risk is influenced by the manner in which we finance our purchases of, and derive income from, our investments. Our primary real estate investments include investments in real estate loans and securities, an investment in a private fund that we sponsor Redwood Opportunity Fund, LP (the Fund) and investments in securitization entities that we sponsor Sequoia and Acacia.

Our direct investments in residential, commercial, and collateralized debt obligations (CDO) securities are currently financed with equity and long-term debt, although we may use short-term debt financing to acquire securities and loans from time to time. These investments are primarily senior and subordinate mortgage-backed securities backed by residential and commercial real estate loans. The long term focus of our operations is to invest in subordinate securities (often below investment grade) that have concentrated structural credit risk. More recently, we have been investing in senior securities (often investment-grade) at distressed prices, which have the first right to cash flows in a securitization and therefore have less concentrated credit risk than subordinate securities.

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

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

Recent Developments

We have had a busy and productive start to 2010. We have been actively managing our investment portfolio, working diligently on helping to restart the private securitization market, and continuing to make progress on re-establishing our core business of facilitating, structuring, and investing in prime residential loans and securities. The following are a few of the highlights from our first quarter operating results:

We reported $47 million in GAAP net income, or $0.58 per share, for the first quarter of 2010. This compares with $40 million in GAAP net income, or $0.51 per share, in the prior quarter. First quarter results included the benefit of significant gains ($37 million in securities gains on sale and a $7 million gain on repurchasing Sequoia asset-backed securities), partially offset by a $9 million loan loss provision, $2 million in impairments on AFS securities, and $4 million in non-recurring equity compensation costs related to the upcoming retirement of George E. Bull, III, our

CEO and co-founder. While securities gains as a percentage of income has been quite high in the past two quarters, we do not anticipate sustained gains at this recent pace.

We estimate that taxable income is $1 million for the first quarter. We would caution against drawing a trend line from this quarter s taxable income as the realization of credit losses was slowed by governmental programs aimed at stalling and reducing mortgage foreclosures. We expect realized credit losses to pick back up as the backlog of defaulted loans is eventually processed. Thus, we currently expect to report a taxable loss for 2010.

46

TABLE OF CONTENTS

Book value per share on a GAAP basis was $12.84 at the end of the first quarter of 2010, increasing by $0.34 from the $12.50 reported at year-end 2009. Our estimate of non-GAAP economic book value per share rose to $13.32 at March 31, 2010, as compared to $13.03 at year-end 2009. Book value increases reflect earnings plus positive market valuation adjustments less dividends.

We invested $189 million and sold $124 million in non-agency mortgage-backed securities during the first quarter of 2010. Our cash balance at March 31, 2010, was $242 million. We have been positioning our investment portfolio to seek to maintain its value in light of possible higher interest rates. At the same time, during the first quarter we entered into swap agreements to fix the cost of our long-term borrowings (at 6.75% for 27 years). We also continue to take advantage of strong demand for non-agency RMBS to sell certain assets the market is bidding to a level above what we would pay for them.

During April 2010, we purchased just $5 million in securities while selling $94 million. We also completed a residential securitization through our Sequoia program and invested $28 million (as discussed below). Our cash balance at April 30, 2010, was $275 million. While we are acutely aware of the opportunity cost of holding cash, we will not let impatience drive us to make poor risk/reward trade-offs. We are increasingly willing to let cash build in order to take advantage of potentially significant opportunities to invest our capital as we grow our residential and commercial businesses.

Restarting Private Mortgage Securitization

In April 2010, we closed a private securitization backed by $238 million of prime jumbo residential first mortgage loans that were originated by CitiMortgage, Inc. within the past 11 months. As sponsor of the securitization, we invested approximately $28 million in the transaction. Specifically, we retained all securities rated below triple-A that were issued as part of the securitization (totaling 6.5% of the face value of the securitization), thereby retaining what is referred to as a horizontal slice of the securitization, plus the interest only securities that were issued as part of the securitization. In addition, we retained 5% of the face value of the triple-A rated securities that were issued as part of the securitization, thereby resulting in us retaining what is referred to as a vertical slice of the securitization. We would not normally have retained triple-A rated securities, but did so to address all possible sponsor risk retention or skin-in-the-game proposals currently being debated by federal legislators and regulators. However, we do not believe that any skin-in-the-game regulations that may ultimately be adopted should require holding both horizontal and vertical slices, as we believe that approach would deter useful and productive securitizations. Once rules governing skin-in-the-game for securitizations have been finalized by the regulators, we may consider selling some or all of the securities we retained that are in excess of the required amount. Regardless of which securities we ultimately retain, we expect that, in aggregate, the securities we retained at the closing of the transaction will deliver attractive investment returns over time.

It has been gratifying to be able to execute the first prime jumbo residential mortgage securitization since August 2008. Importantly, we completed this transaction without credit support from the federal government. To successfully complete this transaction, we focused on addressing issues and concerns of relevant parties, including triple-A investors, regulators, policy makers, rating agencies, and others. And we believe we accomplished our goals of helping to create new standards in the interest of borrowers, mortgage lenders, and securitization investors, while also producing an attractive investment through our retention of the various securities described above. While we are encouraged by the response to this initial securitization, it represents just a small step along a continuum for Redwood. We continue to expect it will take some time before processes evolve and the nation has a fully functioning private securitization market for residential mortgage loans.

To successfully restart securitization, we believe the process begins with triple-A investors. We think a securitization has to provide these investors with the safety and soundness they seek in investments they make: they should be able to dictate the collateral and loan type underlying securitizations they invest in and they should be able to specify the information disclosed to them at the time of investment and on an ongoing basis thereafter. We want investors to come to rely on our Sequoia securitization program for issuing high quality triple-A securities and we want them to take comfort from the fact that our interests are aligned with theirs when we retain securities that are subordinate to triple-A securities they invest in (and which thereby provide credit support to those triple-A securities). In summary, we are trying to bring the highest all-in value to triple-A investors and want them to look first to Redwood s Sequoia securitization program for on-going mortgage-backed investments.

We have also made, and continue to make, changes to our Sequoia securitization program that are intended to benefit mortgage borrowers and mortgage originators. We want originators to have the flexibility to sell us loans when they want. We want them to be positioned to offer their customers (mortgage borrowers) additional products, including loans the originators may not want to hold on their balance sheets. An efficient yield to triple-A investors can be passed through to the originator and on to the borrower. This should allow originators to offer better priced mortgage products to their qualified customers, manage risk to their balance sheets (by transferring much of that risk to us), free up capital, and potentially reduce hedging costs. To this end, we have invested in technology that will allow us to give originators a price commitment to buy loans on a flow basis that meet our collateral requirements.

Balancing safety and soundness with economics will also be critical to effective securitization in the future. We want to increase the level of private mortgage liquidity, but we will need to do so in a manner that protects investors and deters excessive risk-taking. This is central to providing credit to qualified homebuyers at the best possible mortgage rate. In our opinion, the proposed rules governing risk retention are especially important. In order to have securitization sponsors interests aligned properly with the interests of the other securitization investors, there are various proposals to require sponsors to retain risk. We believe that setting risk retention requirements properly is important to keeping the risk in check; it is also important to making credit available to homeowners at a reasonable interest rate. And that is the point of securitization in the first place: to channel funds to qualified borrowers in the most efficient way possible to keep the cost of credit affordable. If too much risk retention is required, securitizations of prime quality mortgages might be uneconomic limiting credit and/or increasing mortgage rates to homeowners. If too little risk retention is required, too much credit might be channeled to borrowers, increasing risk to everyone.

Finally, greater transparency in investor reporting is a critical step to restoring investor confidence in securitization. To that end, the Financial Accounting Standards Board (FASB) recently enacted new accounting guidelines (ASC 860 and ASC 810-10) to address those circumstances under which parties to a securitization transaction are required to consolidate the assets and liabilities of the securitization entity. These new accounting guidelines have been pointed to by many as key to preventing the return of off-balance sheet securitization liabilities or shadow banking transactions that were considered to be a contributor to the financial crisis. We generally believe that consolidation by at least one party to a securitization transaction is important to making sure that risk is properly and fully disclosed and we currently expect to consolidate onto our balance sheet the transaction that we executed in April 2010. However, based on our interpretation of ASC 860 and ASC 810-10, and discussions with various accounting firms and industry participants, it is our opinion that there may be fewer securitization transactions consolidated by other participants in this market than conventional wisdom has thought. Specifically, key consolidation criteria, such as what defines a significant economic interest and control, can depend on subjective determinations by securitization participants. Further, there are cross currents at play with respect to following policymakers suggestions to cede the resolution of delinquent loans to servicers in order to streamline loan modifications, as well as with respect to policymakers attempts to define what skin-in-the-game means. We are not sure how the accounting and regulatory rules pertaining to securitization will ultimately impact our business, but they could significantly influence our ability to compete and the overall competitive landscape depending on who is required to consolidate a securitization transaction and what amount and form of skin-in-the-game sponsors are required to retain.

