REDWOOD TRUST INC
Form 10-K/A
March 16, 2005

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

FORM 10-K

[X]	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended: December 31, 2004

OR

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

For the transition period from to

Commission file number: 1-13759

REDWOOD TRUST, INC.

(Exact name of Registrant as specified in its Charter)

Maryland (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)

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

Title of Each Class:	Name of Exchange on Which Registered:
Common Stock, par value $0.01 per share	**New York Stock Exchange**

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

Indicate by check mark 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 [ ]

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [X] No [ ]

At June 30, 2004, the aggregate market value of the voting stock held by non-affiliates of the Registrant was $1,197,721,400.

The number of shares of the Registrant s Common Stock outstanding on March 14, 2005 was 24,468,358.

Documents Incorporated by Reference

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

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The sole purpose of filing this 10-K/A is to include pages that were inadvertently omitted from the original 10-K filed on March 16th, 2005.

REDWOOD TRUST, INC.
2004 FORM 10-K ANNUAL REPORT

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PART I

Item 1. BUSINESS

CAUTIONARY STATEMENT

This Annual Report on Form 10-K and the documents incorporated by reference herein contain forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including the words anticipated, estimated, should, expect, believe, intend, and si expressions, are intended to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are detailed from time to time in reports filed by us with the Securities and Exchange Commission, or SEC, including Forms 10-Q and 8-K.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. In light of these risks, uncertainties, and assumptions, the forward-looking events mentioned, discussed in, or incorporated by reference into this Annual Report on Form 10-K might not occur. Accordingly, our actual results may differ from our current expectations, estimates, and projections.

Important factors that may impact our actual results include changes in interest rates and market values; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the level of liquidity in the capital markets as it affects our ability to finance our real estate asset portfolio; and other factors not presently identified. For a discussion of risk factors, readers should review the section of this Annual Report on Form 10-K entitled Risk Factors . This Annual Report on Form 10-K contains 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.

REDWOOD TRUST, INC.

Redwood Trust, Inc. (Redwood or we or us) is a financial institution located in Mill Valley, California. We invest in, credit-enhance, and securitize residential and commercial real estate loans and securities. Our primary focus is investing in real estate loans by acquiring and owning securities backed by high-quality real estate loans, particularly jumbo residential loans, that have features such as low loan-to-value ratios, borrowers with strong credit histories, and other indications of quality relative to the range of loans within U.S. real estate markets as a whole.

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

Our Consolidated Balance Sheets, prepared on the basis of generally accepted accounting principles (GAAP) reflects our five types of earning assets: residential real estate loans; home equity lines of credit (HELOC s); residential real estate loan credit-enhancement securities (non-investment grade securities); commercial real estate loans; and a securities portfolio. The securities portfolio consists of diverse residential and commercial real estate securities, primarily investment-grade and BB-rated. Each of these portfolios is a component of our single business of investing in real estate loans and securities. Our current intention is to focus on investing in and managing assets in these five portfolios. We manage our real estate loan investments as a single business, with common staff and management, common financing relationships and flexible capital allocations.

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Our primary focus is investing in assets that will provide high quality cash flows for a long period of time. We typically fund these assets with equity (no debt). We call the assets we own that meet this criteria permanent assets . Thus, our primary goal is to build a permanent asset portfolio that consists primarily of various asset-backed securities (ABS). The ABS in our permanent asset portfolio are collateralized by residential and commercial loans and generally represent the types of securities that have the most concentrated credit risk with respect to the underlying loans. In some instances, we may also invest in ABS that have the most concentrated prepayment risk (and/or interest rate risk, if any). Our permanent assets also include some commercial real estate loan investments. By acquiring and managing these ABS, our permanent asset portfolio is designed to generate long-term cash flows that will fund dividend distributions to our shareholders.

Our discussion of our permanent asset portfolio in this Annual Report refers to these ABS and commercial loans. They may appear within one of the five portfolios presented on our Consolidated Balance Sheets. However, as discussed below, as a result of the way we represent our operations for GAAP purposes, some of our permanent assets are not specifically identifiable on our Consolidated Balance Sheets.

As a result of the form of securitization we have chosen to utilize for most of the securitizations we sponsor, under GAAP we consolidate and report all of the assets of the securitization entities we have sponsored as assets on our Consolidated Balance Sheets, and we consolidate and report all of the ABS issued by those entities and held by unrelated third parties as liabilities on our Consolidated Balance Sheets. The ABS we acquire for our permanent asset portfolio from securitizations we sponsor are not shown as specific assets on our Consolidated Balance Sheets, but rather are represented by the excess of the reported value of the securitized pool of assets over the related liabilities, in each case consolidated from the securitization entities we have sponsored. As a result of this GAAP treatment, no gain on sale is recognized for GAAP purposes from the securitizations we sponsor even if these securitizations are economically profitable for us.

The bulk of our permanent assets consists of securities created from pools of high-quality residential real estate loans. These include securities with concentrated credit risk (credit-enhancement securities, or CES) or concentrated loan prepayment risk (interest-only securities, or IO securities , or IOs). We acquire the bulk of our residential loan CES from securitizations sponsored by others, while we acquired the bulk of our IO securities from the Sequoia securitizations we have sponsored.

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

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

Redwood Trust, Inc. 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.

COMPANY BUSINESS AND STRATEGY

General

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

Securitization of Jumbo Residential Loans

Our primary product/market focus is investing in, credit-enhancing, and securitizing high-quality jumbo residential real estate loans and related securities. Our permanent asset portfolio consists primarily of CES and IOs that were created through the securitization, by us or others, of high-quality jumbo residential real estate loans. The underlying loans have interest rates that are fixed, adjustable or hybrid (hybrids have a fixed rate period that is followed by an adjustable rate period).

Our residential loan securitization activities focus primarily on adjustable-rate jumbo residential loan products.

According to industry sources, approximately $7.9 trillion of residential real estate loans were outstanding in the United States as of December 31, 2004. The amount of residential real estate loans has grown at an average rate of 9% per year for approximately 20 years as home ownership and housing values have generally increased. New originations of residential real estate loans have ranged from $1.0 trillion to $3.8 trillion per year over the last five years. Originations generally increase in years when refinancing activity is stronger due to declines in long-term interest and mortgage rates.

