REDWOOD TRUST INC
Form 10-Q
May 05, 2009

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, 2009

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).Yes x No o

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

Large accelerated filer o Accelerated filer x 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	60,255,977 shares outstanding as of May 4, 2009

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REDWOOD TRUST, INC.

2009 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data) (Unaudited)	March 31, 2009	December 31, 2008
ASSETS		
Real estate loans	$4,540,403	$4,659,336
Real estate securities, at fair value:		
Trading securities	264,342	339,654
Available-for-sale securities	255,223	232,470
Total real estate securities	519,565	572,124
Other investments	61,637	78,244
Cash and cash equivalents	333,153	126,480
Total earning assets	5,454,758	5,436,184
Restricted cash	51,371	53,608
Accrued interest receivable	25,561	31,415
Derivative assets	4,784	3,071
Deferred tax asset	2,739	3,608
Deferred asset-backed securities issuance costs	9,129	9,921
Other assets	32,254	43,942
Total Assets	$5,580,596	$5,581,749
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$	$
Accrued interest payable	14,697	29,417
Derivative liabilities	155,856	177,590
Accrued expenses and other liabilities	11,619	20,118
Dividends payable	15,057	25,103
Asset-backed securities issued Sequoia	4,418,352	4,508,127

Asset-backed securities issued Acacia	290,645	346,931
Long-term debt	150,000	150,000
Total liabilities	5,056,226	5,257,286
EQUITY		
Stockholders Equity		
Common stock, par value $0.01 per share, 101,450,000 and 75,000,000 shares authorized; 60,228,058 and 33,470,557 issued and outstanding	602	336
Additional paid-in capital	1,433,685	1,149,392
Accumulated other comprehensive loss	(85,467)	(56,865)
Cumulative earnings	231,115	266,059
Cumulative distributions to stockholders	(1,073,663)	(1,057,070)
Total stockholders equity	506,272	301,852
Noncontrolling interest	18,098	22,611
Total equity	524,370	324,463
Total Liabilities and Equity	$5,580,596	$5,581,749

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF (LOSS) INCOME

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended March 31, 2009	2008
Interest Income		
Real estate loans	$33,969	$95,623
Real estate securities	47,263	76,528
Other investments	76	732
Cash and cash equivalents	130	3,181
Total interest income	81,438	176,064
Interest Expense		
Short-term debt		(182)
Asset-backed securities issued	(45,834)	(124,585)
Long-term debt	(1,808)	(2,533)
Total interest expense	(47,642)	(127,300)
Net Interest Income	33,796	48,764
Provision for loan losses	(16,032)	(8,058)
Market valuation adjustments, net	(43,242)	(193,932)
Net Interest Loss After Provision and Market Valuation Adjustments	(25,478)	(153,226)
Operating expenses	(10,539)	(16,348)
Realized gains on sales and calls, net	462	42

Net loss before provision for income taxes	(35,555)	(169,532)
Provision for income taxes	(105)	(1,800)
Net loss	(35,660)	(171,332)
Less: Net (loss) income attributable to noncontrolling interest	(716)	255
Net Loss Attributable to Redwood Trust, Inc.	$(34,944)	$(171,587)
Basic (loss) earnings per share:	$(0.65)	$(5.28)
Diluted (loss) earnings per share:	$(0.65)	$(5.28)
Regular dividends declared per common share	$0.25	$0.75
Basic weighted average shares outstanding	53,632,132	32,511,445
Diluted weighted average shares outstanding	53,632,132	32,511,445

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY AND COMPREHENSIVE (LOSS) INCOME

For the Three Months Ended March 31, 2009

For the Three Months Ended March 31, 2008

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Three Months Ended March 31,

	2009	2008
Cash Flows From Operating Activities:		
Net (loss) income	$(34,944)	$(171,587)
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	2,965	(7,664)
Depreciation and amortization of non-financial assets	273	266
Provision for loan losses	16,032	8,058
Non-cash equity award compensation	1,794	1,406
Market valuation adjustments, net	43,242	193,932
Realized gains on sales and calls, net	(462)	(42)
Net change in:		
Accrued interest receivable	6,244	8,020
Deferred income taxes	869	394
Other assets	20,087	6,180
Accrued interest payable	(10,483)	(9,914)
Accrued expenses and other liabilities	(8,499)	(3,216)
Net cash provided by operating activities	37,118	25,833
Cash Flows From Investing Activities:		
Principal payments on real estate loans held-for-investment	83,866	399,844
Purchases of real estate securities available-for-sale	(97,551)	(54,875)
Proceeds from sales of real estate securities available-for-sale	711	
Principal payments on real estate securities available-for-sale	18,588	17,936
Purchases of real estate securities trading		(3,341)
Principal payments on real estate securities trading	28,571	57,298
Principal payments on other investments	3,942	354
Net decrease (increase) in restricted cash	2,237	(31,189)
Net cash provided by investing activities	40,364	386,027
Cash Flows From Financing Activities:		
Net (repayments) borrowings on short-term debt		(5,475)
Repayments on asset-backed securities	(117,142)	(431,228)
Net purchases of interest rate agreements	(7,223)	(1,718)
Net proceeds from issuance of common stock	282,765	10,002
Dividends paid	(26,639)	(25,210)
Change in noncontrolling interests	(2,570)	8,301
Net cash provided by (used in) financing activities	129,191	(445,328)
Net increase (decrease) in cash and cash equivalents	206,673	(33,468)
Cash and cash equivalents at beginning of period	126,480	290,363
Cash and cash equivalents at end of period	$333,153	$256,895
Supplemental Disclosures:		
Cash paid for interest	$62,362	$137,214
Cash received for taxes	$(806)	$
Dividends declared but not paid at end of period	$15,057	$24,532

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2009
(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, 2009 and December 31, 2008, and for the three months ended March 31, 2009 and 2008. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States (GAAP) 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, 2009, may not necessarily be indicative of the results for the year ending December 31, 2009. The unaudited interim consolidated financial statements as of March 31, 2009, 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, 2008. All amounts presented herein, except per share data, are shown in thousands.

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.

Principles of Consolidation

We apply the principles of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140) and FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)) to determine whether we must consolidate any entities where we have continuing involvement.

We consolidate the assets, liabilities, and noncontrolling interests of the Fund that we sponsor, as we are the primary beneficiary of this entity as defined by FIN 46(R). The primary beneficiary is the party that absorbs the majority of a variable interest entity s (VIEs) anticipated losses and/or the majority of the expected returns. Our significant limited partnership interests and ongoing asset management responsibilities constitute this majority. We do not service any assets, including assets owned at the Fund.

We consolidate the assets and liabilities of the Sequoia and Acacia securitization entities that we sponsor that are not accounted for as sales. These entities did not meet the criteria for sale accounting as prescribed by FAS 140 at the time we transferred financial assets to them. Our continuing involvement includes our

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 2. Basis of Presentation (continued)

retention of junior interests and call rights and certain ongoing management responsibilities or other discretionary activities. We do not service any assets, including assets owned at Sequoia or Acacia. For financial reporting purposes, 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 (loss) income, we record interest income on the loans and securities and interest expense on the ABS issued.

During the fourth quarter of 2008, we derecognized the assets and liabilities of certain Sequoia entities due to a sale of our variable interests in those entities and lack of continuing involvement. These assets and liabilities are no longer shown on our consolidated balance sheets as of December 31, 2008.

Note 3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with GAAP 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, the period of time during which we anticipate an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, 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

Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FAS No. 115* (FAS 159) 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, or upon the initial adoption of FAS 159 on January 1, 2008. Subsequent changes in the fair value of these assets, liabilities, and commitments are recorded in the consolidated statements of (loss) income.

Our decision to adopt FAS 159 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 under FAS 115. 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 accounted for at fair value under FAS 159 along with the corresponding liabilities.

See *Note 4* 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. We estimate fair values in accordance with Statement of Financial Accounting Standards No. 157*, Fair Value Measurements* (FAS 157). Under this standard, a fair value measurement represents the price at which a transaction would occur between market participants. This price implies an orderly transaction, or exit price, that is not a forced liquidation or distressed sale 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:

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

March 31, 2009
(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Quoted prices for the same or similar securities;
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 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 conditions for that asset or liability, 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 may not be a 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) must also be evaluated. In circumstances where relevant market inputs cannot be obtained, increased analysis and management judgment are required to estimate fair value. This may require 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 5* 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 under FAS 159. The fair value option was elected on January 1, 2008, for all the loans owned by Acacia securitization entities as of that date. 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 (gains and losses) are recurring and are reported through our consolidated statements of (loss) income 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 independent third parties. These loans are carried at the lower of their cost or fair value in accordance with Statement of Financial Accounting Standards No. 65, *Accounting for Certain Mortgage Banking Activities* (FAS 65), as measured on an individual basis. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. If fair value is lower than amortized cost, changes in fair value (gains and losses) are reported through our consolidated statements of (loss) income in market valuation adjustments, net.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (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 on loans that become greater than 90 days past due is reserved against 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. Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we use the interest method to determine an effective yield and 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 an effective yield to amortize the premium or discount. 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 calculate an effective yield to amortize the premium or discount.

We may exercise our right to call ABS issued by Sequoia and may subsequently sell the underlying loans to third parties. We reclassify held-for-investment loans to held-for-sale loans if we determine that loans will be sold to third parties. Gains or losses on the sale of real estate loans are based on the specific identification method.