Outlook

While regulators and stakeholders differ on financial reform proposals, one thing most everyone seems to agree on is that the U.S. government cannot continue to support 90% of the $11 trillion mortgage market. Private mortgage liquidity needs to return to reduce reliance on Fannie Mae and Freddie Mac (which are referred to as Government Sponsored Enterprises or GSEs). While private securitization will initially be aimed at prime jumbo mortgage loans, private securitization could also provide an alternative to the securitization of non-jumbo loans by the GSEs, as it has in the past. For example, over one quarter of the loans underlying our

48

previous $35 billion in Sequoia program securitizations met the conforming balance guidelines of the GSEs at the time of origination. In addition, securitizations can also help broaden the product set of mortgages by allowing originators to make loans that they might not want to hold on their balance sheet (for example, 30-year fixed rate mortgages).

Our vision since inception has been to build a company that produces high quality, long-term cash flows. Going forward, we believe our best opportunity to realize this vision is to re-establish our core residential credit business, a business in which we facilitate credit risk transfers in the mortgage market. We are not building a securitization business, per se; rather, securitization is a means to an end it has been, and can be, an efficient way to direct capital from investors to the mortgage originators who lend money to borrowers.

We are committed to the ongoing process of enhancing our Sequoia securitization program and securitizations of residential mortgage loans in general. We are approaching this business by thinking of how to bring the highest value to borrowers, originators, and triple-A investors. We led with a bulk purchase of loans from one originator, immediately followed by a securitization of those loans. We intend to execute additional securitization transactions in the future. To acquire loans for securitization we expect to execute additional bulk purchases, as appropriate, and plan to purchase mortgage loans on a loan by loan basis from originators, provided in each case that they meet a certain set of standards on an ongoing basis.

We believe we are well suited to evaluate, structure, and hold credit risk in residential mortgages. We understand how to structure risk in a manner that is attractive to securitization investors according to their appetite for risks and returns. Our business is to take subordinated credit risk and we have a balance sheet that is built to hold illiquid assets. We are not constrained by bank regulations and have a high tolerance for complexity. We also have solid relationships with originators and with investors and believe our team has never been stronger.

We have enough capital to support investments in this business for some time. We believe that we can raise more capital from shareholders if and as we need it, provided that we can make a case for earning ongoing returns. We believe we are enhancing our franchise by preparing for potential significant investment opportunities as demand for prime jumbo (non-conforming) mortgages returns and as the government gradually pulls back its involvement in the mortgage market. As we capitalize on this opportunity, we expect to generate returns by offering investors and originators what they want at a fair price.

We continue to expect to see significant investment opportunities in commercial real estate. Hundreds of billions of dollars of loans are maturing each year over the next several years that will require refinancing. Yet many investors who want to safely put money to work in this important sector currently sit idle. We believe gridlock in this market is caused not by lack of financing but by a lack of realism. Many lenders and borrowers seem to be satisfied to pretend values have not declined by 30% to 50% and appear to be content to hold their positions rather than recognize losses. In the commercial mortgage debacle of the early 1990s, write-offs were not taken until they were forced by bank regulators. Attractive investment opportunities will therefore likely be limited until this extend and pretend environment has ended and borrowers become more realistic about the value of their collateral. Until that time, we will be willing to wait as needed and continue building our team and infrastructure. We are targeting co-investors and properties that may allow us to deploy capital in high-quality subordinate debt investments later in 2010 and in 2011.

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

Our reported GAAP net income was $47 million ($0.58 per share) for the first quarter of 2010, as compared to a GAAP net loss of $35 million ($0.65 per share) for the first quarter of 2009. Our GAAP book value per common share was $12.84 at March 31, 2010, an increase from $8.40 at March 31, 2009. We declared regular quarterly dividends of $0.25 per share for both the first quarter of 2010 and 2009.

TABLE OF CONTENTS

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

Table 1 Net Income

	Three Months Ended March 31,	
(In Thousands, Except Share Data)	2010	2009
Interest income	$58,716	$81,438
Interest expense	(18,182)	(47,642)
Net interest income	40,534	33,796
Provision for loan losses	(9,475)	(16,032)
Market valuation adjustments, net	(11,237)	(43,242)
Net interest income (loss) after provision and market valuation adjustments	19,822	(25,478)
Operating expenses	(17,306)	(10,539)
Realized gains, net	44,338	462
Provision for income taxes	(26)	(105)
Less: Net loss attributable to noncontrolling interest	(15)	(716)
Net Income (Loss)	$46,843	$(34,944)
Diluted weighted average common shares outstanding	78,542,299	53,632,132
Net earnings (loss) per share	$0.58	$(0.65)

Net interest income was $41 million for the first quarter of 2010 as compared to $34 million for the first quarter of 2009, an increase of $7 million. The increase was primarily due to higher average balances of residential senior securities held at Redwood that are funded with equity. Net interest income after provision and market valuation adjustments was $20 million for the first quarter of 2010 as compared to a loss of $25 million for the first quarter of 2009, an increase of $45 million. This increase was primarily due to lower negative market valuation adjustments (MVA) at Redwood due to fewer impairment charges on securities and a $7 million decrease in the provision for loan losses at Sequoia due to lower balances of residential loans.

Operating expenses were $17 million for the first quarter of 2010 as compared to $11 million for the first quarter of 2009, an increase of $6 million. This increase was primarily due to an increase in total compensation expense, including a non-recurring charge of $4 million from the accelerated vesting of equity awards due to the retirement of our Chief Executive Officer which was announced in the first quarter of 2010. We currently expect our quarterly operating costs in 2010 to remain consistent with the expenses in the first quarter of 2010 (excluding the non-recurring charge noted above).

Realized gains, net, were $44 million for the first quarter of 2010 as compared to less than $1 million for the first quarter of 2009, an increase of $43 million. This increase was due to gains on sales of securities and the repurchase of Sequoia ABS during the first quarter of 2010.

The Results of Operations section of this Management s Discussion and Analysis of Financial Condition and Results of Operations contains a detailed analysis of the components of net income.

Our estimated total taxable income was $1 million ($0.01 per share) for the first quarter of 2010 as compared to a taxable loss of $14 million ($0.22 per share) for the first quarter of 2009, an increase of $15 million. Our estimated

REIT taxable income was $10 million ($0.13 per share) for the first quarter of 2010 as compared to a REIT taxable loss of $9 million ($0.14 per share) for the first quarter of 2009, an increase of $19 million. The increase in taxable income was primarily due to a decrease in realized credit losses on subordinate securities. Total realized credit losses for the first quarters of 2010 and 2009 were $24 million and $53 million, or $0.31 and $0.87 per share, respectively.

TABLE OF CONTENTS

Our REIT taxable income is that portion of our total taxable income that we earn at Redwood and its qualifying REIT subsidiaries and determines the minimum amount of dividends we must distribute to shareholders in order to maintain our tax status as a REIT. As a result of our REIT tax loss expectations in 2010, we currently expect that this year s distributions will be characterized as return of capital. However, if credit losses remain at lower levels than experienced in recent quarters and we do generate positive taxable income, a portion of the distributions would be characterized as ordinary income (to the extent of the 2010 income).

Components of Book Value

The Financial Condition, Liquidity, and Capital Resources section of this Management s Discussion and Analysis of Financial Condition and Results of Operations contains a detailed discussion and analysis of the components of GAAP book value at March 31, 2010 and December 31, 2009. The following supplemental non-GAAP components of book value addresses our assets and liabilities at March 31, 2010, as reported under GAAP and as estimated by us using fair values for our investments and long-term debt. We show our investments in the Fund and the Sequoia and Acacia entities as separate line items to highlight our specific ownership interests, as the underlying assets and liabilities of these entities are legally not ours. Our non-GAAP estimated economic value is calculated using bid-side asset marks (or estimated bid-side values) and offer-side marks for our financial liabilities (or estimated offered-side values), as required to determine fair value under GAAP. We believe this method of calculating economic value more closely represents liquidation value and does not represent the higher amount we would have to pay at the offered-side to replace our existing assets or the higher amount we would have to pay to redeem our liabilities. For additional information to consider when reviewing the following table, please see Factors Affecting Management s Estimate of Economic Value below.