The U.S. government-sponsored residential real estate loan investment and credit-enhancement companies, Fannie Mae and Freddie Mac, are prohibited from owning and credit-enhancing real estate loans with balances over certain limits. The limit for single-family real estate loans originated within the continental United States was $359,650 beginning in 2005. Loans with balances larger than this limit are commonly referred to as jumbo loans. We estimate that over the past five years, new originations of jumbo residential real estate loans have ranged between $250 billion and $635 billion per year, constituting between 17% and 24% of total new residential loan originations. We believe that outstanding U.S. jumbo residential real estate loans total over $1.5 trillion as of December 31, 2004. We also believe that the outstanding balance of jumbo residential real estate loans is likely to continue to grow at approximately the same rate as the residential loan market as a whole (between 4% and 12% per year).

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

We estimate that the share of jumbo residential real estate loans outstanding that have been securitized has been increasing steadily from less than 10% in 1990 to over 50% in 2004. As a result of continued bank portfolio demand

and also reduced originations, we expect that the supply of new jumbo loan securitizations may be somewhat reduced in the next few years. Nevertheless, we do expect that there will continue to be a reasonable amount of CES and IO securities available for sale, relative to the purchase rate that we need to maintain to reinvest cash flows generated from the pay down of assets within our portfolio.

Residential Credit-Enhancement Securities

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

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

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

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

The liquidity crisis in the financial markets in 1998 caused many of the participants in this market to withdraw. With reduced demand stemming from reduced competition, and increased supply of securitized product as a result of increased new originations, as well as sales of seasoned loan portfolios, prices of residential credit-enhancement interests declined and the acquisition of these interests became more attractive. Prices further declined in 1999 as financial turmoil continued and many financial institutions reorganized themselves to focus on other businesses.

From late 1998 through 2002, the prices of assets and the margins available in the jumbo residential CES business were generally attractive. In 2003, 2004, and early 2005, while the supply of CES generally increased as a result of an increase in jumbo real estate loan securitizations, there was a general increase in competition, demand, liquidity, and prices in this market. We believe that we will continue to experience increased competition in our efforts to acquire these assets, and that reduced supply is likely in the next few years. These factors may drive prices of residential CES even higher. With higher pricing, we are reducing the rate at which we acquire new securities of this type and our earnings potential is reduced (relative to assets acquired in the last five years) for the assets we do acquire. We have decided due to higher pricing to cease acquiring for our permanent asset portfolio some of the types of residential CES. At current and higher price levels, we may still find some attractive new asset acquisition opportunities, but with reduced acquisitions and increased sales of seasoned assets (as a result of higher prices and our capital recycling disciplines), we could become a net seller of these assets.

Residential Interest-Only Securities

One or more IO securities are typically created during most residential real estate loan securitizations. These securities do not have a principal value. They receive interest payments but no principal payments (thus they are called interest-only).

IO securities can be structured in a variety of ways. Some are simple, and thus are typically more liquid. Other IO securities that absorb a greater degree of the risk of the underlying securitization transaction can be highly complex and thus more difficult to sell or value.

The interest payments made on the IO securities we typically acquire are determined by the spread between the higher level of interest income paid to the securitization entity by the underlying loan collateral less the lower level of interest paid on the owners of the other ABS issued by the securitization entity. Typically if the loans underlying the securitization remain outstanding longer than expected (i.e., the loan prepayment rate is slower than expected), the owner of the IO securities will earn a higher yield than expected at purchase. Faster than expected prepayments generally lower the returns of IO securities holders. Generally, IO securities have little or no effective credit risk.

To the extent there is a mismatch of interest rate characteristics between the securitized loans owned by a securitization entity and the ABS issued by that entity, cash flow payments to the owner of the IO securities may vary as interest rates change. For instance, for most of our Sequoia securitizations there is an interest rate mismatch between Sequoia assets (the majority of which are six-month London Inter-Bank Offered Rate (LIBOR) adjustable rate) and Sequoia ABS issued (the majority of which are one-month LIBOR adjustable rate). For those Sequoia entities from which Redwood has acquired the IO securities (generally, Sequoia 2004-2 and earlier securitizations), Redwood is exposed to this mismatch risk and thus undertakes a hedging program to minimize this risk. Redwood is not exposed to the mismatch risk of those Sequoia transactions from which Redwood has not acquired the IO securities that bear the spread risk. However, the assets and liabilities of these securitization transactions are consolidated onto Redwood s GAAP balance sheet. Redwood s exposure to asset-liability matching issues is therefore significantly less than would be implied by an examination of the assets and liabilities that Redwood reports for GAAP purposes.

We believe that the business of acquiring and owning IO securities generated through the securitization of jumbo residential loans is fragmented. A deeper and more active market for more complex IO securities has developed in the last several years, in part due to interest from money managers, mutual funds, hedge funds, and other capital markets participants seeking attractive fixed income yields. Increased interest in this asset class has increased both prices and liquidity for IO securities. As a result, it has become relatively easier for the Sequoia entities we sponsor to sell IO securities to third parties at attractive prices As a result of increased liquidity and higher prices for IO securities (and similar premium priced asset-backed securities), early in 2004 we ceased acquiring for our permanent asset portfolio most of the larger IO securities generated by Sequoia entities. In special situations, we have continued acquiring a relatively small volume of IO securities from Sequoia entities and securities from securitizations sponsored by others, in each case typically for sale to Acacia CDO securitizations.

The development of a deeper and more liquid market for IO securities has enabled companies that do not have the ability or desire to own IO securities as permanent assets to be more competitive with us in the business of acquiring and securitizing jumbo loans.

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Our Company

Over the past ten years, we have built a company that allows us to compete in the business of investing in, credit-enhancing, and securitizing residential and commercial real estate loans and securities. The key aspects of our business model include:

Business focus. We invest in, credit-enhance, and securitize residential and commercial real estate loans and securities. Our primary source of revenue is interest income, which consists of the monthly loan payments made by homeowners (and to a lesser degree, commercial property owners) on their real estate loans. We are taxed as a real estate investment trust. As a REIT, we generally are not required to pay corporate income taxes on the REIT taxable income that we distribute to stockholders as dividends.