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 as of 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 follow the guidelines of SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and*

Documentation (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), in setting the allowance for loan losses.

We consider the following factors in making such determinations:

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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2009
(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Once we determine applicable default amounts, the timing of the defaults, and severity of losses upon 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 effective 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 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 on at least a quarterly basis.

See *Note 7* for further discussion on the allowance for loan losses.

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

Real Estate Securities, at Fair Value

Trading Securities

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

We primarily denote trading securities as those securities where we have adopted the fair value option under FAS 159. We currently account for certain securities at Redwood and all securities at Acacia entities as trading securities. Prior to the adoption of FAS 159, these securities were accounted for in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115).

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 (loss) income in our consolidated statements of equity, in accordance with FAS 115. We currently account for most securities at Redwood and all securities at the Fund as AFS securities.

When recognizing revenue on our AFS securities, we have determined that credit risk is not remote and therefore employ the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). 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 asset, which includes assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to 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. Actual maturities of our AFS securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS

Note 3. Summary of Significant Accounting Policies (continued)

securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There can be 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 the change could be material.

Yields recognized for each security 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.

We assess each quarter whether a decline in fair value below our cost of the AFS security is an other-than-temporary impairment (OTTI). For determining OTTI, we use the guidelines prescribed under FAS 115, EITF 99-20, and SEC Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (commonly referred to as SAB 59). If there has been an adverse change in the projected future cash flows of the security, we no longer have the ability and intent to hold the security, or we have determined that there will not likely be a recovery of fair value up to (or beyond) the amortized cost of the security within a reasonable period of time, there is an OTTI. Upon the determination of an OTTI, any associated accumulated other comprehensive loss is reclassified into earnings using the specific identification method and reported under market valuation adjustments, net, in our consolidated statements of (loss) income.

In January 2009, the FASB issued FASB Staff Position EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (FSP EITF 99-20-1). FSP EITF 99-20-1 clarified the impairment guidance in EITF 99-20 to ensure a more consistent determination of whether an OTTI has occurred. The implementation of this standard did not impact our consolidated financial position and results of operations as our existing valuation methodology is consistent with the FASB s clarification.

See *Note 8* 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 statements purposes. We elected the fair value option under FAS 159 for this investment on January 1, 2008, and it is recorded on our consolidated balance sheets at its estimated fair value. Changes in fair value are reported through our consolidated statements of (loss) income through market valuation adjustments, net. Interest income is reported through our consolidated statements of (loss) income through interest income, other investments.

See *Note 9* for further discussion on other investments.

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash on hand and highly liquid investments with original maturities of three months or less. At March 31, 2009, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in U.S. Government Treasury Bills or FDIC-insured bank products.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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.

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 under FAS 159, the associated accrued interest on these assets is measured at fair value. For financial assets where we have not elected to adopt FAS 159, 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 on our consolidated balance sheets, in accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133) and FAS 159. 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 (loss) income through market valuation adjustments, net.

On January 1, 2009, we adopted the Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133* (FAS 161). FAS 161 required qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit risk related contingent features in derivative agreements. Our adoption of FAS 161 resulted in increased disclosures, which can be found in *Note 10*.

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.

Prior to 2008, we accounted for derivatives used to hedge interest rate exposure in Acacia securitization entities as cash flow hedges. At January 1, 2008, all of our consolidated derivatives designated as cash flow hedges were de-designated and accounted for as trading instruments. To the extent 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 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 classified as financing activities within our consolidated statements of cash flows.

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NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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 have consolidated for financial reporting purposes. Net purchases and proceeds from CDS are classified as financing activities within our consolidated statements of cash flows.

See *Note 10* for further discussion on derivative financial instruments.

Deferred Tax Assets

Income recognition for GAAP and tax differ in material respects. These differences often 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 for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is recognized as an expense. Our deferred tax assets are primarily generated by differences in GAAP and taxable income at our taxable subsidiaries. GAAP and tax differences at the REIT may create additional deferred tax assets or liabilities to the extent we do not distribute all of our taxable income.

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are costs associated with the issuance of ABS from the Sequoia securitization entities we sponsor. These costs 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 to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21). Sequoia deferred ABS issuance costs are accounted for in accordance with APB 21.

As of January 1, 2008, deferred issuance costs associated with Acacia securitizations were included as part of our adoption of FAS 159 for assets and liabilities at Acacia. As a result, these deferred costs were charged to retained earnings as a part of a one-time cumulative effect adjustment on January 1, 2008.

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, purchased interest, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair value. All other assets are reported at cost.

See *Note 11* 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 late November 2008 we have had no short-term debt outstanding.

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NOTES TO FINANCIAL STATEMENTS
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Note 3. Summary of Significant Accounting Policies (continued)

Accrued Interest Payable

Accrued interest payable represents interest that is due and payable to third parties. Interest is generally paid within thirty days to three months of recording the payable, based upon our remittance requirements. For borrowings where we have elected the fair value option under FAS 159, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected to adopt FAS 159, 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

Effective January 1, 2008, Acacia ABS issued are accounted for under FAS 159 and carried at their estimated fair values on our consolidated balance sheets. Changes in fair value (gains or losses) are reported in our consolidated statements of (loss) income through market valuation adjustments, net. Prior to January 1, 2008, Acacia ABS issued were accounted for under the same method as Sequoia ABS issued.

See *Note 12* 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. These notes contain an earlier optional redemption date without penalty.

See *Note 13* for further discussion on long-term debt.

Equity

(Loss) Earnings Per Share

Basic (loss) earnings per share (EPS) are computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) EPS are computed by dividing net (loss) income 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 Statement of Financial Accounting Standards No. 128, *Earnings per Share* (FAS 128), if there is a loss from continuing operations, the common stock equivalents are deemed antidilutive and diluted (loss) EPS is calculated in the same manner as basic (loss) EPS.

On January 1, 2009, we adopted, FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (EITF 03-6-1). EITF 03-6-1 states

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are participating securities as defined in EITF 03-6, *Participating Securities and the Two-Class Method under FASB Statement No. 128* (EITF 03-6), and therefore should be included in computing EPS using the two-class method. Our adoption of EITF 03-6-1 required us to recast previously reported EPS, and did not have a significant impact on EPS.

Other Comprehensive (Loss) Income

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements previously designated as cash flow hedges under FAS 133 are reported as components of other comprehensive (loss) income on our consolidated statements of equity and comprehensive (loss) income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive (loss) income 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 Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160), the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third parties is shown as net income attributable to noncontrolling interest in our consolidated statements of (loss) income. A reconciliation of equity attributable to noncontrolling interest is disclosed in our consolidated statements of equity and comprehensive (loss) income.

Equity Compensation Plans

Incentive Plan

In March 2008, we amended our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. This amendment was approved by our shareholders in May 2008. 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, stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors.

The cost of equity awards is determined in accordance with Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), and amortized over the vesting term using an accelerated method in accordance with FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Options or Award Plans* (FIN 28) and FAS 123R. Stock options, deferred stock units, and restricted stock granted to employees generally vest over a four-year period. Non-employee directors are provided annual awards under the Incentive Plan that generally vest immediately.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Employee Stock Purchase Plan

In May 2002, our stockholders approved our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), effective July 1, 2002. 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 16* 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. Beginning in 2003, we elected to retain up to 10% of our REIT ordinary taxable income and had provisioned for corporate income taxes on the retained income while maintaining our REIT status. In August 2008, our Board of Directors decided to distribute as dividends 100% of our REIT taxable income generated in 2007 and 2008 and our tax provisions changed accordingly.

We assess our tax positions for all open tax years and determine whether we have any material unrecognized liabilities in accordance with Financial Accounting Standard Board Interpretation Number 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48). 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 (loss) income.

See *Note 18* for further discussion on taxes.

Recent Accounting Pronouncements

In April 2009, the FASB issued FASB Staff Position FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP 157-4). The purpose of this FSP is to provide additional guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased, and determining when a transaction is not orderly. FSP 157-4 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. We do not anticipate the implementation of this standard to have a material impact on our consolidated financial position and results of operations as our existing valuation methodology is consistent with the FASB s clarification.

In April 2009, FASB issued FASB Staff Position FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP 107-1), which expands the fair value disclosures required for all financial instruments within the scope of FAS 107 to interim periods for publicly traded entities. The FSP also requires companies to disclose the method(s) and significant assumptions used to estimate the fair value of

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2009

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

financial instruments in financial statements on an interim basis and to highlight any changes of the methods and significant assumptions from prior periods. FSP 107-1 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. We do not anticipate the implementation of this standard to have a material impact on our consolidated financial position and results of operations as our existing disclosures are consistent with the FASB s clarification.