Table 2 Book Value and Economic Value at March 31, 2010

(In Millions, Except per Share Data)	GAAP Book Value	Adjustments	Estimate of Non-GAAP Economic Value
Cash and cash equivalents	$ 242	$	$ 242
Real estate securities at Redwood			
Residential	830		830
Commercial	9		9
CDO	1		1
Total real estate securities at Redwood	840		840
Investments in the Fund	16		16
Investments in Sequoia	77	(29)	48
Investments in Acacia	1		1
Total cash, securities, and investments	1,176		1,147
Long-term debt	(140)	67	(73)
Other assets/liabilities, net	(38)		(38)
Stockholders Equity	**$ 998**		**$ 1,036**
Book Value Per Share	**$ 12.84**		**$ 13.32**

During the first quarter of 2010, our GAAP book value increased by $0.34 per share to $12.84 per share at March 31, 2010, as compared to December 31, 2009. The change resulted from an aggregate of $0.59 per share from earnings and market value increases on investments during the quarter, offset by $0.25 per share of dividends paid to shareholders. Our estimate of non-GAAP economic value increased by $0.29 per share to $13.32 per share at March 31, 2010, as compared to December 31, 2009. The increase resulted from $0.76 per share from net cash flows and net positive market valuation adjustments on our securities and investments, less $0.22 per share of cash operating and interest expense and $0.25 per share of dividends. Economic value is determined by calculating the fair value of our investments in consolidated entities directly as opposed to deriving their reported GAAP values by netting their consolidated assets and liabilities. In calculating our estimate of economic value, we also value our long-term debt at its estimated fair value rather than its amortized cost basis as reported for GAAP.

TABLE OF CONTENTS

Factors Affecting Management s Estimate of Economic Value

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

Cash, Securities, and Investments at Redwood

We have segmented our securities portfolio by acquisition date in the chart below to highlight that 93% of the economic value of our cash, securities, and investments are currently held in cash or in recently acquired securities. Our future earnings will be primarily driven by the performance of these recent investments along with how we deploy our existing cash and future cash flows.

Cash, Securities, and Investments at Redwood March 31, 2010 ($ in millions)

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

TABLE OF CONTENTS

Real Estate Securities at Redwood

The following table presents the components of fair value (which equals GAAP carrying value) for real estate securities at Redwood at March 31, 2010. We categorize our securities by portfolio vintage (the year(s) the securities were issued), by priority of cash flows senior, re-REMIC, and subordinate and, for residential, by quality of underlying loans prime and non-prime.

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

March 31, 2010 (In Millions)	2004 & Earlier	2005	2006	2008	Total	% of Total Securities
Residential						
Senior						
Prime	$ 14	$ 286	$ 72		$ 372	44 %
Non-prime	117	232	19		368	44 %
Total Senior	131	518	91		740	88 %
Re-REMIC prime	5	8	54		67	8 %
Subordinate						
Prime	12	3	2		17	2 %
Non-prime	6				6	1 %
Total Subordinate	18	3	2		23	3 %
Total Residential	154	529	147		830	99 %
Commercial	7	2			9	1 %
CDO		1			1	%
Total Securities at Redwood	$ 161	$ 532	$ 147		$ 840	100 %

During the first quarter of 2010, our securities portfolio grew to $840 million from $781 million, primarily as acquisitions of $180 million (excluding the acquisition of $9 million of Sequoia ABS issued) exceeded sales and pay downs. In addition, the value of the securities still held at March 31, 2010, increased by $15 million during the period.

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

Senior RMBS Prices

Source: JPMorgan Chase

53

TABLE OF CONTENTS

Investments in the Fund and Securitization Entities

The GAAP reported value of our investments in the Fund, Sequoia entities, and Acacia entities totaled $94 million, or 8% of our cash, securities, and investments at March 31, 2010. The fair value (which equals GAAP carrying value) of our investment in the Fund was $16 million. The Fund is primarily invested in non-prime residential securities and is managed by a subsidiary of Redwood. Our investment represents a 52% interest in the Fund.

The GAAP carrying value of our investments in Sequoia entities was $77 million and the fair value was $48 million. The $48 million of fair value consists of $38 million of interest-only securities (IOs) and $10 million of senior and subordinate securities and is calculated using the same valuation process that we follow to fair value our other real estate securities. These IOs earn the spread between the coupon rate on the $2.1 billion notional amount of underlying adjustable rate mortgage (ARM) loans and the cost of funds (indexed to one-month LIBOR) on the ABS issued within each respective securitization entity. Returns on IOs increase when prepayments slow and decrease when prepayments speed up.

The GAAP carrying value and fair value of our investments in Acacia entities was $1 million at March 31, 2010. These investments consist of equity interests and securities in the Acacia entities we sponsor, which have minimal value, as well as the value of future management fees we expect to receive from Acacia entities, which we discounted at a 45% rate.

Capital Resources and Liquidity

Throughout the first quarter of 2010, we maintained our strong balance sheet and liquidity. We ended the first quarter of 2010 with total capital of $1.1 billion, which consists of $998 million of common equity and $140 million of 30-year long-term debt due in 2037. We had no short-term debt at March 31, 2010. We use our capital to invest in earning assets, fund our operations, fund working capital, and meet lender capital requirements with respect to collateralized borrowings, if any. Through our internal risk-adjusted capital policy, we allocate capital for our earning assets to meet liquidity needs that we estimate may arise. Currently, we have allocated risk-capital equal to 100% of the fair value of our investments. The amount of remaining capital that exceeds our risk-adjusted capital guidelines is excess capital that can be invested to support business growth. Excess capital generally equals our cash balance less pending investment settlements and other internal capital allocations we have established for the prudent operations of our company. Our excess capital at March 31, 2010 was $181 million and at April 30, 2010 was $233 million. Given the amount of our excess capital, it seems unlikely we would seek additional capital in the near term. If circumstances should change, we would likely look first at our own balance sheet for sources of cash before considering other options.

At March 31, 2010, we had $242 million in cash and cash equivalents, or $3.11 per share, and at April 30, 2010, we had $275 million in cash and cash equivalents, or $3.53 per share. Most of our cash and cash equivalents were invested in U.S. Treasury Bills. Our quarterly sources and uses of our cash is one of the financial metrics on which we focus. Therefore, as a supplement to the Consolidated Statements of Cash Flows included in this Quarterly Report on Form 10-Q, we show in the table below (i) the beginning cash balances at March 31, 2010 and December 31, 2009 (which are GAAP amounts), (ii) the ending cash balances at March 31, 2010 and December 31, 2009 (which are GAAP amounts), and (iii) the components of sources and uses of cash organized in a manner consistent with the way management analyzes them by aggregating and netting all items within our GAAP Consolidated Statements of Cash Flows that were attributable to the quarters presented. This table excludes the gross cash flow generated by our Sequoia and Acacia securitization entities and the Fund (cash flow that is not available to Redwood), but does include the cash flow distributed to Redwood as a result of our investments in these entities. In addition, please note that in the table below we now include proceeds from sales as a component of business cash flow and as part of cash flow from securities and investments. While it is our intention when we acquire assets to hold them to maturity and receive principal and interest payments over their lives, we sell assets from time to time as part of our continuing management of risk and return expectations. A sale effectively accelerates the receipt of cash flow we would have otherwise expected to receive over time.

TABLE OF CONTENTS

In the first quarter of 2010, cash flow continued to be strong and in line with our expectations. Our business cash flows exceeded dividend distributions and this excess funded our acquisitions. We had a modest net outflow of cash and ended the first quarter with $242 million in cash and cash equivalents.