Our primary product focus is residential and commercial loans that are high quality. High quality means real estate loans that typically have features such as low loan-to-value ratios, borrowers with strong credit histories, and other indications of quality relative to the range of loans within U.S. real estate markets as a whole. We currently sponsor the securitization (through our Sequoia program) of all the residential real estate loans we acquire. We also sponsor the re-securitization (through our Acacia CDO program) of the bulk of the real estate securities we acquire that are not CES.

Our focus is to manage a permanent portfolio of assets funded with equity and generating long-term cash flows. Most of the assets we own in our permanent asset portfolio are securities we have acquired from securitizations sponsored by others. The remainder of our permanent asset portfolio (except for a small amount of commercial real estate loans) consists of securities from securitizations of residential loans we sponsored as part of our Sequoia program and re-securitizations of residential and commercial real estate loan-backed securities we sponsored as part of our Acacia CDO program.

For our permanent asset portfolio, we typically invest in securities (from securitizations sponsored by us or by others) that have concentrated credit and prepayment risk. We believe we have built the specialized knowledge and operations, and a highly efficient and specialized corporate structure, to support a successful program of creating and investing in these types of securities.

Stong balance sheet. We seek to maintain a balance sheet that we believe should allow us to weather potential general economic downturns and liquidity crises. Our permanent assets do have concentrated risks; however, our maximum loss exposure to these assets generally limited to our adjusted acquisition cost basis (adjusted for payments received and cumulative amortization subsequent to acquisition) for these assets. Furthermore, we do not leverage or borrow against these assets in the normal course of business. We believe our largely financially un-leveraged capital structure (except for debt assumed to accumulate assets as inventory for sale to securitization entities) and our robust capital position (we maintain equity capital greater than our maximum loss from all our permanent portfolio assets combined) are the principal elements of a strong balance sheet.

Emphasis on long-term asset portfolio. Through our operations, we seek to structure, acquire, and build a portfolio of valuable real estate securities. We seek to structure and own long-term assets that generally have expected average lives of five to ten years. The long-term nature of these assets helps to reduce reinvestment risk and generally provides us with more stable and proprietary cash flows that help support our goal of maintaining steady dividends over time.

Specialized expertise and scalable operations. We believe we have developed the specialized expertise necessary to efficiently and economically invest in, credit-enhance, and securitize jumbo residential real estate loans, commercial real estate loans, and other real estate loan assets. Our accumulated market knowledge, relationships with mortgage originators and others, sophisticated risk-adjusted capital policies, strict underwriting procedures, and successful experience with shifting financial market conditions allow us to acquire and securitize real estate loans and own and manage our permanent asset portfolio and effectively manage the risks inherent in those businesses. We build and maintain relationships with large mortgage originators, banks that are likely to sell real estate loan portfolios, Wall Street investment firms that broker real estate loans and securities, and the buyers of ABS from the securitizations we sponsor. We continue to develop our staff, analytics, models, and other capabilities that help us structure securitization transactions and cash flows, evaluate the credit quality of individual loans and pools of loans, underwrite loans effectively, and monitor trends in credit quality and expected losses in our existing assets. We establish relationships with our servicing companies to assist with monthly surveillance, loss mitigation efforts, delinquent loan workout strategies, and liquidation of defaults for the loans underlying the securities we have invested in. Aside from collaborating with servicers on these issues, we insist that specific foreclosure timelines be followed and that representations and warranties made to us by sellers are enforced. For balance sheet management, we work to project cash flows and earnings, determine capital requirements, source borrowings efficiently, preserve liquidity, and monitor and manage risks effectively.

We believe that our operations are scalable. In the long run, we do not expect our operating expenses to grow at the same rate as our net interest income, should we expand our capital base and our portfolios. Thus, other factors being equal, we believe that growth in our capital could be accretive to earnings and dividends per share.

Competitive advantages. As a REIT, we pay only limited income taxes, traditionally one of the largest costs of doing business. In addition, we are not subject to the extensive regulations applicable to banks, thrifts, insurance companies, and mortgage banking companies; nor are we subject to the rules governing regulated investment companies. We believe the absence of business-restrictive regulations in our market sector is a competitive advantage. The regulations applicable to certain financial companies can cause capital inefficiencies and higher operating costs for certain of our competitors. We believe our structure enables us to acquire attractive investments that are not feasible or practical for other financial companies.

Investment flexibility. We are open to investing in, credit-enhancing, and securitizing other types of real estate mortgage assets that may complement and benefit our core business activities. In addition to our investments in CES and IO securities backed by jumbo residential loans and HELOCs, we currently invest in commercial real estate CES, commercial real estate loan participations, and CDO equity securities backed by diverse types of residential and commercial real estate loans and securities. Depending on the relative attractiveness of the opportunities in these or new product lines, we may increase or decrease the size of and capital allocation to these portfolios over time.

Our Strategy

Our primary financial objective is to produce a steady, regular dividend for stockholders, primarily through investing in, credit-enhancing, and securitizing high-quality residential and commercial real estate loans and securities. Although our primary objective is steady, regular dividends, we believe it may be possible to raise our regular dividend rate from time to time if we can increase our core rate of sustainable profitability. This may be accomplished if we become more efficient and productive (which, in our view, would most likely to be accomplished through growth), if we diversify our sources of investment opportunity and risk, and/or if we increase tangible book value per share through retention of a portion of our earnings or through accretive stock offerings at prices in excess of book value.

The key aspects of our strategy include:

Preserve portfolio quality. In our experience, the highest long-term risk-adjusted returns come from investing in, credit-enhancing, and securitizing high-quality real estate loans and securities. For this reason, when we take concentrated first-loss credit risk, we focus primarily on acquiring securities for our permanent asset portfolio that are backed by A quality or prime quality jumbo residential real estate loans, prime quality home equity lines of credit, and commercial real estate loans that meet the generally higher quality standards of the commercial mortgage-backed securitization (CMBS) market.