In April 2009, the FASB issued FASB Staff Position FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP 115-2), which establishes a new method of recognizing and reporting OTTI of debt securities, as well as additional disclosure requirements related to debt and equity securities. Prior to the effective date of this FSP (April 1, 2009), OTTI were based on a market value decline below a security s cost basis and a corresponding adverse change in expected future cash flows due to credit related factors, as defined by EITF 99-20. Impairments were also evaluated based on whether an entity could assert the ability and intent to hold the investment until a recovery of fair value. If the entity could not make this assertion, the cost basis of the security was written down to current fair value, with the entire write-down recognized in current earnings. Under FSP 115-2, the determination of OTTI for debt securities is changed. The presence of impairment continues to be based upon a market value decline below a security s cost basis and a corresponding adverse change in expected future cash flows. However, the provisions of EITF 99-20 are amended to now consider any adverse changes in cash flows, including non-credit factors such as changes in floating interest rates. This FSP also eliminates the ability and intent provision and requires impairment to be considered other-than-temporary if an entity (i) intends to sell the security, (ii) will more likely than not be required to the sell the security before it recovers in value, or (iii) does not expect to recover the security s amortized cost basis, even if the entity does not intend to sell the security. Under these scenarios, the impairment is other than temporary and the full amount of impairment should be recognized currently in earnings. However, if an entity does not intend to sell the impaired debt security and it is more likely than not that it will not be required to sell before recovery, the OTTI should be separated into (i) the estimated amount relating to credit loss, and (ii) the amount relating to all other factors. Only the estimated credit loss amount is recognized currently in earnings, with the remainder of the loss amount recognized in other comprehensive income.

FSP 115-2 is effective for interim and annual periods ending after June 15, 2009. Upon adoption of this FSP, a cumulative effect transition adjustment is required to reclassify the non-credit portion of any OTTI previously recorded through earnings to accumulated other comprehensive (loss) income for investments held as of the beginning of the period of adoption. The cumulative effect adjustment is determined based on the difference between the present value of the cash flows expected to be collected and the amortized cost basis of the debt security as of the beginning of the period of adoption and should include any related tax effects. The difference between the new amortized cost basis and the cash flows expected to be collected should be accreted as interest income in accordance with existing guidance. We expect that adoption of this standard will have a significant impact on our reported results for the following reasons (i) the cumulative effect adjustment of adopting the standard will be significant, and (ii) a significant portion of OTTI taken during periods prior to the effective date of this standard will no longer be recoverable through earnings in future periods. We are currently evaluating these amounts.

In April 2009, the SEC issued Staff Accounting Bulletin 111, *Other than Temporary Impairment of Certain Investments in Equity Securities* (SAB 111), which amends SAB 59 to exclude OTTI on debt securities from its scope. The SEC issued SAB 111 to align its guidance with that of the FASB and FAS 115-2, ensuring consistency in standards for determining impairments. SAB 111 is effective upon adoption of FAS 115-2.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 4. Fair Value Option

We have not elected the fair value option for any financial instruments that were acquired from third parties subsequent to our initial adoption of FAS 159 on January 1, 2008. We did elect 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. These ABS issued had been previously eliminated as intercompany assets for financial reporting purposes. Upon recognition of these ABS, we recorded a $7 million negative market valuation adjustment through the consolidated statement of (loss) income in accordance with our election to adopt FAS 159 for these securities.

Transition Adjustment Due to the Adoption of FAS 159 on January 1, 2008

We adopted FAS 159 on January 1, 2008, and elected to apply the fair value option for the assets (loans, securities, and unamortized deferred ABS issuance costs) and liabilities (ABS issued) of our consolidated Acacia securitization entities. We also elected the fair value option for certain securities at Redwood that we anticipated potentially selling or securitizing in the future. We did not elect the fair value option for the assets and liabilities at Sequoia, as these assets and liabilities are accounted for using similar measurement attributes (i.e., cost basis) and do not generally create substantial volatility in our earnings. We also did not elect the fair value option for most subordinate securities and other investments at Redwood, as these assets were funded with equity and are not anticipated to be funded with a combination of debt and equity in the future, or securitized. The one-time election of FAS 159 resulted in a $1.5 billion cumulative effect transition adjustment at January 1, 2008.

As of March 31, 2009, the loans at Acacia had an aggregate fair value of $10 million and an unpaid principal balance of $26 million, the securities had an aggregate fair value of $260 million and face value of $3.1 billion, and asset-backed securities issued at Acacia had an aggregate fair value of $291 million and an unpaid principal balance of $3.1 billion.

Prior to the application of FAS 159, we were required to mark-to-market the assets, but not the liabilities, of Acacia entities, even though the assets and liabilities were paired within the same legal structure and the ABS issued by each Acacia entity would be repaid directly and solely from the cash flows generated by the assets of that entity. Electing the fair value option for the assets and liabilities of Acacia enabled us to mitigate the volatility in earnings and book value that results from the use of different measurement attributes. As a result of this fair value election we de-designated all cash flow hedge accounting elections for our interest rate agreements, which reduced the complexity of accounting with regards to derivatives under FAS 133. Additionally, there was no deferred tax impact associated with the adoption since the net unrealized losses in accumulated other comprehensive loss that were reclassified to retained earnings were generated at the REIT, which distributes predominantly all of its taxable income.

Note 5. Fair Value of Financial Instruments

FAS 157 defines fair value, establishes a hierarchy of information used in measuring fair value, and enhances the disclosure of information about fair value measurements. FAS 157 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. FAS 157 also provides that relevant market data, to the extent available, and not internally generated or entity specific information, should be used to determine fair value.

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Note 5. 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, 2009 and December 31, 2008.

	March 31, 2009		December 31, 2008	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Real estate loans (held-for-investment)	$ 4,528,220	$ 2,595,656	$ 4,644,734	$ 2,618,323
Real estate loans (held-for-sale)	2,577	2,577	2,624	2,624
Real estate loans (fair value)	9,606	9,606	11,977	11,977
Trading securities	264,342	264,342	339,654	339,654
Available-for-sale securities	255,223	255,223	232,470	232,470
Other investments	61,637	61,637	78,244	78,244
Cash and equivalents	333,153	333,153	126,480	126,480
Restricted cash	51,371	51,371	53,608	53,608
Accrued interest receivable	25,561	25,561	31,415	31,415
Derivative assets	4,784	4,784	3,071	3,071
REO (included in other assets)	18,926	18,926	19,264	19,264
Liabilities				
Short-term debt				
Accrued interest payable	14,697	14,697	29,417	29,417
Derivative liabilities	155,856	155,856	177,590	177,590
ABS Issued				

ABS issued Sequoia	4,418,352	2,548,264	4,508,127	2,967,763
ABS issued Acacia	290,645	290,645	346,931	346,931
Total ABS issued	4,708,997	2,838,909	4,855,058	3,314,694
Long-term debt	150,000	42,000	150,000	41,628

FAS 157 requires us to estimate and disclose fair values based on the following three-level hierarchy that prioritizes market inputs.

Level 1: Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable market data.

Level 3: Unobservable inputs (e.g., an entity s own data or assumptions).

Level 3 inputs include unobservable inputs that are used when there is little, if any, market activity for the asset or liability measured at fair value. In certain cases, the 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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 5. 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, 2009

		Fair Value Measurements Using		
(In Thousands)	Carrying Value	Level 1	Level 2	Level 3
Assets				
Real estate loans	$ 9,606		$	$ 9,606
Trading securities	264,342			264,342

Available-for-sale securities	255,223			255,223
Other investments	61,637		61,637	
Derivative assets	4,784		4,514	270
Liabilities				
ABS issued Acacia	290,645			290,645
Derivative liabilities	155,856		94,311	61,545

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2008

(In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3
Assets				
Real estate loans	$ 11,977		$	$ 11,977
Trading securities	339,654			339,654
Available-for-sale securities	232,470			232,470
Other investments	78,244		78,244	
Derivative assets	3,071		2,829	242
Liabilities				
ABS issued Acacia	346,931			346,931
Derivative liabilities	177,590		99,698	77,892

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents additional information about the assets and liabilities recorded at fair value on our consolidated balance sheet on a recurring basis for which Level 3 inputs were used.

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

	Gains (Losses) Included in	Purchases, Sales, Other Settlements	Ending Balance 3/31/2009

Three Months Ended March 31, 2009 (In Thousands)	Beginning Balance 12/31/2008	Principal Paydowns	Net Loss	Other Comprehensive Loss	and Issuances, Net	
Assets						
Real estate loans	$11,977	$(125)	$(2,246)	$	$	$9,606
Trading securities	339,654	(28,571)	(46,425)		(316)	264,342
Available-for-sale securities	232,470	(18,588)	(29,035)	(31,644)	102,020	255,223
Derivative assets	242		160		(132)	270
Liabilities						
ABS issued Acacia	346,931	(28,834)	(31,689)		4,237	290,645
Derivative liabilities	77,892		(271)		(16,076)	61,545

Three Months Ended March 31, 2008 (In Thousands)	Beginning Balance 1/1/2008[1]	Principal Paydowns	Gains (Losses) Included in Net Loss	Other Comprehensive Loss	Purchases, Sales, Other Settlements and Issuances, Net	Ending Balance 3/31/2008
Assets						
Real estate loans	$25,426	$(116)	$(4,660)	$(1,849)	$	$18,801
Trading securities	1,804,511	(57,298)	(797,980)		3,343	952,576
Available-for-sale securities	317,090	(17,936)	(133,058)	21,017	54,917	242,030
Derivative assets	114		31		(75)	70
Liabilities						
ABS issued Acacia	1,893,441	(37,440)	(809,841)			1,046,160
Derivative liabilities	57,397		17,809		(2,707)	72,499

(1) Beginning balance reflects the adoption of FAS 159 on January 1, 2008.

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NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the portion of gains or losses included in our consolidated statement of (loss) income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at March 31, 2009 and 2008. Gains or losses incurred on assets or liabilities sold or otherwise disposed of during the three months ended March 31, 2009 and 2008 are not included in this presentation.