Table 4 Redwood Sources and Uses of Cash

(In Millions)	Three Months Ended March 31, 2010	Three Months Ended December 31, 2009
Beginning Cash Balance	$ 243	$ 217
Business cash flow		
Cash flow from securities and investments	193	134
Asset management fees	1	1
Cash operating expenses	(16)	(11)
Interest expense on long-term debt	(1)	(1)
Total business cash flow	177	123
Other sources and uses		
Changes in working capital	(2)	(9)
Acquisitions(1)	(156)	(68)
Dividends	(20)	(20)
Net other uses	(178)	(97)
Net uses (sources) of cash	(1)	26
Ending Cash Balance	$ 242	$ 243

(1) Total acquisitions in the first quarter of 2010 were $189 million, $33 million which are not reflected in this table because they did not settle until early April 2010. In the fourth quarter of 2009, all acquisitions were settled within the period.

We believe our current GAAP income statement is reflective of our current underlying business trends, especially given the nature of the assets we currently hold. We also consider cash flow one of a number of other important operating metrics; however, we realize that quarterly cash flow measures have limitations. In particular, we note:

When securities are purchased at large discounts from face value it is difficult to determine what portion of the cash received is a return of principal and what portion is a return on principal. It is only at the end of an asset s life that we can accurately determine what portion of the cumulative cash received (whether principal or interest) was income and what was a return of capital.

Certain investments may generate cash flow in a quarter that is not necessarily reflective of the long-term economic yield we will earn on the investments. For example, in prior periods we have acquired re-REMIC support securities at what we believe to be attractive yields. Due to their terms, however, the securities are locked out of receiving any principal payments for years. Because of the deferred receipt of principal payments, looking solely at the early quarterly cash flow may not be indicative of economic returns.

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

55

TABLE OF CONTENTS

The table below presents the source of our cash flow from securities and investments for the three months ended March 31, 2010 and December 31, 2009.

Table 5 Cash Flow from Securities and Investments

(In Millions)	Three Months Ended March 31, 2010	December 31, 2009
Securities at Redwood		
Residential senior		
Principal and interest	$ 40	$ 41
Proceeds from sales	73	27
Total residential senior	113	68
Residential Re-REMIC		
Principal and interest	3	4
Proceeds from sales	51	31
Total residential Re-REMIC	54	35
Residential subordinates principal and interest	8	10
Commercial and CDO subordinates		
Principal and interest	1	1
Proceeds from sales		8
Total commercial and CDO subordinates	1	9
Total cash flow from securities at Redwood	176	122
Investments in the Fund	9	2
Investments in Sequoia entities	8	10
Investments in Acacia entities		
Total Cash Flow from Securities and Investments	$ 193	$ 134

Total cash flow from securities and investments was $193 million for the first quarter of 2010, an increase of $59 million from the prior quarter, primarily due to an increased level of sales. Total sales proceeds from securities were $124 million in the first quarter of 2010. These first quarter sales resulted in the recognition of $38 million in GAAP gains. Redwood s investment in the Fund generated $9 million of cash flow primarily due to sales of securities during the period.

56

Results of Operations

The tables below present the results of Redwood, the Fund, and securitization entities and supplement our consolidated GAAP results for the three months ended March 31, 2010 and 2009. Securitization entities include Sequoia and Acacia entities that have been consolidated for financial reporting purposes.

Table 6 Consolidating Income Statements

	Three Months Ended March 31, 2010				
(In Thousands)	Redwood Parent Only	The Fund	Securitization Entities	Intercompany Adjustments	Redwood Consolidated
Interest income	$ 27,301	$ 1,588	$ 29,738	$ 89	$ 58,716
Management fees	587			(587)	
Interest expense	(1,116)		(17,270)	204	(18,182)
Net interest income	26,772	1,588	12,468	(294)	40,534
Provision for loan losses			(9,475)		(9,475)
Market valuation adjustments, net	(3,062)	(381)	(7,794)		(11,237)
Net interest income (loss) after provision and market valuation adjustments	23,710	1,207	(4,801)	(294)	19,822
Operating expenses	(16,796)	(373)	(431)	294	(17,306)
Realized gains (losses), net	38,245	(866)	6,959		44,338
Loss from the Fund	(17)			17	
Income from Securitization Entities	1,727			(1,727)	
Noncontrolling interest		15			15
Net income (loss) before provision for taxes	46,869	(17)	1,727	(1,710)	46,869
Provision for income taxes	(26)				(26)
Net Income (Loss)	$ 46,843	$ (17)	$ 1,727	$ (1,710)	$ 46,843

	Three Months Ended March 31, 2009				
(In Thousands)	Redwood Parent Only	The Fund	Securitization Entities	Intercompany Adjustments	Redwood Consolidated
Interest income	$ 21,827	$ 2,816	$ 56,172	$ 623	$ 81,438
Management fees	1,032			(1,032)	
Interest expense	(1,808)		(45,886)	52	(47,642)
Net interest income	21,051	2,816	10,286	(357)	33,796
Provision for loan losses			(16,032)		(16,032)
Market valuation adjustments, net	(26,286)	(3,889)	(13,067)		(43,242)
Net interest (loss) income after provision and market valuation adjustments	(5,235)	(1,073)	(18,813)	(357)	(25,478)
Operating expenses	(10,460)	(430)	(6)	357	(10,539)
Realized gains, net	337		125		462

Loss from the Fund	(787)			787	
Loss from Securitization Entities	(18,694)			18,694	
Noncontrolling interest		716			716
Net (loss) income before provision for taxes	(34,839)	(787)	(18,694)	19,481	(34,839)
Provision for income taxes	(105)				(105)
Net (Loss) Income	$(34,944)	$(787)	$(18,694)	$19,481	$(34,944)

TABLE OF CONTENTS

Results of Operations Redwood

The following table presents the net interest income (loss) after market valuation adjustments (MVA) at Redwood for the three months ended March 31, 2010 and 2009.

Table 7 Net Interest Income (Loss) after MVA at Redwood

(Dollars in Thousands)	Three Months Ended March 31, 2010 Total Interest Income/ (Expense)	Average Amortized Cost	Yield	2009 Total Interest Income/(Expense)	Average Amortized Cost	Yield
Interest Income						
Real estate loans	$36	$244	59.06%	$64	$2,762	9.27 %
Trading securities	2,957	20,493	57.72%	2,972	5,668	209.75%
Available-for-sale securities	24,293	674,631	14.41%	18,750	259,777	28.88 %
Cash and cash equivalents	15	224,734	0.03 %	41	304,872	0.05 %
Total Interest Income	27,301			21,827		
Management fees	587			1,032		
Interest Expense						
Long-term debt	(1,116)	138,145	(3.23)%	(1,808)	147,193	(4.91)%
Total Interest Expense	(1,116)			(1,808)		
Net Interest Income	26,772			21,051		
Market valuation adjustments, net	(3,062)			(26,286)		
Net Interest Income (Loss) After MVA at Redwood	$23,710			$(5,235)		

Net interest income after MVA at Redwood was $24 million for the three months ended March 31, 2010, as compared to negative $5 million for the three months ended March 31, 2009, an increase of $29 million. The difference was primarily due to a significant decline in negative market valuation adjustments during the first quarter of 2010 due to fewer impairments on subordinate securities. Additionally, interest income from senior residential securities acquired during 2009 more than offset declining interest income from subordinate securities acquired in prior periods. Interest expense declined due to lower benchmark LIBOR rates on our long-term debt.

Analysis of Interest Income at Redwood

Interest income at Redwood was $27 million for the three months ended March 31, 2010, as compared to $22 million for the three months ended March 31, 2009, an increase of $5 million. Increases in balances were partially offset by lower interest rates and yields. The following table details how interest income changed as a result of changes in average investment balances (volume) and changes in interest yields (rate).

Table 8 Interest Income at Redwood Volume and Rate Changes

(In Thousands)	Change in Interest Income Three Months Ended March 31, 2010 vs. March 31, 2009		
	Volume	Rate	Total Change
Real estate loans	$ (58)	$ 30	$ (28)
Trading securities	8,246	(8,261)	(15)
Available-for-sale securities	29,935	(24,392)	5,543
Cash and cash equivalents	(11)	(15)	(26)
Total Interest Income	$ 38,112	$ (32,638)	$ 5,474

58

We classify most senior, Re-REMIC, and subordinate securities as available-for-sale (AFS) securities under GAAP. The following table presents the components of the interest income we earned on AFS securities for the three months ended March 31, 2010 and 2009.