Within the prime residential real estate loan category, there are degrees of quality: A , Alt-A , and A minus. As compared to the residential market as a whole, we believe our portfolio of residential CES is backed by loans that are generally concentrated in the top quality end of the A residential real estate loan category. We generally invest in securities backed by residential real estate loans from large, high-quality national mortgage origination companies. We also have some of the highest quality servicing companies processing our loan payments and assisting with loss mitigation. While we do acquire (and sell to Acacia) securities backed by residential loans that are less than A quality, nearly all of the securities of this type that Acacia acquires are rated investment-grade because they are credit-enhanced in some form by others, which mitigates Acacia s risk of credit loss from these securities and thus reduces our risk of loss as the owner of the CDO equity securities issued by Acacia.

Maintain geographic diversity. We invest in securities that are backed by loans that, in aggregate, are located in all 50 states. With the exception of California and Florida, no one state generally represents more than 5% of our residential credit exposure. Our exposure to California residential loans through our ownership of CES sponsored by others and us is 40% to 50% of our total exposure, which is approximately the same percentage as California s percentage of the total U.S. jumbo residential real estate loan market. Less than 1% of the jumbo loans on which we take concentrated credit risk are located in any one zip code in the United States.

Manage interest rate risk and prepayment risk. We generally seek to put ourselves in a position where changes in interest rates would not be likely to materially harm our ability to meet our long-term goals or maintain our regular dividend rate. We use debt to finance on a temporary basis loans and securities that we are accumulating as inventory for sale to securitization entities. This debt ($203 million at December 31, 2004) is short-term floating rate debt. We believe this debt is a good interest rate match for the floating and adjustable-rate assets we are accumulating as inventory, but does not provide a good interest rate match for fixed and hybrid (fixed and then floating rate) assets. When we acquire fixed and hybrid rate assets on a temporary basis as inventory for securitization, we use interest rate agreements (such as interest rate swaps and interest rate futures) to modify the interest rate characteristics of our debt so that it matches the characteristics of these assets. When we sell these assets to a securitization entity, we close out the interest rate agreement transactions that are associated with these liabilities. This program has been effective, even as interest rates change, in matching our debt to these assets during the short period we own these assets.

Our permanent asset portfolio is currently financed with equity and, therefore, there is no asset-liability mismatch. However, our future earnings and cash flow from each of our permanent portfolio assets could potentially be affected by changes in interest rates and prepayment rates. For instance, our earnings from residential CES will generally benefit over time if the underlying loans prepay quickly. Our earnings from residential IO securities will generally benefit from slower prepayments of the underlying loans. The bulk of the loans underlying our residential CES are fixed or hybrid rate loans, while the bulk of the loans underlying our residential IO securities portfolio are adjustable-rate. A significant decrease in fixed and hybrid prepayment rates could have some negative effect on our long-term earnings. In the recent past, fixed and hybrid prepayments have decreased, although not to levels that would reduce our earnings from these assets to unattractive levels. During 2004, we reduced our on-going purchases of IO securities from our Sequoia securitizations and increased our volume of purchases of residential CES backed by adjustable-rate loans (these CES benefit from faster prepayments and, thus, tend to reduce our overall prepayment risk with respect to adjustable rate loans). As a result of these activities, we believe we are currently positioned to benefit to a small degree (generally, in the long-term) from an increase in adjustable-rate loan prepayments (and a decrease in these prepayment rates might not be favorable).

In addition to affecting prepayment rates, changes in interest rates can directly affect earnings from some of our permanent assets, even though they are equity-financed. Fixed rate assets can provide steady earnings as interest rates change; however, floating and adjustable rate assets generally produce higher earnings as short term interest rates increase and lower earnings as short term interest rates decrease (assuming all other factors are constant). We have a mix of both fixed rate and floating rate assets in our permanent asset portfolio. Our earnings from some of the more complex IO securities we own could also vary in the short term due to changes in interest rates. For instance, many of the IO securities we have purchased from Sequoia securitizations earn the net interest spread between the yield generated by the underlying one- and six-month LIBOR-indexed loans and the cost of primarily one-month LIBOR-indexed payments to ABS holders. If short-term interest rates were to rise rapidly, this spread could be compressed for a few months, reducing our earnings generated from these IO securities. To stabilize our earnings from this source, we use interest rate swaps and futures that effectively synthetically convert Sequoia s ABS payments from a one-month LIBOR to a six-month LIBOR index, thus matching the characteristics of the income payments generated by the loans. This program has been effective at stabilizing the returns we earn from these IO securities as short-term interest rates change. For Sequoia transactions completed after Sequoia 2004-2, we have not acquired the IO securities and, thus, we are unaffected by interest rate mismatches within these transactions and we do not hedge the liabilities associated with these transactions.

Manage capital levels. We manage our capital levels, and thus our access to borrowings and liquidity, through risk-adjusted capital policies supervised by our senior executives. For most of our permanent assets, our minimum equity capital requirement is 100% of our investment. Thus, our minimum internal equity capital requirement equals our maximum loss amount for those assets. For assets held temporarily as inventory prior to the sale to a securitization, our minimum internal equity capital requirement is generally materially higher than the amount required by the lenders that have advanced us the debt we use to fund these assets. We believe our conservative and well developed risk-adjusted capital guidelines are an important tool that helps us achieve our goals and mitigate the risks of our business. We continually seek to improve the effective use of our capital without changing our underlying goals and policies. Through these policies, we believe we effectively assign a capital adequacy guideline amount and maintain sufficient cash to appropriately manage our capital needs. In most circumstances in which our actual capital levels decreased below our capital adequacy guideline amount, we would expect to cease the acquisition of new assets until capital guideline levels were restored through loan prepayments, asset sales, securitization transactions, capital raising, or other means.

Our current plan is to continue to sell all the residential real estate loans we acquire and the bulk of the real estate securities we acquire to securitization entities we sponsor. We currently plan to restrict our use of debt to the temporary funding of assets under accumulation as inventory for sale to a securitization entity. To the extent that we do have real estate assets funded with debt that are subject to margin calls, our capital requirement guidelines will fluctuate over time, based on changes in these assets credit quality, liquidity characteristics, potential for market value fluctuation, interest rate risks, prepayment risks, and the over-collateralization requirements for these assets as set by our collateralized lenders.