Portion of Gains or (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2009 and 2008 Included in Net Loss

(In Thousands)	Included in Net Loss Three Months Ended March 31, 2009	March 31, 2008
Assets		
Real estate loans	$ (2,246)	$ (4,660)
Trading securities	(46,471)	(794,133)
Available-for-sale securities	(29,035)	(143,922)
Derivative assets	160	31
Liabilities		
ABS issued Acacia	31,689	809,841
Derivative liabilities	271	(14,604)

The following table presents assets and liabilities recorded at fair value on a non-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 Non-Recurring Basis as of March 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)	$ 2,577			$ 2,577	$ (21)
REO	18,926			18,926	(765)

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of December 31, 2008

(In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3
Assets				
Real estate loans (held-for-sale)	$ 2,624			$ 2,624
REO	19,264			19,264

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Note 5. Fair Value of Financial Instruments (continued)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of (loss) income for the three months ended March 31, 2009 and 2008.

Market Valuation Adjustments, Net

	Three Months Ended March 31,	
(In Thousands)	2009	2008
Assets		
Real estate loans (fair value)	$ (2,246)	$ (4,660)
Real estate loans (held-for-sale)	(786)	(860)
Trading securities	(46,425)	(797,979)
Impairments on AFS securities	(29,035)	(144,098)
Liabilities		
ABS issued Acacia	31,689	809,841
Derivative instruments, net	3,561	(56,176)
Market Valuation Adjustments, Net	$ (43,242)	$ (193,932)

A description of the instruments measured at fair value under FAS 157 as well as the general classification of such instruments pursuant to the valuation hierarchy described above under FAS 157 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).

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).

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

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Note 5. Fair Value of Financial Instruments (continued)

generally be verified and model selection does not involve significant management judgment (Level 2). For other derivatives, 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.

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).

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).

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).

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Note 6. 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.

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans reported on our consolidated balance sheets at March 31, 2009 and December 31, 2008.

(In Thousands)	March 31, 2009	December 31, 2008
Residential real estate loans (held-for-sale)	$ 2,577	$ 2,624
Residential real estate loans (held-for-investment)	4,527,972	4,644,486
Commercial real estate loans (fair value)	9,606	11,977
Commercial real estate loans (held-for-investment)	248	249
Total Real Estate Loans	$ 4,540,403	$ 4,659,336

Residential Real Estate Loans Held-for-Sale

Residential real estate loans held-for-sale are owned with equity. At March 31, 2009, there were 15 residential loans held-for-sale with $5 million in outstanding principal value and a lower of cost or fair value of $3 million. At December 31, 2008, there were 15 residential loans held-for-sale with $5 million in outstanding principal value and a lower of cost or fair value of $3 million.

Residential Real Estate Loans Held-for-Investment

Residential real estate loans held-for-investment are owned at Sequoia entities that we consolidate for financial reporting purposes. The following table provides additional information on residential real estate loans held-for-investment at March 31, 2009 and December 31, 2008.

Residential Real Estate Loans Held-for-Investment

(In Thousands)	March 31, 2009	December 31, 2008
Principal value	$4,515,744	$4,612,564
Unamortized premium, net	60,175	67,635
Allowance for loan losses	(47,947)	(35,713)
Carrying Value	$4,527,972	$4,644,486

Of the $4.5 billion of principal face and $60 million of unamortized premium on these loans at March 31, 2009, $2.0 billion of principal face and $41 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the first quarter of 2009, 2% of these residential loans prepaid and we amortized 14% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal face was $2.5 billion and the unamortized premium was $19 million at March 31, 2009. During the first quarter of 2009, 2% of these residential loans prepaid and we amortized 4% of the premium.

Of the $4.6 billion of principal face and $68 million of unamortized premium on these loans at December 31, 2008, $2.0 billion of principal face and $48 million of unamortized premium relates to residential loans acquired prior to July 1, 2004, and $2.6 billion of principal face and $20 million of unamortized premium relates to residential loans acquired after July 1, 2004.

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NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 6. Real Estate Loans (continued)

Commercial Real Estate Loans at Fair Value

Commercial real estate loans at fair value are owned at Acacia entities that we consolidate for financial reporting purposes. On January 1, 2008, we elected the fair value option under FAS 159 for loans at Acacia and record them at their estimated fair values. Prior to 2008, these loans were classified as held-for-investment. At March 31, 2009, there were five commercial loans at fair value, none of which are delinquent, with an outstanding principal value of $26 million and a fair value of $10 million.

Commercial Real Estate Loans Held-for-Investment

Commercial real estate loans held-for-investment are owned with equity. The following table provides additional information on commercial real estate loans held-for-investment as of March 31, 2009 and December 31, 2008.

Commercial Real Estate Loans Held-for-Investment

(In Thousands)	March 31, 2009	December 31, 2008
Principal value	$ 11,096	$ 11,098
Unamortized discount	(359)	(360)
Discount designated as credit reserve	(8,141)	(8,141)
Allowance for loan losses	(2,348)	(2,348)
Carrying Value	$ 248	$ 249

At March 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. During the first quarter of 2007, we fully reserved for an anticipated loss on a $10 million mezzanine commercial loan, which was originated to finance a condominium-conversion project. We do not expect to recover any outstanding principal upon completion and sale of the condominium units, and thus maintained the reserve as of March 31, 2009.

Note 7. 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, 2009 and December 31, 2008, 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 held-for-investment for the three months ended March 31, 2009 and 2008.

	Three Months Ended March 31,	
(In Thousands)	2009	2008
Balance at beginning of period	$ 35,713	$ 18,282
Charge-offs, net	(3,798)	(1,896)
Provision for credit losses	16,032	8,058
Balance at End of Period	$ 47,947	$ 24,444

Serious delinquencies on consolidated Sequoia loans were $158 million and $84 million as of March 31, 2009 and 2008, respectively. Serious delinquencies include loans delinquent more than 90 days and in foreclosure. As a percentage of current loan balances, serious delinquencies were 3.50% and 1.25% at March 31, 2009 and 2008, respectively.

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Note 7. Allowance for Loan Losses (continued)

When foreclosure is pursued 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 2009, there were $4 million of charge-offs that reduced our allowance for loan losses. These charge-offs arose from $15 million of defaulted loan principal. Foreclosed property is subsequently recorded as REO, a component of other assets. Subsequent declines in the value of an REO property below its cost basis are recorded in our consolidated statements of (loss) income as a component of market valuation adjustments, net. We had $1 million of negative market valuation adjustments during the first quarter of 2009 stemming from a decrease in the fair value of REO.

Activity in the Allowance for Losses on Commercial Loans

There was no activity in the allowance for loan losses for our commercial loans for the three months ended March 31, 2009 and 2008.

Note 8. 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, 2009 and December 31, 2008.

March 31, 2009 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 195,698	$ 31,231	$ 202,440	$ 429,369
Commercial	22,915		42,520	65,435
CDO	2,657	7,030	15,074	24,761
Total Real Estate Securities	$ 221,270	$ 38,261	$ 260,034	$ 519,565

December 31, 2008 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	$ 144,885	$ 36,172	$ 244,523	$ 425,580
Commercial	42,490		67,889	110,379
CDO	3,610	11,318	21,237	36,165
Total Real Estate Securities	$ 190,985	$ 47,490	$ 333,649	$ 572,124

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 8. Real Estate Securities (continued)

The following table presents our securities by trading and AFS, collateral type, and entity as of March 31, 2009 and December 31, 2008. We present this information by senior and subordinate interests. Senior interests are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Subordinate interests are all interests below senior interests and may not necessarily be in a first-loss position.

March 31, 2009	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$	$ 3,389	$ 3,389	$ 87,766	$	$ 87,766
Residential non-prime	711	85,347	86,058	73,672	22,386	96,058
Commercial		7,800	7,800			
Total Senior Securities	711	96,536	97,247	161,438	22,386	183,824
Subordinate Securities						
Residential prime	692	37,063	37,755	28,320		28,320
Residential non-prime	273	76,641	76,914	4,264	8,845	13,109
Commercial		34,720	34,720	22,915		22,915
CDO	2,632	15,074	17,706	25	7,030	7,055
Total Subordinate Securities	3,597	163,498	167,095	55,524	15,875	71,399
Total Real Estate Securities	$ 4,308	$ 260,034	$ 264,342	$ 216,962	$ 38,261	$ 255,223

December 31, 2008	Trading			AFS		
(In Thousands)	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	$ 60	$ 11,934	$ 11,994	$ 50,904	$	$ 50,904
Residential non-prime	905	90,638	91,543	41,915	26,531	68,446
Commercial		7,540	7,540			
Total Senior Securities	965	110,112	111,077	92,819	26,531	119,350
Subordinate Securities						
Residential prime	1,141	44,983	46,124	42,646		42,646
Residential non-prime	314	96,968	97,282	7,000	9,641	16,641
Commercial		60,349	60,349	42,490		42,490
CDO	3,585	21,237	24,822	25	11,318	11,343
Total Subordinate Securities	5,040	223,537	228,577	92,161	20,959	113,120
Total Real Estate Securities	$ 6,005	$ 333,649	$ 339,654	$ 184,980	$ 47,490	$ 232,470

We finance securities using equity as well as through our investments in the Fund and Acacia entities that we consolidate. Securities owned at the Fund and Acacia entities are pledged to those entities.