Table 9 Interest Income AFS Securities at Redwood

Three Months Ended March 31, 2010 (Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of[1] Interest Income	Yield as a Result of[1] Discount (Premium) Amortization	Yield as a Result of[1] Total Interest Income
Senior Residential	$8,062	$10,602	$18,664	$575,688	5.60 %	7.37 %	12.97 %
Re-REMIC Residential	2,576	(651)	1,925	45,852	22.47 %	(5.68)%	16.79 %
Subordinate							
Residential	3,229	(253)	2,976	45,421	28.44 %	(2.23)%	26.21 %
Commercial	1,035	(319)	716	7,670	53.98 %	(16.64)%	37.34 %
CDO	38	(26)	12				
Total Subordinate	4,302	(598)	3,704	53,091	32.41 %	(4.51)%	27.90 %
Total AFS Securities	$14,940	$9,353	$24,293	$674,631	8.86 %	5.55 %	14.41 %

Three Months Ended March 31, 2009 (Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of[1] Interest Income	Yield as a Result of[1] Discount (Premium) Amortization	Yield as a Result of[1] Total Interest Income
Senior Residential	$2,787	$3,322	$6,109	$164,200	6.79 %	8.09 %	14.88 %
Subordinate							
Residential	8,691	3,440	12,131	49,170	70.70 %	27.98 %	98.68 %
Commercial	4,550	(4,050)	500	46,382	39.24 %	(34.93)%	4.31 %
CDO	10		10	25			
Total Subordinate	13,251	(610)	12,641	95,577	55.46 %	(2.55)%	52.91 %
Total AFS Securities	$16,038	$2,712	$18,750	$259,777	24.70 %	4.18 %	28.88 %

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

Analysis of Interest Expense at Redwood

Interest expense at Redwood was $1 million for the three months ended March 31, 2010, as compared to $2 million for the three months ended March 31, 2009, a decline of $1 million, primarily as a result of lower short-term interest rates, as well as lower average debt balances as a result of the extinguishment of $10 million of long-term debt during 2009.

Market Valuation Adjustments at Redwood

The following table shows the impact of market valuation adjustments at Redwood for the three months ended March 31, 2010 and 2009.

Table 10 Impact of Market Valuation Adjustments at Redwood

	Three Months Ended March 31,	
(In Millions)	2010	2009
Market valuation adjustments, net		
Change in fair value of assets and liabilities	$ (1)	$ (1)
Impairment on AFS securities	(2)	(25)
Total Market Valuation Adjustments, Net	$ (3)	$ (26)

59

TABLE OF CONTENTS

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

For the first quarter of 2010, we recognized an aggregate $3 million of OTTI at Redwood. Of this amount, $2 million was related to credit factors and recognized in our consolidated statement of income, and the remaining $1 million was recognized as a reduction in stockholders equity. For the first quarter of 2009, we recognized an aggregate $25 million of OTTI at Redwood. Unrealized losses and OTTI related to non-credit factors totaled $10 million for the first quarter of 2010 and $28 million for the first quarter of 2009.

Operating Expenses

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

Table 11 Operating Expenses

	Three Months Ended March 31,	
(In Thousands)	2010	2009
Fixed compensation expense	$ 4,109	$ 4,028
Variable compensation expense	1,880	556
Equity compensation expense	6,059	1,795
Severance expense	81	28
Total compensation expense	12,129	6,407
Systems	1,577	1,594
Office costs	1,765	1,750
Accounting and legal	1,466	559
Other operating expenses	369	229
Total Operating Expenses	$ 17,306	$ 10,539

Operating expenses were $17 million for the three months ended March 31, 2010, as compared to $11 million for the three months ended March 31, 2009, an increase of $6 million. The increase was primarily due to a $4 million non-recurring equity compensation expense related to the accelerated vesting of equity awards from the announced retirement of our Chief Executive Officer. The remaining $2 million increase was the result of a rise in our legal fees and operating expenses of $1 million associated with the expansion of our residential securitization business and an increase in our variable compensation expense of $1 million. We currently expect our quarterly operating costs in 2010 to remain consistent with the expenses in the first quarter of 2010 (excluding the non-recurring charge noted above).

Gains and Losses

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

Table 12 Realized Gains, Net

	Three Months Ended March 31,	
(In Thousands)	2010	2009
Net gains on sales of real estate securities	$ 37,379	$ 337
Net gains on repurchase of Sequoia ABS	6,959	125
Total Realized Gains, Net	$ 44,338	$ 462

Realized gains of $44 million for the three months ended March 31, 2010, reflect $37 million in gains on the sales of securities as part of our ongoing portfolio management activities and the repurchase of $15 million of Sequoia ABS at a significant discount to the principal amount owed, resulting in a $7 million gain.

TABLE OF CONTENTS

Results of Operations the Fund

The following table presents the components of the interest income we earned on AFS securities at the Fund in the three months ended March 31, 2010 and 2009.

Table 13 Interest Income AFS Securities at the Fund

Three Months Ended March 31, 2010 (Dollars in Thousands)	Interest Income	Discount Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of Interest Income	Yield as a Result of Discount Amortization	Total Interest Income
Senior Residential	$ 114	$ 729	$ 843	$ 23,750	1.92 %	12.28 %	14.20 %
Subordinate							
Residential	58	167	225	6,886	3.37 %	9.70 %	13.07 %
CDO	142	378	520	11,498	4.94 %	13.15 %	18.09 %
Total Subordinate	200	545	745	18,384	4.35 %	11.86 %	16.21 %
Total AFS Securities	$ 314	$ 1,274	$ 1,588	$ 42,134	2.98 %	12.09 %	15.07 %

Three Months Ended March 31, 2009 (Dollars in Thousands)	Interest Income	Discount Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of Interest Income	Yield as a Result of Discount Amortization	Total Interest Income
Senior							
Residential	$ 207	$ 1,808	$ 2,015	$ 36,606	2.26 %	19.76 %	22.02 %
CDO	147	37	184	6,310	9.32 %	2.35 %	11.67 %
Total Senior	354	1,845	2,199	42,916	3.30 %	17.20 %	20.50 %
Subordinate							
Residential	86	287	373	11,930	2.88 %	9.62 %	12.50 %
CDO	170	73	243	7,473	9.10 %	3.91 %	13.01 %
Total Subordinate	256	360	616	19,403	5.28 %	7.42 %	12.70 %
Total AFS Securities	$ 610	$ 2,205	$ 2,815	$ 62,319	3.92 %	14.15 %	18.07 %

Net interest income at the Fund was $2 million for the three months ended March 31, 2010, and $3 million for the three months ended March 31, 2009. The declines in net interest income were primarily a result of lower balances and reduced coupon income due to lower benchmark LIBOR rates on adjustable rate securities.

Market Valuation Adjustments at the Fund

At the Fund, there were less than $1 million and $4 million of negative market valuation adjustments on AFS securities recognized through our consolidated statements of income (loss) for the three months ended March 31, 2010 and 2009, respectively, all of which were deemed to be OTTI related to credit factors.

TABLE OF CONTENTS

Results of Operations Securitization Entities

The following table presents the net interest income at our securitization entities for the three months ended March 31, 2010 and 2009.

Table 14 Net Interest Income Securitization Entities

Three Months Ended March 31, 2010 (Dollars in Thousands)	Interest Income/ (Expense)	Premium Amortization	Total Interest Income/ (Expense)	Average Amortized Cost	Yield
Interest Income					
Residential real estate loans	$16,830	$(2,371)	$14,459	$3,681,427	1.57%
Commercial real estate loans	296		296	13,750	8.61%
Trading Securities	14,972		14,972	267,476	22.39%
Other investments	9		9	18,616	0.19%
Cash and cash equivalents	2		2	83,140	0.01%
Total Interest Income	32,109	(2,371)	29,738		
Interest Expense					
ABS issued Sequoia (1)	(9,175)	(177)	(9,352)	3,589,269	(1.04)%
ABS issued Acacia	(7,424)		(7,424)	288,241	(10.30)%
Interest rate agreements Sequoia	139		139		
Interest rate agreements Acacia	(633)		(633)		
Total Interest Expense	(17,093)	(177)	(17,270)		
Net Interest Income	$15,016	$(2,548)	$12,468		

(1) Sequoia ABS premium amortization includes $210 thousand of bond issuance premium amortization and negative $387 thousand of deferred bond issuance costs (DBIC) amortization.