Pursue growth and diversification. We are pursuing a long-term growth strategy, seeking to increase the amount of equity capital we have employed in our business of investing in, credit-enhancing, and securitizing real estate loans and securities. As we increase our equity, we believe we will be able to strengthen our relationships with our customers from whom we buy real estate assets, thus potentially giving us certain pricing, cost, and other competitive advantages. As we increase the size of our capital base, we believe that we may benefit from improved operating expense ratios, lower borrowing expenses, improved capital efficiencies, and related factors that may improve earnings and dividends per share. In order to continue to grow, we have been expanding our capabilities and financing arrangements to allow us to increase our investment in diverse residential and commercial real estate securities and loans. We believe diversification into related new product areas may provide us with diversification of both risk and opportunity, and help us to achieve our long-term growth goals.

Acquiring and Creating Permanent Assets

Our Consolidated Balance Sheets include loans and securities we have acquired and securitized through the Sequoia and Acacia programs. Below is a discussion of our permanent asset portfolio by type of underlying collateral. It is these permanent assets that have the concentrated credit risk and/or prepayment risk, and that generates long-term cash flows to fund our dividend distributions. Due to GAAP accounting treatments, some of the permanent assets do not appear as assets on our Consolidated Balance Sheets; they are effectively reported as an excess of assets over liabilities consolidated from securitization entities we sponsor.

Residential Real Estate Loans

Our Consolidated Balance Sheets show residential real estate loans , which includes the residential loans that we own temporarily as inventory prior to sale to a securitization entity ($193 million at December 31, 2004), in addition to loans that are consolidated onto our balance sheet from the Sequoia brand-name ABS entities that we have sponsored ($23.6 billion as of December 31, 2004). The residential real estate loans we are accumulating as inventory for sale to securitization entities and the residential real estate loans included on our Consolidated Balance Sheets from securitizations we have sponsored consist of high quality residential loans that generally have relatively low loan-to-value ratios and borrowers with relatively high credit scores (in each case relative to the U.S. residential real estate loans as a whole). Most of these loans are jumbo loans that have loan balances that exceed (at origination) the loan limit imposed on Fannie Mae and Freddie Mac (currently $359,650) and, therefore, they were not eligible at origination for purchase or credit-enhancement by these government-sponsored enterprises. Almost of all of the residential loans in our consolidated residential real estate loans are adjustable-rate loans with an interest rate that adjusts each month, three months, or six months.

We make bulk purchases of residential whole loan portfolios that meet our acquisition criteria and that are priced attractively relative to the value of ABS that could be issued in a securitization of these loans. In addition, we acquire new loans on a continuous or flow basis from originators that have loan programs that meet our desired quality and loan type standards.

We plan to continue to accumulate inventories and sponsor the securitization of high-quality jumbo residential loans when loans are available on attractive terms relative to our anticipated proceeds from a sale to a securitization entity (i.e., the market value of the loans is less than the market value of the ABS backed by these loans that could be sold by that entity). We currently focus on adjustable-rate real estate loans, and we may also from time to time acquire and sponsor the securitization of hybrid or fixed rate loans.

The process of securitization commences when we underwrite and acquire residential real estate loans from sellers. We generally seek to quickly build an inventory of these loans that is large enough (at least $200 million) to support an efficient securitization. We source our loan acquisitions from large, well established mortgage origination companies and large banks and thrifts.

Our Consolidated Statements of Income reflect interest income that flows to us as owners of loans held temporarily as inventory prior to sale to a securitization entity and also interest income flowing to consolidated securitization entities that own the loans that have been securitized in transactions sponsored by us. Interest income for GAAP consists of cash interest payments from loans, less net amortization of premiums paid at acquisition in excess of principal value of loans, less credit provision expenses incurred to provide for credit reserves for credit losses. With respect to these loans, our Consolidated Statements of Income also include interest expenses associated with debt ($203 million at December 31, 2004) incurred to finance the purchase of loans on a temporary basis as inventory prior to sale to a securitization entity and consolidated interest expenses associated with the ABS issued ($23.6 billion at December 31, 2004) by consolidated securitization entities. Interest expenses for ABS issued include cash payments to ABS holders, plus amortization of ABS issuance fees, less net amortization of premiums and discounts received from the sale of ABS at prices above or below principal value (including amortization of the sale price of ABS sold in interest-only form). For GAAP purposes, ABS issued by these entities that are acquired by us for our permanent asset portfolio are not recognized as asset-backed securities issued liabilities on our Consolidated Balance Sheets nor are the assets we acquire shown as assets on our Consolidated Balance Sheets. Both of these items are eliminated on consolidation for GAAP purposes. Similarly, the interest expenses for the securitization entities for securities we acquire and the interest income we receive as an owner of these securities are also eliminated on consolidation for GAAP purposes.

Also included in consolidated interest expenses (to the extent we elect hedge accounting) are the costs or benefits associated with interest rate agreements (such as interest rate swaps and futures) associated with our hedging the variable interest rate payments in the liabilities associated with these residential assets.

We typically acquire for our permanent asset portfolio the CES issued by the residential loan securitizations that we sponsor. These securities bear concentrated credit risk with respect to the securitized loans, and are typically in a first-loss position or a second-loss position with respect to credit losses incurred within the securitization (credit losses reduce the principal value of the securities we have acquired). Typically, first-loss securities do not have a credit rating (they are NR, or not rated securities) and second-loss securities typically have a below-investment grade credit rating of B.

Prepayment rates are an additional factor in the returns we will experience from these CES. Faster prepayment rates generally result in a faster return of principal from these securities, which generally increases our investment returns. We acquire CES at their market value, which is a steep discount to the principal of the security in most cases, due to the concentration of credit risk. If the principal of these securities is not entirely eliminated by credit losses in the underlying loan pools over time, under the terms of the securitization structures we will eventually receive principal payments. Principal payments from these securities will typically commence three to ten years after the securitization date. A higher level of delinquencies and/or cumulative credit loss within the securitized pool of loans can delay, reduce, or eliminate principal payments. Prepayment rates also affect the date of principal return; slower prepayment rates generally delay the return of principal and faster prepayment rates generally accelerate the return of principal. An earlier date of principal (if any) returned to the securities, generally increases our investment returns since we acquired these securities at a discount price to principal value.