AFS Securities

When we purchase a credit-sensitive AFS security at a significant discount to its face value, we often do not amortize into income a significant portion of this discount that we are entitled to earn but 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. The amount of

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Note 8. Real Estate Securities (continued)

principal face that we do not amortize into income is designated as a credit reserve on the security, with any remaining net unamortized discounts or premiums amortized into income over time using the interest method in accordance with EITF 99-20.

The following table presents the carrying value (which equals fair value) of AFS securities as of March 31, 2009 and December 31, 2008.

March 31, 2009 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$ 1,141,994	$ 512,117	$ 89,256	$ 1,743,367
Credit reserve	(601,864)	(497,784)	(86,962)	(1,186,610)
Net unamortized (discount) premium	(254,228)	13,798	8,240	(232,190)
Amortized cost	285,902	28,131	10,534	324,567
Gross unrealized gains	3,756	1,998		5,754
Gross unrealized losses	(64,405)	(7,214)	(3,479)	(75,098)
Carrying Value	$ 225,253	$ 22,915	$ 7,055	$ 255,223

December 31, 2008 (In Thousands)	Residential	Commercial	CDO	Total
Current face	$ 1,146,071	$ 514,169	$ 92,522	$ 1,752,762
Credit reserve	(731,468)	(497,047)	(59,828)	(1,288,343)
Net unamortized (discount) premium	(211,262)	35,069	(18,056)	(194,249)
Amortized cost	203,341	52,191	14,638	270,170
Gross unrealized gains	7,989	2,308	19	10,316
Gross unrealized losses	(32,693)	(12,009)	(3,314)	(48,016)

Carrying Value	$178,637	$42,490	$11,343	$232,470

The following table presents the changes for the three months ended March 31, 2009, of the unamortized discount and designated credit reserves on AFS securities.

Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

Three Months Ended March 31, 2009 (In Thousands)	Residential Credit Reserve	Residential Unamortized Discount Net	Commercial Credit Reserve	Commercial Unamortized Discount Net	CDO Credit Reserve	CDO Unamortized Discount Net
Beginning balance January 1, 2009	$731,468	$211,262	$497,047	$(35,069)	$59,828	$18,056
Amortization of net discount		(8,857)		4,050		(109)
Realized credit losses	(136,522)		(2,052)		(3,000)	
Acquisitions	327	57,626				
Sales, calls, other	(3,810)	(537)			58	
Impairments	5,135		20,010		3,889	
Transfers/release of credit reserves	5,266	(5,266)	(17,221)	17,221	26,187	(26,187)
Ending Balance March 31, 2009	$601,864	$254,228	$497,784	$(13,798)	$86,962	$(8,240)

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Note 8. Real Estate Securities (continued)

The loans underlying our residential subordinate securities totaled $110 billion at March 31, 2009, and consist of $94 billion prime and $16 billion non-prime loans. These loans are located nationwide with a large concentration in California (46%). Serious delinquencies (90+ days, in foreclosure or REO) at March 31, 2009 were 5.22% of current principal balances. For loans in prime pools, serious delinquencies were 2.44% of current balances. For loans in non-prime pools, serious delinquencies were 21.75% of current balances.

The loans underlying our commercial subordinate securities totaled $48 billion at March 31, 2009, and consist primarily of office (39%), retail (28%), and multifamily (16%) commercial loans. These loans are located nationwide. Serious delinquencies (60+ days and in foreclosure or REO) at March 31, 2009 were 1.41% of current principal balances.

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position and not deemed to be other-than-temporarily impaired as of March 31, 2009 and December 31, 2008.

AFS Securities with Unrealized Losses

March 31, 2009 (In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$267,741	$(63,615)	$204,126	$1,831	$(790)	$1,041
Commercial	18,480	(7,214)	11,266			
CDO	6,297	(3,479)	2,818			
Total Securities	$292,518	$(74,308)	$218,210	$1,831	$(790)	$1,041

December 31, 2008 (In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value	Total Amortized Cost	Gross Unrealized Losses	Total Fair Value
Residential	$100,635	$(32,693)	$67,942	$	$	$
Commercial	38,001	(12,009)	25,992			
CDO	14,351	(3,314)	11,037			
Total Securities	$152,987	$(48,016)	$104,971	$	$	$

Of the $75 million of unrealized losses at March 31, 2009, $20 million relates to securities owned at the Fund.

At March 31, 2009, our consolidated balances sheets included 616 AFS securities, of which 247 were in an unrealized loss position and eight were in an unrealized loss position for twelve consecutive months or longer. At December 31, 2008, our consolidated balance sheets included 594 AFS securities, of which 194 were in an unrealized loss position and none were in a continuous loss position for twelve months or longer. The number of AFS securities reported on our consolidated balance sheets increased as a result of acquisitions during the quarter.

For the three months ended March 31, 2009, we recognized other-than-temporary impairments on AFS securities of $29 million, through market valuation adjustments, net, in our consolidated statements of (loss) income. For the three months ended March 31, 2008, we recognized other-than-temporary impairments of $144 million.

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Note 8. Real Estate Securities (continued)

Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded to realized gains (losses) on sales and calls, net, in our consolidated statements of (loss) income. The following table presents the gross realized gains on sales and calls of AFS securities for the three months ended March 31, 2009 and 2008.

(In Thousands)	Three Months Ended March 31, 2009	2008
Gross realized gains sales	$ 337	$
Gross realized gains calls		42
Total Realized Gains on Sales and Calls	$ 337	$ 42

Note 9. 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 references residential mortgage-backed securities issued in 2006 that were initially A and BBB-rated. The fair value of the GIC was $62 million as of March 31, 2009, which is equal to its carrying value. The GIC has been drawn down by $18 million since its acquisition to cover credit losses and principal reductions on the referenced securities.

Note 10. 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.

The following table shows the aggregate fair value and notional amount of our derivative financial instruments as of March 31, 2009 and December 31, 2008.

(In Thousands)	March 31, 2009 Fair Value	March 31, 2009 Notional Amount	December 31, 2008 Fair Value	December 31, 2008 Notional Amount
Interest rate caps purchased	$ 3,455	$ 712,400	$ 1,683	$ 714,400
Interest rate caps sold			(1,084)	250,000
Interest rate swaps	(92,982)	975,834	(97,226)	1,013,781
Credit default swaps	(61,545)	61,604	(77,892)	78,206
Total Derivative Financial Instruments	$ (151,072)	$ 1,749,838	$ (174,519)	$ 2,056,387

Of the negative $151 million value of derivative financial instruments at March 31, 2009, $5 million was recorded as derivative assets and $156 million was recorded as derivative liabilities on our consolidated balance sheet. Of the negative $175 million value of derivative financial instruments at December 31, 2008, $3 million was recorded as derivative assets and $178 million was recorded as derivative liabilities on our consolidated balance sheet.

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Note 10. Derivative Financial Instruments (continued)

Interest Rate Agreements

We currently account for our interest rate agreements as trading instruments in accordance with FAS 133. Changes in the fair value of the interest rate agreements and all associated income and expenses are reported in our consolidated statements of (loss) income as a component of market valuation adjustments, net. We had net valuation adjustments on interest rate agreements of positive $3 million for the three months ended March 31, 2009, and negative $38 million for the three months ended March 31, 2008.

We did not have any interest rate agreements designated as cash flow hedges during the three months ended March 31, 2009. For interest rate agreements previously designated as cash flow hedges, our total unrealized loss included in accumulated other comprehensive loss was negative $26 million at March 31, 2009 and negative $27 million at December 31, 2008.

For both the three months ending March 31, 2008 and 2009, we reclassified $1 million of previously designated cash flow hedge other comprehensive loss to interest expense.

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, 2009 the reference securities underlying our CDS experienced principal losses resulting in a $17 million obligation. During the three months ended March 31, 2009 and 2008, the fair value of these CDS increased less than $1 million and decreased $18 million, respectively.

The following table presents the fair value of our CDS along with certain risk characteristics as of March 31, 2009 and December 31, 2008. All of these CDS have expiration dates of greater than 15 years.

(In Thousands)	March 31, 2009 Fair Value	March 31, 2009 Maximum Payout/ Notional Amount	December 31, 2008 Fair Value	December 31, 2008 Maximum Payout/ Notional Amount
Credit rating of referenced securities				
BB/B	$	$	$ (9,943)	$ 9,967
CCC/CC/C	(61,545)	61,604	(67,949)	68,239
Total	$ (61,545)	$ 61,604	$ (77,892)	$ 78,206

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Note 10. Derivative Financial Instruments (continued)

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, 2009, Redwood and its affiliates had nineteen International Swaps and Derivatives Association (ISDA) agreements with ten different bank counterparties. We had one open derivative position at March 31, 2009, and were in compliance with our ISDA counterparty.

Note 11. Other Assets

Other assets as of March 31, 2009, and December 31, 2008, are summarized in the following table.

Other Assets

(In Thousands)

	March 31, 2009	December 31, 2008
REO	$ 18,926	$ 19,264
Fixed assets and leasehold improvements	4,732	5,103
Principal receivable	633	1,647
Income tax receivables	3,452	4,225
Prepaid expenses	1,361	9,119
Other	3,150	4,584
Total Other Assets	$ 32,254	$ 43,942

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at March 31, 2009, was $19 million, of which $9 million related to transfers into REO in the first quarter of 2009, offset by $8 million of REO liquidations, and $1 million of negative market valuation adjustments during this same period. The carrying value of REO as of December 31, 2008 was $19 million, of which $38 million related to transfers into REO during 2008, offset by $21 million of REO liquidations, $8 million of negative valuation changes, and $5 million of REO derecognized as a result of our deconsolidations of certain Sequoia entities.