Three Months Ended March 31, 2009 (Dollars in Thousands)	Interest Income/ (Expense)	Premium Amortization	Total Interest Income/ (Expense)	Average Amortized Cost	Yield
Interest Income					
Residential real estate loans	$41,092	$(7,459)	$33,633	$4,568,212	2.94%
Commercial real estate loans	272		272	11,144	9.76%
Trading Securities	22,103		22,103	318,094	27.79%
Other investments	76		76	75,359	0.40%
Cash and cash equivalents	88		88	39,730	0.89%
Total Interest Income	63,631	(7,459)	56,172		
Interest Expense					
ABS issued Sequoia (1)	(24,875)	(218)	(25,093)	4,460,962	(2.25)%
ABS issued Acacia	(19,695)		(19,695)	325,392	(24.21)%
Interest rate agreements Sequoia	(21)		(21)		
Interest rate agreements Acacia	(1,077)		(1,077)		

Total Interest Expense	(45,668)	(218)	(45,886)
Net Interest Income	$ 17,963	$ (7,677)	$ 10,286

(1) Sequoia ABS premium amortization includes $335 thousand of bond issuance premium amortization and negative $553 million of DBIC amortization.

Net interest income at the consolidated securitization entities was $12 million for the three months ended March 31, 2010, as compared to $10 million for the three months ended March 31, 2009, an increase of $2 million. The increase was primarily due to the amount and timing of changes between income yields on securities and loans and expense yields on ABS issued. These changes were largely due to changes in benchmark LIBOR interest rates. Overall interest income and interest expense declined during these periods due to lower average balances of loans, securities, and ABS issued.

62

TABLE OF CONTENTS

Analysis of Interest Income at Securitization Entities

Interest income at our securitization entities was $30 million for the three months ended March 31, 2010, as compared to $56 million for the three months ended March 31, 2009, a decline of $26 million. Interest income declined primarily due to lower benchmark LIBOR interest rates on loans and securities along with lower average balances at our securitization entities. Average balances of loans at consolidated Sequoia entities decreased due to principal repayments on loans and securities with no offsetting acquisition activity. The average prepayment rate for Sequoia loans was 7% during the first quarter of 2010 as compared to 9% in the first quarter of 2009. Average balances of loans at consolidated Sequoia entities also decreased due to the deconsolidation of certain Sequoia entities during the past twelve months. The following table details how interest income changed as a result of changes in average investment balances (volume) and changes in interest yields (rate) at our securitization entities.

Table 15 Interest Income at Securitization Entities Volume and Rate Changes

	Change in Interest Income Three Months Ended March 31, 2010 vs. March 31, 2009		
(In Thousands)	Volume	Rate	Total Change
Residential real estate loans	$ (6,528)	$ (12,645)	$ (19,173)
Commercial real estate loans	64	(40)	24
Trading Securities	(3,518)	(3,614)	(7,132)
Other investments	(57)	(10)	(67)
Cash and cash equivalents	96	(182)	(86)
Total Interest Income	$ (9,943)	$ (16,491)	$ (26,434)

Analysis of Interest Expense at Securitization Entities

Interest expense at our securitization entities was $17 million for the three months ended March 31, 2010, as compared to $46 million for the three months ended March 31, 2009, a decline of $29 million. Interest expense declined primarily due to lower average balances of ABS issued at our securitization entities along with lower benchmark LIBOR interest rates on obligations of consolidated securitization entities. The following table details how interest expense at our securitization entities changed as a result of changes in average debt balances (volume) and interest yields (rate).

Table 16 Interest Expense at Securitization Entities Volume and Rate Changes

	Change in Interest Expense Three Months Ended March 31, 2010 vs. March 31, 2009		
(In Thousands)	Volume	Rate	Total Change
ABS Issued Sequoia	$ (4,907)	$ (10,994)	$ (15,901)
ABS Issued Acacia	(2,372)	(10,343)	(12,715)
Total Interest Expense	$ (7,279)	$ (21,337)	$ (28,616)

Loan Loss Provision at Sequoia

We continued to build our allowance for loan losses in the first quarter of 2010 through a provision that was well in excess of our charge-offs during the quarter. The provision for loan losses was $9 million for the three months ended March 31, 2010, as compared to $16 million for the three months ended March 31, 2009. The provision for loan losses exceeded net charge-offs of $3 million (or 0.07% of outstanding loan balances) and $4 million (or 0.08% of outstanding loan balances) for the three months ended March 31, 2010 and 2009, respectively. These charge-offs were generated by $9 million and $15 million of defaulted loans in the three months ended March 31, 2010 and 2009, respectively, for average implied loss severities of 30% and 26% for the three months ended March 31, 2010 and 2009, respectively. This resulted in an increase of $7 million and $12 million in our allowance for loan losses for the three months ended March 31, 2010 and 2009, respectively.

Credit deterioration in the loan portfolio has been most notable in certain states and more recent loan vintages. Loans originated in California, Florida, Georgia, Connecticut, and Arizona accounted for a disproportionately large share (57%) of seriously delinquent loans held by consolidated Sequoia entities at March 31, 2010. Loans originated in 2007 had the largest increase in serious delinquencies over the past three months.

Market Valuation Adjustments at Securitization Entities

We apply the fair value option provided under GAAP for the assets (loans, securities, and unamortized deferred ABS issuance costs) and liabilities (ABS issued) of our consolidated Acacia securitization entities. This option requires that changes in the fair value of these assets, liabilities, and commitments be recorded in the consolidated statements of income (loss) each reporting period. Derivative assets and liabilities at Acacia securitization entities are accounted for as trading derivatives with all changes in the fair value of these assets and liabilities recorded through our consolidated statements of income (loss). There were a net negative $8 million and negative $12 million of market valuation adjustments on these assets and liabilities recognized through our consolidated statements of income (loss) for the three months ended March 31, 2010 and 2009, respectively. At consolidated Sequoia entities, there were less than $1 million and $1 million of negative market valuation adjustments on real estate owned (REO) properties recognized through our consolidated statements of income (loss) for the three months ended March 31, 2010 and 2009, respectively.

Potential GAAP Earnings Volatility

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues, some of which are described below.

Changes in Premium Amortization for Loans at Sequoia

The unamortized premium for loans owned by Sequoia was $48 million at March 31, 2010. The amount of periodic premium amortization expense we recognize is volatile and dependent on a number of factors, including credit performance of the underlying loans, changes in prepayment speeds, and changes in short-term interest rates. Loan premium amortization was $2 million in the three months ended March 31, 2010, compared to $7 million in the three months ended March 31, 2009.

Changes in Yields for Securities at Redwood and the Fund

The yields we project on real estate securities can have a significant effect on the periodic interest income we recognize for financial reporting purposes. Yields can vary as a function of credit results, prepayment rates, and interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to face value), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to face value), the yield over the remaining life of the security may be adjusted downward.

Changes in the actual maturities of real estate securities may also affect their yields to maturity. Actual maturities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There is no assurance that our assumptions used to estimate future cash flows or the current period s yield for each asset will not change in the near term, and any change could be material.

Changes in Fair Values of Securities

All securities owned at Redwood and consolidated entities are classified as either trading or AFS securities, and in both cases are carried on our consolidated balance sheets at their estimated fair values. For trading securities, changes in fair values are recorded in the consolidated statements of income (loss). Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant GAAP earnings volatility each quarter.

TABLE OF CONTENTS

For AFS securities, cumulative unrealized gains and losses are recorded as a component of accumulated other comprehensive income (loss) in our consolidated statements of equity. Unrealized gains and losses are not charged against current earnings to the extent they are temporary in nature. Certain factors may require us; however, to recognize these amounts as other-than-temporary impairments and record them through our current earnings. Factors that determine other-than-temporary-impairment include a change in our ability or intent to hold assets, adverse changes to projected cash flows of assets, or the likelihood that declines in the fair values of assets would not return to their previous levels within a reasonable time. Impairments can lead to significant GAAP earnings volatility each quarter.

Changes in Fair Values of Derivative Financial Instruments

We can experience significant earnings volatility from our use of derivatives. We generally use derivatives to hedge cash flows on assets and liabilities that have different coupon rates (fixed rates versus floating rates, or floating rates based on different indices). The nature of the instruments we use and the accounting treatment for the specific assets, liabilities, and derivatives may lead to volatile periodic earnings, even when we are meeting our hedging objectives.