For Sequoia securitizations we sponsored prior to March 2004, we also acquired for our permanent asset portfolio (and also as inventory for our Acacia resecuritization program) some or all of the issued IO securities. The IO securities holder receives interest payments based on a notional value of principal, but has no right to receive principal payments. These IO securities are, for the most part, rated AAA by credit rating agencies, as the risk of economic loss to the IO securities holders as a result of credit losses within the underlying loan pool is remote. However, these IO securities do bear prepayment risk with respect to the securitized loans. In general, a slower rate of prepayment enhances the economic returns of the owner of the IO securities. There are many different types of IO securities, and their payment structures can be complex. In general, the notional principal value of an IO security (which determines the level of interest payments made to the IO securities owner) will be higher over the long run (thus resulting in a greater level of interest payments to the IO securities owner) if the underlying loans prepay at a slower rate. A very rapid prepayment rate for the underlying loans, if sustained over a period of several years, could result in a very low or negative rate of investment return for the IO securities owner.

The bulk of the loans underlying the IO securities we have acquired for our permanent asset portfolio are adjustable-rate residential loans with coupon rates that adjust each month, three months, or six months as a function of LIBOR short-term interest rates. Upon acquisition, we have generally assumed that the long-term prepayment rate (Conditional Prepayment Rate or CPR) for these loans will be 25% of the balance of the loans each year. In our experience, CPRs on these loans have ranged from 10% to 40%, but over the past decade average CPRs on these types of loans have rarely exceeded 25% over a sustained period of several years. Many factors influence the prepayment rates of adjustable-rate loans. One major factor is the shape of the yield curve. We expect that a flat or inverted yield curve where short-term rates are slightly less than, equal to, or greater than long term interest rates should generally result in faster prepayment rates on adjustable-rate residential loans. In this case, faster prepayments of adjustable-rate loans would likely produce lower economic returns on our IO securities. However, these faster prepayments would produce higher economic returns from the CES we have acquired from adjustable-rate residential loan securitizations. As of December 31, 2004, we believe any increase in returns would likely offset and may exceed the concurrent reduction in returns over the long term that we would earn from IO securities on CES we own that are backed by adjustable-rate loans. However, the timing of the recognition of these generally offsetting returns would likely not match, as residential CES are longer-lived securities and the recognition of higher returns from faster ARM prepayments may occur at a subsequent point in time.

Our Acacia CDO program assets also have a degree of exposure to the loans shown on our Consolidated Balance Sheets as residential real estate loans . Acacia entities have acquired second-loss securities (usually rated B), third-loss securities (usually rated BB), investment-grade securities, and a small amount of IO securities from the Sequoia name-brand residential loan securitization entities we have sponsored. Thus, the credit, prepayment, and interest rate performance of the loans shown on our Consolidated Balance Sheets as residential real estate loans are one of the many factors that affect the economic returns we earn from our investment in Acacia CDO equity securities.

Our exposure to securities we acquire from Sequoia securitization entities is generally limited to our investment in these securities. As a result, our maximum loss from the loans consolidated on to our Consolidated Balance Sheets from securitization entities is a small fraction (usually less than 3% and often less than 1%) of the aggregate loan balances reported. Since we hold the permanent asset securities we acquire from Sequoia and Acacia with equity as permanent assets, and generally do not borrow against or leverage these securities, the maximum loss we could sustain from these assets is generally less than our equity capital base.

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Residential Home Equity Lines of Credit

During the second quarter of 2004, we acquired a $335 million portfolio of high-quality home equity lines of credit and sold these HELOCs to an ABS entity (Sequoia HELOC Trust 2004-1) for securitization. We may acquire and sponsor the securitization of more HELOCs in the future. In general, this HELOC securitization should be considered a pilot program with respect to efforts to build a new product line. We expect our securitization volume in HELOCs will most likely grow slowly (if at all) over a period of years, unless prices decline because banks reduce the amount of these assets held in their portfolios.

The HELOC portfolio securitized by Sequoia HELOC Trust 2004-1 consists of adjustable-rate first and second lien residential loans with a 10-year revolving period and a maturity from origination of 10 years. During the revolving period, borrowers have the option of drawing funds up to the available credit limit. As a result, the balance of each loan, and the total balance of this portfolio, may increase if borrowers increase their draws. The interest rate on the HELOCs adjusts as a function of the prime short-term interest rate. The HELOC portfolio is generally high quality and is characterized by relatively high FICO credit scores (average of 725) and relatively low loan-to-value ratios (average of 75%) for the combination of the first-lien and second-lien (if any) loans, assuming a maximum draw. The borrowers in this HELOC portfolio are similar in many ways to the borrowers in our consolidated residential real estate loan portfolio. In general, however, due to the second-lien nature of many of these HELOCs, we expect delinquencies for HELOCs to be somewhat higher than we experience with our consolidated residential real estate loan portfolio. The loss frequency of our HELOCs should be approximately similar to our other residential loans of the same vintage, we believe, but we expect the loss severity (credit loss from a default, as a percentage of the loan balance) of HELOCs could be significantly higher (close to 100%). Due to the higher loss severity, we expect cumulative credit losses over time on securitized HELOCs could be materially higher than for the other residential loans in Sequoia. We have factored this higher loss expectation into our acquisition pricing and securitization calculations. As a result, we believe these securitized HELOCs can produce significantly higher losses than our other residential loans while, at the same time, we still can earn an attractive rate of return from the over-collateralization (OC securities) we acquired from the HELOC securitization trust. The OC securities are the functional equivalent of a combination of the CES and the IO securities issued from the securitization of these HELOCs.