At March 31, 2009, there were 95 single-family properties recorded on our balance sheet, of which, 92 were owned at Sequoia and 3 were owned at Redwood. At December 31, 2008, there were 93 single-family properties recorded on our balance sheet, of which, 90 were owned at Sequoia and 3 were owned at Redwood. The states of California, Ohio, Georgia, and Michigan accounted for 60% of our REO balance at March 31, 2009.

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Note 12. 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.

The components of ABS issued by consolidated securitization entities we sponsor as of March 31, 2009 and December 31, 2008, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	March 31, 2009			December 31, 2008		
(In Thousands)	Sequoia	Acacia	Total	Sequoia	Acacia	Total
Certificates with principal value	$4,396,893	$3,108,914	$7,505,807	$4,485,201	$3,134,699	$7,619,900
Interest-only certificates	22,400		22,400	23,532		23,532
Unamortized premium	3,662		3,662	4,003		4,003
Unamortized discount	(4,603)		(4,603)	(4,609)		(4,609)
Fair value adjustment, net		(2,818,269)	(2,818,269)		(2,787,768)	(2,787,768)
Total ABS Issued	$4,418,352	$290,645	$4,708,997	$4,508,127	$346,931	$4,855,058
Range of weighted average interest rates, by series	0.67% to 5.93%	1.76% to 2.25%		1.65% to 5.93%	2.44% to 5.23%	
Stated maturities	2024 2047	2039 2052		2024 2047	2039 2052	
Number of series	37	10		37	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, 2009, all of the $4.7 billion reported value of ABS issued ($7.5 billion principal value) had contractual maturities of over five years.

Amortization of Sequoia deferred ABS issuance costs was less than $1 million and $2 million for the three months ended March 31, 2009 and 2008, respectively.

The following table summarizes the accrued interest payable on ABS issued as of March 31, 2009 and December 31, 2008. 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, 2009	December 31, 2008
Sequoia	$ 6,120	$ 7,326
Acacia	7,721	20,615
Total Accrued Interest Payable on ABS Issued	$ 13,841	$ 27,941

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 12. 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, 2009 and December 31, 2008.

Collateral for Asset-Backed Securities Issued

	March 31, 2009			December 31, 2008		
(In Thousands)	Sequoia	Acacia	Total	Sequoia	Acacia	Total
Real estate loans	$4,527,972	$9,606	$4,537,578	$4,644,486	$11,977	$4,656,463
Real estate securities		332,080	332,080		407,526	407,526
Other investments		61,637	61,637		78,244	78,244
Real estate owned (REO)	18,179		18,179	18,428		18,428
Restricted cash	267	47,106	47,373	283	48,298	48,581
Accrued interest receivable	13,658	6,228	19,886	17,884	7,484	25,368
Total Collateral for ABS Issued	$4,560,076	$456,657	$5,016,733	$4,681,081	$553,529	$5,234,610

Note 13. 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 4.91% and 6.93%, for the three months ended March 31, 2009 and 2008, 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 4.91% and 6.93%, for the three months ended March 31, 2009 and 2008, respectively. The earliest optional redemption date without a penalty is July 30, 2012.

At both March 31, 2009 and December 31, 2008, the accrued interest payable balance on long-term Redwood debt was $1 million. There are no financial covenants associated with our long-term debt.

Note 14. Commitments and Contingencies

As of March 31, 2009, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $13 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 both the three months ended March 31, 2009 and 2008.

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NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 14. Commitments and Contingencies (continued)

The following table presents our future lease commitments as of March 31, 2009.

Future Lease Commitments by Year

(In Thousands)	March 31, 2009
2009	$ 1,281
2010	1,709
2011	1,831
2012	1,882
2013	1,439
2014 and thereafter	5,253
Total	$ 13,395

Leasehold improvements for our offices are amortized into expense over the ten-year lease term, expiring in 2013. The unamortized leasehold improvement balance at both March 31, 2009 and December 31, 2008 was $4 million.

At March 31, 2009, there are no material pending legal proceedings to which we or any of our subsidiaries is a party or of which our property is the subject.

Note 15. Equity

Earnings Per Share

The following table provides the basic and diluted (loss) earnings per share computations for the three months ended March 31, 2009 and 2008.

Basic and Diluted (Loss) Earnings Per Share

In Thousands, Except Share Data	Three Months Ended March 31, 2009	2008
Net (loss) income attributable to Redwood Trust, Inc.	$(34,944)	$(171,587)
Basic weighted average shares outstanding	53,632,132	32,511,445
Net effect of dilutive stock options		
Diluted weighted average shares outstanding	53,632,132	32,511,445
Basic (Loss) Earnings Per Share:	$(0.65)	$(5.28)
Diluted (Loss) Earnings Per Share:	$(0.65)	$(5.28)

For the three months ended March 31, 2009 and 2008, there were no dilutive equity awards based on our reported net loss for these periods. For the three months ended March 31, 2009 and 2008, the number of outstanding equity awards that were antidilutive totaled 1,009,291, and 1,319,346, 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, 2009 and 2008, there were no shares acquired under this plan. As of March 31, 2009, there remained 4,658,344 shares available for repurchase under this plan.

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NOTES TO FINANCIAL STATEMENTS March 31, 2009 (Unaudited)

Note 15. Equity (continued)

Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third parties. As of March 31, 2009, the noncontrolling interest was $18 million, representing a 48% third party interest in the Fund. Income allocated to the noncontrolling interest is based on the third party LP ownership percentage. The 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.

Accumulated Other Comprehensive Loss

The following table provides a summary of the components of accumulated other comprehensive loss as of March 31, 2009 and December 31, 2008.

(In Thousands)	March 31, 2009	December 31, 2008
Net unrealized loss on real estate securities	$(69,344)	$(37,702)
Reclassification of unrealized loss to noncontrolling interest	9,706	7,764
Net unrealized loss on interest rate agreements accounted for as cash flow hedges	(25,829)	(26,927)
Total Accumulated Other Comprehensive Loss	$(85,467)	$(56,865)

At March 31, 2009, the net unrealized loss on AFS securities was $69 million, as compared to a net unrealized loss of $38 million at December 31, 2008. During the first quarter of 2009, $14 million of net unrealized loss was reclassified to earnings upon recognition of OTTI, and $44 million of additional fair value declines in securities were recognized as unrealized losses. The net effect of these adjustments was an increase in accumulated other comprehensive loss of $31 million during the quarter. A portion of these unrealized losses are on AFS securities owned by the Fund. These losses were $10 million and $8 million at March 31, 2009 and December 31, 2008, respectively.

At March 31, 2009, interest rate agreements had an unrealized loss of $26 million, which will be expensed through our consolidated statements of (loss) income over the remaining lives of previously designated hedged item (See *Note 10*). During the both three months ended March 31, 2009 and 2008, $1 million of unrealized losses associated with interest rate agreements previously designated as cash flow hedges were reclassified into interest expense.

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Note 16. Equity Compensation Plans

As of March 31, 2009 and December 31, 2008, 1,092,249 and 1,005,937 shares of common stock, respectively, were available for grant under Redwood s Incentive Plan. The unamortized cost of nonvested awards totaled $14 million at March 31, 2009, as shown in the following table:

(In Thousands)	March 31, 2009				
	Stock Options	Restricted Stock	Deferred	Employee Stock	Total

		Stock Units	Purchase Program	
Unrecognized compensation cost at beginning of period	$ 701	$ 14,714	$	$ 15,415
Equity grants			177	177
Equity compensation cost	(107)	(1,644)	(44)	(1,795)
Unrecognized Compensation Cost at End of Period	$ 594	$ 13,070	$ 133	$ 13,797

The weighted average amortization period remaining for all of our equity awards was one year at March 31, 2009.

Stock Options

As of March 31, 2009 and December 31, 2008, there were 641,373 and 647,873, respectively, of stock options outstanding. All of the outstanding stock options were fully vested as of March 31, 2009. The aggregate intrinsic value of the options outstanding and options currently exercisable was less than $1 million at both March 31, 2009 and December 31, 2008.

There were 6,500 and 27,599 stock options exercised for the three months ended March 31, 2009 and 2008, respectively, and none of these were exercised by executive officers. The total intrinsic value or gain (fair market value less exercise price) for options exercised was less than $1 million for both the three months ended March 31, 2009 and 2008.

Restricted Stock

As of March 31, 2009 and December 31, 2008, there were 44,693 and 53,242 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through January 2013. There were no restricted stock awards granted during the three months ended March 31, 2009.

Deferred Stock Units

As of March 31, 2009 and December 31, 2008, there were 1,484,110 and 1,730,531, respectively, of DSUs outstanding, of which 318,389 and 522,826, respectively, had vested. There were no DSUs granted during the three months ended March 31, 2009. During the three months ended March 31, 2009, DSU distributions 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.

Employee Stock Purchase Plan

The ESPP allows a maximum of 100,000 shares of common stock to be purchased in aggregate for all employees. As of March 31, 2009 and December 31, 2008, 73,316 and 67,306 shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2009
(Unaudited)

Note 17. Operating Expenses

Components of our operating expenses for the three months ended March 31, 2009 and 2008 are presented in the following table.