Some of our derivatives are accounted for as trading instruments and their changes in market values flow through our consolidated statements of income (loss). The assets and liabilities we hedge may not be similarly accounted for as our hedging derivatives (e.g., they may be reported at cost, or only other-than-temporary impairments may be reported through our consolidated statements of income (loss)). This could lead to reported income and book values in specific periods that do not necessarily reflect the economics of our hedging strategy. Even when the assets and liabilities are similarly accounted for as trading instruments, periodic changes in their value may not coincide as other market factors (e.g., supply and demand) may affect certain instruments and not others at any given time.

Results of Operations   Estimated Taxable Income (Loss)

The following table summarizes our estimated taxable income (loss) and distributions to shareholders for the three months ended March 31, 2010 and 2009. At both March 31, 2010 and 2009, we had no undistributed REIT taxable income.

Table 17 Estimated Taxable Income (Loss) and Distributions to Shareholders

	Three Months Ended March 31,	
(In Thousands, Except per Share Data)	2010	2009
Estimated Taxable Income (Loss)		
REIT taxable income (loss)	$ 9,831	$ (8,701)
Taxable REIT subsidiary loss	(8,683)	(4,846)
Total Estimated Taxable Income (Loss)	$ 1,148	$ (13,547)
Distributed to shareholders	$ 19,475	$ 15,087

Our estimated total taxable income for the first quarter of 2010 was $1 million ($0.01 per share) and included $24 million in credit losses. This compared to estimated total taxable loss for the first quarter of 2009 of $14 million ($0.22 per share), which included $53 million of credit losses. We continue to expect credit losses to be the primary factor in 2010 and result in a taxable loss for the year.

For the three months ended March 31, 2010, we paid a regular quarterly dividend of $0.25. As a result of our REIT tax loss expectations in 2010, we currently expect that this year s distributions will be characterized as return of capital. However, if credit losses remain at lower levels than experienced in recent quarters and we do generate positive taxable income, a portion of the distributions would be characterized as ordinary income (to the extent of the 2010 income). Dividends characterized as return of capital are not taxable and reduce the basis of shares held at each quarterly distribution date.

Differences between Taxable Income (Loss) and GAAP Income (Loss)

Differences between taxable income and GAAP income are largely due to the following:; (i) we cannot establish loss reserves for future anticipated events for tax but can for GAAP as realized credit losses are expensed when incurred for tax and these losses are anticipated through lower yields on assets or through loss provisions for GAAP; (ii) the timing, and possibly the amount, of some expenses (e.g., compensation expenses) are different for tax than for GAAP; (iii) since amortization and impairments differ for tax and GAAP, the tax and GAAP gains and losses on sales may differ, resulting in differences in realized gains on sale; for tax, we net capital gains on sales against any available capital losses; and, (iv) for tax, we do not consolidate noncontrolling interests or securitization entities as we do under GAAP. As a result of these differences in accounting, our taxable income can vary significantly from our GAAP income during certain reporting periods.

The tables below reconcile our tax and GAAP income (loss) for the three months ended March 31, 2010 and 2009.

Table 18 Differences between Estimated Taxable Income (Loss) and GAAP Net Income (Loss)

	Three Months Ended March 31, 2010		
(In Thousands, Except per Share Data)	Tax	GAAP	Differences
Interest income	$ 37,677	$ 58,716	$ (21,039)
Interest expense	(1,075)	(18,182)	17,107
Net interest income	36,602	40,534	(3,932)
Provision for loan losses		(9,475)	9,475
Realized credit losses	(24,251)		(24,251)
Market valuation adjustments, net		(11,237)	11,237
Operating expenses	(11,203)	(17,306)	6,103
Realized gains, net		44,338	(44,338)
Provision for income taxes		(26)	26
Less: Net income attributable to noncontrolling interest		(15)	15
Net Income (Loss)	$ 1,148	$ 46,843	$ (45,695)
Estimated income (loss) per share	$ 0.01	$ 0.58	$ (0.57)

	Three Months Ended March 31, 2009		
(In Thousands, Except per Share Data)	Tax	GAAP	Differences
Interest income	$ 50,484	$ 81,438	$ (30,954)
Interest expense	(1,330)	(47,642)	46,312
Net interest income	49,154	33,796	15,358
Provision for loan losses		(16,032)	16,032
Realized credit losses	(52,613)		(52,613)
Market valuation adjustments, net		(43,242)	43,242
Operating expenses	(10,088)	(10,539)	451
Realized gains, net		462	(462)
Provision for income taxes		(105)	105
Less: Net income attributable to noncontrolling interest		(716)	716
Net (Loss) Income	$ (13,547)	$ (34,944)	$ 21,397
Estimated (loss) income per share	$ (0.22)	$ (0.65)	$ 0.43

Potential Taxable Income Volatility

We expect quarter-to-quarter estimated taxable income volatility for a variety of reasons, including those described below.

Credit Losses on Securities and Loans at Redwood

To determine estimated taxable income we are generally not permitted to anticipate, or reserve for, credit losses on investments which are generally purchased at a discount. For tax purposes, we accrue the entire purchase discount on a security into taxable income over the expected life of the security. Estimated taxable income is reduced when actual credit losses occur. For GAAP purposes, we establish a credit reserve and only accrete a portion of the purchase discount, if any, into income and write-down securities that become impaired. Our income recognition is therefore faster for tax as compared to GAAP, especially in the early years of owning a security (when there are generally few credit losses). At March 31, 2010, the cumulative difference between the GAAP and tax amortized costs basis of our residential, commercial, and CDO subordinate securities (excluding our investments in the Fund and our securitization entities) was $252 million.

The timing of losses which results from loan defaults will cause volatility in our tax results. During the first quarter of 2010, we realized $24 million of credit losses on securities for tax that we had previously provisioned for under GAAP. Realized credit losses were based on our tax basis, which differs materially from our basis for GAAP purposes. We anticipate an additional $252 million of tax losses on securities, based on our projection of face losses and assuming a similar tax basis as we have recently experienced. As of March 31, 2010, for GAAP we had a designated credit reserve of $615 million on our securities and an allowance for loan losses of $61 million for our consolidated residential and commercial loans. As we have no credit reserves or allowances for tax, any future credit losses on securities or loans will have a more significant impact on tax earnings than on GAAP earnings and may create significant taxable income volatility to the extent the level of credit losses fluctuates during reporting periods. We anticipate that tax losses will continue to be a significant factor in 2010, although the quarterly timing of actual losses is difficult to accurately project.

Recognition of Gain on Sale

Since amortization and impairments on assets differ for GAAP and tax, the GAAP and tax basis on assets sold may differ, resulting in differences in gains and losses on sale. Thus, although we sold assets in the first quarter of 2010 and realized a gain for GAAP purposes of $37 million, for tax purposes these sales generated gains of $34 million. The majority of this difference relates to the timing variances in the recognition of income and losses. In addition, gains realized for tax may be offset by prior capital losses and, thus, not affect taxable income. As of March 31, 2010, the REIT had $85 million in capital loss carry-forwards ($1.09 per share) that can be used to offset future capital gains over the next five years. Since our intention is to generally invest in assets for the long-term, it is difficult to anticipate when sales may occur and, thus, when or whether we might exhaust these capital loss carry-forwards.

Prepayments on Securities

As part of our investment in Sequoia securitization entities, we have retained interest-only (IOs) securities at the time they are issued. Our current tax basis in these securities is $19 million. The return on IOs is sensitive to prepayments, and, to the extent prepayments vary quarter over quarter, income from these IOs will vary. Typically, fast prepayments reduce yields and slow prepayments increase yields. We are not permitted to recognize a negative yield under tax accounting rules, so during periods of fast prepayments our periodic premium expense for tax purposes can be relatively low and the tax cost basis for these securities may not be significantly reduced. In periods prior to 2008, we did experience fast prepayments on these loans. More recently, prepayments have been slowing, and our tax basis is now below the fair values for these IOs. Most of our Sequoia securitizations are callable or will become callable over the next two years, although we do not currently anticipate calling any Sequoia securitizations in 2010 or 2011. If we do call a Sequoia securitization, the remaining tax basis in the IOs is written off, creating an ordinary loss at the call date.

Prepayments also affect the quarterly recognition on other securities we own. We are required to use particular prepayment assumptions for the remaining lives of each security. As actual prepayment speeds vary, the yield we recognize for tax purposes in a quarter will be adjusted accordingly. Thus, to the extent prepayments differ from our long-term assumptions or vary from quarter to quarter, the yield recognized will also vary and this difference could be material for a specific security.