Credit losses reduce our returns from our investment in the HELOC securities. In addition, if the net rate of prepayment of the HELOC loans (net of draws) is relatively fast, our earnings from the OC securities we acquired could be significantly lower than if net prepayments are relatively slow. Furthermore, the ABS issued by Sequoia HELOC Trust 2004-1 have an adjustable-rate coupon that adjusts as a function of the LIBOR index. If LIBOR should rise relative to the prime interest rate that determines the rate paid by the HELOC borrowers, our earnings from the OC securities we own would be reduced.

As with residential loans described in the section above, the assets and the liabilities of Sequoia HELOC Trust 2004-1 are consolidated on our balance sheet, and the interest income the trust earns on these HELOCs and the interest expenses the trust pays to ABS holders are reported as interest income and expense on our Consolidated Statements of Income.

Residential Credit-Enhanced Securities

We own residential CES acquired from ABS securitizations sponsored by other financial institutions. These are included in our residential CES portfolio as reported on our Consolidated Balance Sheets, as are residential CES from securitizations sponsored by others that have been acquired by Acacia entities. As noted in the residential loan discussion above, the residential CES issued by the securitizations of residential loans that we have sponsored (generally under the Sequoia label) are not reported on our Consolidated Balance Sheets, even though they are similar to the CES we own that are sponsored by financial institutions. The discussion below relates entirely to that portion of our residential CES that were acquired from securitizations sponsored by others and thus appear on our Consolidated Balance Sheets as residential CES. (Since we did not sponsor these entities, the assets and ABS liabilities of these entities are not reported on our Consolidated Balance Sheets, only our adjusted cost basis in the security that we or Acacia acquired is included).

Residential CES are the securities, issued by a residential loan ABS entity, that bear the bulk of the likely credit risk of the pool of loans that were securitized. By bearing the credit risk, these securities credit-enhance the other securities issued by the ABS entity, allowing those securities to earn high ratings from credit rating agencies, thus allowing them to be sold to a wide variety of capital markets investors. The CES that bear the concentrated credit risk typically have below investment-grade credit ratings. The maximum loss for the owner of these securities is limited to the investment made in purchasing the CES.

Generally, we acquire CES from leading high-quality national mortgage origination firms and certain other smaller firms that specialize in high-quality jumbo residential real estate loan originations. We also have in the past worked with large banks that are sellers of seasoned portfolios of high-quality jumbo residential real estate loans. We either work directly with these customers or we work in conjunction with an investment bank on these transactions. Our CES are backed by fixed-rate, hybrid, and adjustable-rate residential real estate loans.

The principal value of the CES in any rated senior/subordinated securitization is determined by the credit rating agencies: Moody s Investors Service, Standard & Poor s Rating Services, and/or Fitch Ratings. These credit agencies examine each pool of residential real estate loans in detail. Based on their review of individual loan characteristics, they determine the credit-enhancement levels necessary to award investment grade ratings to the bulk of the ABS securities formed from these loans.

Our actual investment, and our risk, is less than the principal value of our CES since we acquire these interests at a discount to principal value. For GAAP purposes, we designate a portion of this discount as our credit protection for future losses; the remainder we amortize into income over time. For tax purposes, we cannot anticipate future credit losses. Thus, the entire discount is projected to be amortized into income, and when the losses occur, there will be a tax deductible expense.

Our first defense against credit loss is the quality of the residential real estate loans we credit-enhance. These loans are generally in the high-quality range, as measured by such loan factors as loan-to-value ratios, debt-to-income ratios; credit quality and FICO score of the borrower, and completeness of documentation. The loans are secured by the borrowers homes. Compared to most corporate and consumer loans, the residential real estate loans that we credit enhance have a much lower loss frequency and a much lower loss severity. (The loss severity is the percentage of the loan principal and accrued interest that we lose upon default.)

Our exposure to credit risks of the residential real estate loans that we credit-enhance is further limited in a number of respects as described below:

Risk tranching. A typical residential real estate loan securitization has three CES: a first-loss security; a second-loss security; and a third-loss security. Our first-loss security investments are directly exposed to the risk of principal loss on any loan in the underlying loan pool that may default. Our second-loss securities are exposed to credit loss if cumulative pool losses exceed the remaining principal value of the first-loss security. Our third-loss securities are exposed to loss if cumulative pool losses exceed the remaining principal value of both the first- and second-loss security. Thus, not all our investments in CES are immediately exposed to loss, and to the extent a third-party owns a first-loss security or another security that is junior to the security we own, we benefit from the credit enhancement provided by others.

Limited maximum loss. Our potential credit exposure to the residential real estate loans that we credit-enhance is limited to our investment in the CES that we own.

Credit protection established at acquisition. We acquire CES at a discount to their principal value. For GAAP purposes, we designate a portion of this discount as credit protection against future credit losses. For many economic circumstances, we believe that this protection should be large enough to absorb future losses for GAAP purposes. We establish the amount of our credit protection at acquisition and adjust it over time following a review of the underlying collateral, economic conditions, and other factors. If future credit results are favorable, we may not need all of the amounts designated as credit protection. In such event, we may then re-designate some of these GAAP credit protection balances as a discount to be amortized into GAAP income over time. If future credit results are worse than previously anticipated, we would either recognize a reduced yield from these securities or we would recognize an impairment. The establishment or re-designation of GAAP credit protection balances for these securities does not affect our cash flow or our taxable income and does not protect us from the economic effect of future losses.

Mortgage insurance. A small portion of the loans underlying our residential CES portfolio consists of residential real estate loans with initial loan-to-value, or LTV, ratios in excess of 80%. For the vast majority of these higher-LTV ratio loans, we benefit from primary mortgage insurance provided on our behalf by the mortgage insurance companies (or from similar protection provided by pledged asset accounts). Thus, for what would otherwise be our most risky mortgage loans, we have passed much of the risk on to third parties and our effective LTV ratios on these loans are lower than 80%.

The securities in the CES portfolio represent first-loss, second-loss, and third-loss interests. We fund the first-loss and second-loss interests with equity and they are included as part of our permanent asset portfolio. The third-loss interest is generally sold to our Acacia CDO entities; thus, these third-loss interests do not represent permanent assets as only the equity we acquire from Acacia is deemed a permanent asset.