Operating Expenses

(In Thousands)	Three Months Ended March 31, 2009	2008
Fixed compensation expense	$ 4,028	$ 5,674
Variable compensation expense	556	1,857
Equity compensation expense	1,795	3,306
Severance expense	28	
Total compensation expense	6,407	10,837
Systems	1,594	2,141
Due diligence	7	10
Office costs	1,750	1,514
Accounting and legal	559	1,101
Other operating expenses	222	745
Total Operating Expenses	$ 10,539	$ 16,348

Note 18. Taxes

For the three months ended March 31, 2009 and 2008, our provision for income taxes was less than $1 million and $2 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at March 31, 2009 and 2008.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

	March 31, 2009	2008
Federal statutory rate	34.0 %	35.0 %
State statutory rate, net of Federal tax effect	7.2 %	7.0 %
Differences in taxable income from GAAP (loss) income	(41.5)%	(68.9)%
Dividends paid deduction		25.8 %
Effective Tax Rate	(0.3)%	(1.1)%

In November 2008, our Board of Directors announced its intention to reduce our quarterly dividend to shareholders to $0.25 per share, and during the first quarter of 2009 the Board of Directors declared a first quarter regular dividend of $0.25 per share. We currently anticipate recognizing a REIT taxable loss for 2009, and thus, these dividend distributions will likely be characterized as a return of capital and not ordinary income. As a result, there is no impact on our effective tax rate due to these dividends.

Our taxable income before dividend distributions has historically been higher than our GAAP net (loss) income primarily due to the accounting for credit losses and the market valuation write-downs taken on our assets for GAAP accounting purposes but not for tax. In 2008, negative market valuation adjustments for GAAP were significant and we reported a GAAP net loss while reporting taxable income for the same period. As a result, the impact in 2008 on the effective tax rate of the dividends paid deduction was an increase in the effective tax rate. Generally, our dividend distributions reduce our effective tax rate when we report both positive GAAP and taxable income.

We assessed our tax positions in accordance with FIN 48 for all open tax years (Federal years 2005 to 2008, State years 2004 to 2008) and as of March 31, 2009 and December 31, 2008, and concluded that we have no material unrecognized liabilities.

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 focused on investing in, financing, and managing residential and commercial real estate loans and securities. We seek to invest in assets that have the potential to provide 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 consolida 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 web site any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our web site includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non generally accepted accounting principles (GAAP) financial measures (as defined in the SEC s Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. The information on our website is not part of this 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 2008 Annual Report on Form 10-K under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are described below and may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

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Statements regarding the following subjects, among others, are forward-looking by their nature: (i) credit protection we expect to be able to rely on, the effect of prepayment speeds, potential returns on investments we make, and our expectation of future cash flows from investments; (ii) the potential effect of government initiatives and programs and whether or not we would participate in such programs; (iii) our expected rate of capital deployment and our future capital needs and sources; (iv) our views on the potential effects of changes in accounting standards; (v) our belief that some of the securities we own have the potential to produce earnings in excess of our current expectations; (vi) the types of investments we may make, including that we may acquire commercial real estate mortgage assets; (vii) the intention of our board of directors to pay a regular dividend of $0.25 per share per quarter in 2009 and our expectations that: dividends paid in 2009 will constitute a return of capital, and we will report a taxable loss for 2009; (viii) our view of trends in the housing market, mortgage delinquencies, and credit losses; and (ix) our expectation that a deconsolidation event in the second quarter with respect to one of our Sequoia entities may occur and that we would, as a result, reverse a related allowance for loan losses.

Important factors, among others, that may affect our actual results include: changes in interest rates; changes in mortgage prepayment rates; the timing of credit losses within our portfolio; our exposure to adjustable-rate and negative amortization mortgage loans; the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the concentration of the credit risks we are exposed to; the ability of counterparties to satisfy their obligations to us; legislative and regulatory actions affecting the mortgage industry or our business; the availability of high quality assets for purchase at attractive prices; declines in home prices and commercial real estate prices; increases in mortgage payment delinquencies; changes in the level of liquidity in the capital markets which may adversely affect our ability to finance our real estate asset portfolio; changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale, each of which may adversely affect the values of securities we own; the extent of changes in the values of securities we own and the impact of adjustments reflecting those changes on our income statement and balance sheet, including our equity; our ability to maintain the positive stockholders equity necessary to enable us to pay the dividends required to maintain our status as a real estate investment trust for tax purposes; our ability to generate the amount of cash flow we expect from our investment portfolio; changes in our investment, financing, and hedging strategies and the new risks that those changes may expose us to; changes in the competitive landscape within our industry, including changes that may affect our ability to retain or attract personnel; our failure to manage various operational risks associated with our business; our failure to maintain appropriate internal controls over financial reporting; our failure to properly administer and manage our securitization entities; risks we may be exposed to if we expand our business activities, such as risks relating to significantly increasing our direct holdings of loans; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; our ability to successfully deploy the proceeds from our recent common equity offering and raise additional capital to fund our investing activity; and other factors not presently identified. Fair values for our securities and asset-backed securities (ABS) issued are dependent upon a number of market-based assumptions including future interest rates, prepayment rates, discount rates, credit loss rates, and the timing of credit losses. We use these assumptions to generate cash flow estimates and internal values for each individual security.

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

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

Our direct investments in residential, commercial, and collateralized debt obligations (CDO) securities are currently financed 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 high-quality residential and commercial real estate loans. High-quality real estate loans are loans that typically have low loan-to-value ratios, borrowers with strong credit histories, and other indications of quality relative to the range of loans within U.S. real estate markets as a whole. 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), which have the first right to cash flows in a securitization and therefore 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

During the first quarter of 2009, our investment cash flows remained strong, we took advantage of attractive investment opportunities, and housing and credit fundamentals remained in line with our modeling expectations.

Since the beginning of the year, we have invested $240 million in residential mortgage-backed securities that we believe have the potential to generate attractive unlevered returns. We invested $98 million during the first quarter of 2009 and $142 million in the second quarter through May 1, 2009. The vast majority of these investments were in senior residential securities backed by pre-2006 prime or near prime loans that are well protected from a credit standpoint and well positioned to benefit from any uptick in prepayments. We have not acquired any commercial real estate assets since early 2007, but we have been actively monitoring developments and may identify investments that are adequately protected from loss and have the potential to provide stable, long-term cash flows, at attractive yields.

From the middle of 2007 through November 2008, trading activity between willing buyers and sellers of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) was light, and prices for virtually all mortgage-backed assets headed in one direction down. This steady, steep decline was fueled by rapidly deteriorating credit fundamentals and was exacerbated by the extraordinary deleveraging that took place in the financial markets. The chart below illustrates the prices that investors were paying to compensate for the perceived credit risk of RMBS and CMBS over the last two years.

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RMBS and CMBS Prices

Source: Credit Suisse, JPMorgan Chase, Redwood Trust

Since November 2008, prices for senior residential and commercial mortgage-backed securities have been on a roller coaster ride, as buyers and sellers sentiment has shifted back and forth from focusing on negative credit fundamentals (causing prices to move lower and trading activity to decline) to focusing on the potential positive technical benefits from government programs (causing prices to move higher and trading activity to increase). In contrast to price movements in senior securities, prices for subordinate residential and commercial securities have only moved lower, as the focus has been solely on the fundamentals. We believe residential subordinate securities are likely to be negatively impacted by the government s loan modification initiatives.

From November 2008 through the end of January 2009, prices for senior mortgage-backed securities increased based on a positive market reaction to the initial high-level outline of government initiatives for legacy assets. By February 2009, in the absence of actionable details on these initiatives and with a pall looming over the health of banks, fear re-gripped the financial markets. As a consequence, trading activity fell dramatically and investor focus turned back to the negative credit fundamentals. Prices for senior securities dropped to a point where prices dipped below the November lows.

In mid-March, the government announced the outline of its Public-Private Investment Program (PPIP), designed to spur the purchase of up to $1 trillion of legacy residential assets (loans and securities), and signaled that it would expand the existing $1 trillion Term Asset-Backed Securities Loan Facility (TALF) to provide financing for the purchase of senior legacy residential and commercial mortgage-backed securities. In response to these announcements, prices for senior residential and commercial securities began to rise, although, by quarter-end, prices generally remained below year-end levels. As a result, we were required under GAAP to reflect additional negative market valuation adjustments in our first quarter financial statements. Since March 31, 2009, trading activity has been robust and prices for senior securities have continued to rise. In the near term it is difficult to anticipate the direction of prices since we believe they will depend largely on the success of PPIP, TALF, and other government programs.

In an attempt to stabilize or increase asset values, the government has indicated that it is considering offering what appears on the surface to be very attractive, non-recourse financing under TALF to potential acquirers of banks legacy securitized assets. Some of our competitors, including hedge funds and other market participants, have been actively buying senior securities in anticipation of leveraging these investments through financing provided under TALF, and hopefully increasing investment returns. So far, the details on TALF are limited, however, and key terms and potential regulatory restrictions imposed on program participants have not yet been disclosed by the government.

We would consider using TALF as a source of leverage if we became comfortable with the resulting liquidity risk and any operating restrictions that may be imposed by the government. It has long been our policy to avoid liquidity risk and that policy has enabled us to withstand this current crisis. Leverage does not improve the performance of the underlying collateral. As a matter of fact, the extensive use of leverage

contributed to the current crisis. Furthermore, one of our competitive advantages has been our ability to operate in an entrepreneurial manner without government-imposed constraints; we are reluctant to compromise that ability. Until enough of the details on TALF are disclosed to allow us to make an informed judgment on the impact of the program on our balance sheet and operations, we will continue to acquire assets based upon unlevered return expectations.