Compensation Expense at Redwood

The total tax expense for equity award compensation is dependent upon varying factors such as the timing of payments of dividend equivalent rights, the exercise of stock options, the distribution of deferred stock units, and the cash deferrals to and withdrawals from our Executive Deferred Compensation Plan. For GAAP, the total expense associated with an equity award is determined at the award date and is recognized over the vesting period. For tax, the total expense is recognized at the date of distribution or exercise, not the award date. In addition, some compensation may not be deductible for tax if it exceeds certain levels and is

TABLE OF CONTENTS

not performance-based. Thus, the total amount of compensation expense, as well as the timing, could be significantly different for tax than for GAAP. In addition, since the decision to exercise options or distribute DSUs or cash out of the Executive Deferred Compensation Plan is an employee s, it can be difficult to project when the tax expense will occur. Should there be significant differences in quarterly activity in this regard, our taxable income could be volatile.

Financial Condition

The majority of the assets shown on our consolidated balance sheets are owned by our securitization entities. The earning assets of these entities represent 78% of our consolidated earning assets and the liabilities (ABS issued) of these entities represent 95% of our consolidated liabilities. Although we consolidate these assets and liabilities for financial reporting purposes, they are bankruptcy-remote from us. That is, they are structured so that our liabilities are not liabilities of the securitization entities and the ABS issued by the securitization entities are not obligations of ours.

The following table shows the components of our balance sheet at March 31, 2010.

Table 19 Consolidating Balance Sheet

March 31, 2010 (In Millions)	Redwood Parent Only	The Fund	Securitization Entities	Intercompany Adjustments	Redwood Consolidated
Real estate loans	$ 2	$	$ 3,660	$	$ 3,662
Real estate securities, at fair value:					
Trading securities	20		269		289
Available-for-sale securities	820	27			847
Other investments			11		11
Cash and cash equivalents	242				242
Investment in the Fund	16			(16)	
Investment in Securitization Entities	78			(78)	
Total earning assets	1,178	27	3,940	(94)	5,051
Other assets	23	3	118		144
Total Assets	$ 1,201	$ 30	$ 4,058	$ (94)	$ 5,195
Short-term debt	$	$	$	$	$
Other liabilities	63	1	143		207
Asset-backed securities issued			3,837		3,837
Long-term debt	140				140
Total liabilities	203	1	3,980		4,184
Stockholders equity	998	16	78	(94)	998
Noncontrolling interest		13			13
Total equity	998	29	78	(94)	1,011
Total Liabilities and Equity	$ 1,201	$ 30	$ 4,058	$ (94)	$ 5,195

68

TABLE OF CONTENTS

Analysis of Earning Assets

Real Estate Securities at Redwood

The following table provides real estate securities activity at Redwood for the three months ended March 31, 2010.

Table 20 Real Estate Securities Activity at Redwood

Three Months Ended March 31, 2010	Residential					
(In Millions)	Senior	Re-REMIC	Subordinate	Commercial	CDO	Total
Beginning fair value	$ 644	$ 106	$ 21	$ 9	$ 1	$ 781
Acquisitions	174		6			180
Sales	(58)	(28)				(86)
Effect of principal payments	(21)		(1)			(22)
Change in fair value, net	1	(11)	(3)			(13)
Ending Fair Value	$ 740	$ 67	$ 23	$ 9	$ 1	$ 840

Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests. The commercial and CDO securities that we own are subordinate securities.

The following table presents the carrying value (which equals fair value) as a percent of face value for securities owned at Redwood at March 31, 2010 and December 31, 2009.

Table 21 Fair Value as Percent of Principal Value for Real Estate Securities

March 31, 2010	2004 & Earlier		2005		2006 2008		Total	
(Dollars in Millions)	Value	%	Value	%	Value	%	Value	%
Residential Senior								
Prime	$ 14	84 %	$ 286	84 %	$ 73	78 %	$ 373	83 %
Non-prime	116	82 %	232	77 %	19	59 %	367	77 %
Total	130	82 %	518	81 %	92	73 %	740	80 %
Residential Re-REMIC	5	46 %	8	46 %	54	45 %	67	46 %
Residential Subordinate								
Prime	13	7 %	3	5 %	1	2 %	17	5 %
Non-prime	6	29 %					6	10 %
Total	19	9 %	3	5 %	1	2 %	23	6 %
Commercial	7	16 %	2	1 %			9	6 %
CDO			1	7 %			1	7 %
Total Securities at Redwood	$ 161		$ 532		$ 147		$ 840	

December 31, 2009	2004 & Earlier		2005		2006 2008		Total	
(Dollars in Millions)	Value	%	Value	%	Value	%	Value	%
Residential Senior								
Prime	$ 14	81 %	$ 248	81 %	$ 67	76 %	$ 329	80 %
Non-prime	118	81 %	183	72 %	14	43 %	315	73 %
Total	132	81 %	431	77 %	81	67 %	644	76 %
Residential Re-REMIC	4	41 %	13	41 %	89	42 %	106	41 %
Residential Subordinate								
Prime	15	8 %	3	5 %	2	2 %	20	6 %
Non-prime			1	11 %			1	11 %
Total	15	8 %	4	5 %	2	2 %	21	5 %
Commercial	7	16 %	2	1 %			9	6 %
CDO			1	7 %			1	7 %
Total Securities at Redwood	$ 158		$ 451		$ 172		$ 781	

Residential Securities at Redwood

Prime residential securities are residential mortgage-backed securities backed by prime loans. Many of these loans are jumbo loans, with loan balances greater than existing GSE conforming loan limits. Prime securities typically have relatively high weighted average FICO scores (700 or higher), low weighted average loan-to-value ratios (75% LTV or less), and limited concentrations of investor properties. Regardless of whether or not the loans backing a mortgage-backed security are of prime quality, there is still a risk that the borrower may not be able to repay the loan.

TABLE OF CONTENTS

Non-prime securities are residential mortgage-backed securities that are generally backed by non-prime loans. Most of the borrowers backing non-prime loans have lower FICO scores or impaired credit histories, but exhibit the ability to repay the loan. To compensate for the greater risks and higher costs to service non-prime loans, borrowers often pay higher interest rates, and possibly higher origination fees. We use loss assumptions that are significantly higher when acquiring securities backed by non-prime loans than we use when acquiring securities backed by prime loans.

The following table presents the components of carrying value at March 31, 2010 and December 31, 2009, for our residential securities.

Table 22 Carrying Value of Residential Securities at Redwood

March 31, 2010	Residential	
(In Millions)	Prime	Non-prime
Current face of AFS securities	$ 922	$ 528
Credit reserve	(319)	(62)
Net unamortized discount	(206)	(136)
Amortized cost	397	330
Gross unrealized gains	84	29
Gross unrealized losses	(26)	(4)
Carrying value of AFS securities	455	355
Carrying value of trading securities	1	19
Total Carrying Value of Residential Securities	$ 456	$ 374

December 31, 2009	Residential	
(In Millions)	Prime	Non-prime
Current face of AFS securities	$ 1,016	$ 496
Credit reserve	(375)	(84)
Net unamortized discount	(248)	(135)
Amortized cost	393	277
Gross unrealized gains	90	41
Gross unrealized losses	(29)	(8)
Carrying value of AFS securities	454	310
Carrying value of trading securities	1	6
Total Carrying Value of Residential Securities	$ 455	$ 316

TABLE OF CONTENTS

The following table details the carrying value of residential securities at Redwood by the product type and collateral vintage at March 31, 2010 and December 31, 2009. At March 31, 2010, the securities we held consisted of fixed-rate assets (38%), adjustable-rate assets that reset within the next year (43%), hybrid assets that reset between 12 and 36 months (6%), and hybrid assets that reset after 36 months (13%).

Table 23 Carrying Value of Residential Securities at Redwood By Product and Vintage

March 31, 2010 (In Millions)	Vintage 2004 & Earlier	2005	2006	2008	Total
Prime					
ARM	$ 1	$	$		$ 1
Hybrid	23	287	95		405
Fixed	7	10	33		50
Total prime	31	297	128		456
Non-prime					
Option ARM		21	8		29
ARM	6				6
Hybrid	98	24			