Another program that deserves comment is PPIP. Here again, the details of the program have yet to be fully disclosed. Conceptually, the U.S. Treasury will select private-sector firms to manage new investment funds to be formed to acquire legacy loans and securities. The government will provide equity funding to be invested alongside the private investors in these funds, as well as non-recourse financing up to certain limits. We have thought long and hard about whether Redwood Asset Management (a Redwood subsidiary) should become a manager under the PPIP program. Redwood is well positioned to be a manager given our successful 15-year track record of managing residential credit risk, and we have the people, systems, and resources to proceed. There are positives, negatives, and unknowns associated with participation. Although it could significantly increase assets under management, the actual economics of such a mandate currently do not appear compelling. Moreover, there are questions relating to the Treasury s share of the economics and potential limitations that could prevent us from capitalizing on attractive investment opportunities for Redwood shareholders. For now, the balance tips on the side of not participating, but we continue to monitor the situation and will re-evaluate our decision if warranted. Regardless of whether Redwood Asset Management participates in PPIP, we remain firmly committed to our third-party asset management initiative and are moving forward to grow the business, as it represents an important source of capital for us to acquire and manage additional assets.

In addition to the significant government actions taken during the first quarter of 2009, mark-to-market accounting standards will change in the second quarter based upon two new financial statement positions (FSPs) issued by the Financial Accounting Standards Board (FASB) in April 2009. These new FSPs will affect our future GAAP earnings; however, they will not affect our future cash flow, book value, or economic returns. The first FSP clarifies how to measure fair value in an inactive market. We do not expect this first FSP to have much of an impact on our pricing process or future earnings. The second FSP revises previous FASB guidance for measuring new impairments and eliminates the recapture of previously taken impairment charges that subsequently proved to be unnecessary. This second FSP will have positive and negative impacts on our future GAAP earnings. On the positive side, the guidance will likely reduce the amount of new future impairment charges against earnings. On the negative side, it will limit some of the future recapture of prior impairment charges, which under existing guidance, would have flowed through our income statement. Instead, previously recorded impairment charges that prove to have been unnecessary will be recorded as a positive equity adjustment. In the end, the benefit will still be reflected in book value, but it will not flow through earnings. We will adopt this standard in the second quarter; it is too early to estimate the impact.

Outlook

We remain focused on cash flows, capitalizing on investment opportunities, staying abreast of government initiatives and determining if and when to participate in those initiatives. We enter the second quarter with strong cash flow from our investment portfolio, increased prepayment activity, firming prices for senior securities and increased trading volume in the market, and ample to cash to invest.

At our current rate of capital deployment, we would expect to invest our excess capital over the course of the next few months. In deciding whether to raise additional capital, we must consider both our future capital needs and alternative sources of capital. The needs side of the capital equation involves an analysis of both the near-term how much capital we need to capitalize on secondary investment opportunities, and the long-term how much capital we need for investment in our core business in the years ahead. Alternative methods of raising capital include generating capital internally through asset sales or re-securitizations, raising third-party funds through private placements to expand our asset management business, or accessing the equity markets through the sale of common stock. We may reduce our capital needs if we are able to leverage some of our investments through TALF, although, as we noted above, it is too early to determine whether it makes sense for us to participate in that program.

Decisions around capital require speculation on future market conditions and investment opportunities. As markets continue to remain fluid, it is difficult to predict the actions we will take. Our highest near-term priority is to get our arms around the level and attractiveness of secondary market investment opportunities. We will remain true to our core values and consider raising additional common equity only if we believe there are attractive investment opportunities that with the potential to lead us to higher levels of earnings and dividends per share over the long-term.

We expect that GAAP earnings will remain volatile in the near term due to mark-to-market (MTM) adjustments. We may recognize additional GAAP impairment losses on residential, commercial, and CDO securities held at Redwood and the Fund. Negative MTM balance sheet write-downs that have not yet been realized through our income statement totaled $75 million at March 31, 2009. Future income statement impairment charges related to these unrealized losses will be ameliorated by the recently announced FSP discussed above and, in any event, will not affect GAAP book value since these MTM losses were already deducted from equity at March 31, 2009. The fair value accounting principles we follow for the assets and liabilities at Acacia may also contribute to future MTM volatility.

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

Summary of Results of Operations and Financial Condition

Our reported GAAP net loss was $35 million ($0.65 per share) for the first quarter of 2009 as compared to a GAAP net loss of $172 million ($5.28 per share) for the first quarter of 2008. Our GAAP book value per common share was $8.40 at March 31, 2009, a decrease from $9.02 at December 31, 2008. We declared a regular dividend of $0.25 per share for the first quarter of 2009 and $0.75 per share for the first quarter of 2008.

The following table presents the components of our GAAP net loss for the first quarter of 2009 and 2008.

Table 1 Net Income

	Three Months Ended March 31,	
(In Thousands, Except Share Data)	2009	2008
Interest income	$ 81,438	$ 176,064
Interest expense	(47,642)	(127,300)
Net interest income	33,796	48,764
Provision for loan losses	(16,032)	(8,058)
Market valuation adjustments, net	(43,242)	(193,932)
Net interest loss after provision and market valuation adjustments	(25,478)	(153,226)
Operating expenses	(10,539)	(16,348)
Realized gains on sales and calls, net	462	42
Provision for income taxes	(105)	(1,800)
Less: Net loss attributable to noncontrolling interest	(716)	255
Net Loss	$ (34,944)	$ (171,587)
Diluted weighted average common shares outstanding	53,632,132	32,511,445
Net loss per share	$ (0.65)	$ (5.28)

Our net loss of $35 million for the first quarter of 2009 included net negative market valuation adjustments (MVA) of $43 million on real estate securities and derivatives, a reduction from net negative MVA of $194 million for the first quarter of 2008. This reduction was primarily due to fewer impairment charges on securities. Our provision for loan losses at Sequoia was $16 million for the first quarter of 2009, as compared to $8 million for the first quarter of 2008. As of March 31, 2009, we have an allowance for loan

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losses for one of the Sequoia entities that exceeds our economic investment in that entity by $15 million. Upon the occurrence of certain events, which may occur in the second quarter, we will be permitted to deconsolidate that

Sequoia entity and upon deconsolidation, will record a gain to the extent of the excess allowance for loan losses.

Net interest income was $34 million for the first three months of 2009 as compared to $49 million for the first three months of 2008. Net interest income at Redwood declined by $12 million due to higher credit losses, slower prepayments, and lower interest rates on securities. Net interest income at Sequoia declined by $4 million due to lower interest rates on adjustable rate loans. These declines were partially offset by $1 million increase in net interest income generated on securities at the Fund during the first quarter of 2009. Net interest income at Acacia was $2 million for both the first quarters of 2009 and 2008.

Operating expenses decreased by $6 million in the first quarter of 2009 as compared to the first quarter of 2008 primarily due to a reduction in headcount and fewer legal and consulting expenses.

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

Our estimated total taxable loss was $14 million ($0.22 per share) for the first quarter of 2009, as compared to our estimated total taxable income of $26 million ($0.79 per share) for the first quarter of 2008. Our estimated REIT taxable loss was $9 million ($0.14 per share) for the first quarter of 2009, as compared to our estimated REIT taxable income of $25 million ($0.76 per share) for the first quarter of 2008. 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.

The decrease in REIT taxable income for the first quarter of 2009 as compared to the first quarter of 2008 was primarily due to an increase in realized credit losses on subordinate securities. For tax purposes, we are not permitted to establish credit reserves on securities and do not record impairments or other changes in the fair value of financial assets or liabilities. Realized credit losses at the REIT for tax purposes for the first quarters of 2009 and 2008 were $48 million and $14 million, or $0.80 and $0.41 per share, respectively.

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Book Value

The Financial Condition, Liquidity, and Capital Resources section of this Management s Discussion and Analysis contains a detailed discussion and analysis of the components of GAAP book value at March 31, 2009 and December 31, 2008. The following supplemental non-GAAP components of book value addresses our assets and liabilities at March 31, 2009, as reported under GAAP and as estimated by us using fair values for our investments. We show our investments in the Fund, and the Sequoia and Acacia entities as separate line items to highlight our specific ownership interests, as the underlying assets and liabilities of these entities are legally not ours. Our estimated economic value is calculated using bid-side asset marks, as required to determine fair value under GAAP. This method of calculating economic value more closely represents liquidation value and does not represent the higher amount we would have to pay at the offered-side to replace our existing assets. For additional information to consider when reviewing the following supplemental non-GAAP components of book value, please see Factors Affecting Management s Estimate of Economic Value below.

Table 2 Book Value

March 31, 2009

(In Millions, Except per Share Data)	As Reported	Adjustments	Management s Estimate of Economic Value
Cash and cash equivalents	$ 333		$ 333
Real estate securities at Redwood			
Residential	195		195
Commercial	23		23
CDO	3		3
Subtotal real estate securities	221		221
Investments in the Fund	22		22
Investments in Sequoia	70	(9)[(a)]	61
Investments in Acacia	7	(2)[(b)]	5
Total securities and investments	320		309
Long-term debt	(150)	108 [(c)]	(42)
Other assets/liabilities, net[(d)]	3		3
Stockholders Equity	$ 506		$ 603
Book Value Per Share	$ 8.40		$