Commercial Real Estate Loans and Commercial Real Estate Securities included in our Securities Portfolio

While our primary investment focus is securities backed by high-quality residential real estate loans, we also invest in commercial real estate loans and securities. Starting in 1998, we originated commercial real estate loans for our portfolio. Currently, we do not originate many commercial loans, and our general goal is to acquire commercial real estate loans or work jointly with originators of commercial loans to structure commercial loan participations. We usually acquire the junior participation. For certain loans, we are still effectively the originator. We acquire (or originate) commercial real estate loans, junior commercial loan participations, mezzanine commercial loans, commercial real estate loan securities and commercial CES.

The commercial loans we own are financed with equity and included as part of our permanent asset portfolio. In order to reduce our investment and increase our returns in a loan, we may sell a senior interest loan. In this scenario, we retain the primary credit risk and our permanent asset is equal to our investment in this junior interest in the loan. For GAAP purposes, these transactions are accounted for as financings so the commercial loans are consolidated into our assets and the senior interest issued by the financing vehicles is included in our consolidated liabilities. We also may sell commercial loans, securities, and loan participants to Acacia securitization entities from which we acquire CDO equity securities for our permanent asset portfolio. In addition, we may acquire interests in joint ventures of other entities that invest in these types of commercial loans and securities.

We are also acquiring additional commercial real estate securities to be held for the long-term in our permanent asset portfolio and seek to increase our investments in commercial CES (first-loss and second-loss securities). This will expose us to additional first-loss credit risk with respect to the commercial real estate loans underlying these securities. We may invest in commercial CES in conjunction with partners. At this time, our commercial CES are reported as part of our securities portfolio.

To date, we have had few delinquencies and losses on our investments in commercial real estate loans and commercial CES. A slowing economy, and factors particular to each commercial loan or pool of commercial loans underlying the securities, could cause credit losses in the future. As this occurs, we would provide for future losses for GAAP purposes by creating a specific credit reserve on a loan-by-loan basis or by changing our credit-loss projections on our commercial mortgage backed securities and thereby considering whether permanent impairment on such securities must be recognized.

Securities Portfolio

Our securities portfolio , as reported on our Consolidated Balance Sheets, consists of real estate securities including prime residential, HELOC, sub-prime residential, manufactured housing, second-lien residential, commercial real estate investment-grade and CES, real estate CDO securities (including CDO equity and preference share securities), and corporate debt issued by conventional equity REITs that own commercial real estate properties. As investors in these mostly investment-grade and BB-rated securities, we are typically exposed to the credit risk of the underlying real estate loans but we also benefit for most of these securities (except for those assets in first-loss position) from some credit-enhancement from first-loss or other junior securities that are owned by others.

Our reported consolidated securities portfolio contains (i) a small amount of equity-funded securities (typically first-loss and second-loss commercial and CDO assets), that we intend to keep in our permanent asset portfolio, (ii) a variable amount (usually up to $300 million) of debt-funded securities that we are holding temporarily for future sale to an Acacia ABS entity, and (iii) the bulk of this portfolio of securities that we have sold to Acacia ABS entities but that are included on our Consolidated Balance Sheets. Acacia issues CDO ABS to fund the acquisition of these assets. We consolidate Acacia s assets, and we reflect Acacia s issuance of CDO ABS as ABS liabilities on our Consolidated Balance Sheets. Our economic exposure to securities sold to Acacia entities is generally limited to any investment we make in the CDO equity securities issued by those entities. We intend to continue to sponsor Acacia brand-name CDO resecuritization transactions so long as we believe the proceeds from sale of CDOs (including the market value of the securities we may acquire for our permanent asset portfolio) will be greater than or equal to the cost of accumulating the securities we sell to these entities.

To the extent we sponsor the resecuritization of fixed-rate and hybrid securities within Acacia entities, an interest rate mismatch is created, as the ABS issued by Acacia are generally adjustable-rate securities. Acacia typically enters into an interest rate agreements to reduce any such mismatch. These interest rate agreements usually cannot be changed during the life of the securitization. To mitigate any mismatches that may arise over time within the Acacia securitization entities, we may enter into interest rate agreements outside of Acacia.

We may seek to sponsor the securitization of CDOs with assets that are predominately commercial real estate based. We may also undertake a high-grade CDO securitization in which we accumulate primarily AA rated (as well as AAA and A rated) securities (mostly real estate related) for resecuritization. High-grade CDOs are typically relatively large in size ($1 billion is not uncommon), so accumulation risk could be an issue. Also, the security that we intend to acquire from such a high-grade CDO securitization the CDO equity ABS would be highly leveraged with respect to the credit performance of the underlying high-grade securities portfolio.

RISK FACTORS

The following is a summary of the risk factors that we currently believe are important and that could cause our results to differ from expectations. This is not an exhaustive list; other factors not listed here could be material to our results. Some of the risks discussed below relate to our permanent asset portfolio. In some cases, under GAAP, these investments are not reported on our Consolidated Balance Sheets. However, the economic risk remains and variations in returns from these assets would impact GAAP balances and income in some manner.

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

Risks Related to our Business

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

Our permanent asset portfolio produces the bulk of our profits. It consists of securities we have acquired from securitizations sponsored by us and by others (plus a small amount of commercial real estate loans). Each of the securities we own employs a high degree of internal structural leverage and concentrates its risk into a few securities that we acquire. No amount of risk management or mitigation can change the variable nature of cash flows, market values, and financial results generated by concentrated risks in our investments backed by real estate loans and securities, which, in turn, can result in variable returns to us and our stockholders. We generally fund our acquisitions for our permanent asset portfolio using our equity capital. Since we are not using financial leverage, or debt, to seek to increase our returns from these securities, we only acquire securities that we believe can earn a high enough yield to enable us to provide our stockholders with an attractive equity rate of return. In general, we expect to earn an internal rate of return, or IRR, of cash flows from each of our permanent asset portfolio assets that we believe is likely to equal or exceed 14% on a pre-tax and pre-overhead basis. In order to earn this rate of return on a financially un-leveraged basis, we generally acquire the most risky securities

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from any securitization. Most securitizations of residential and commercial real estate loans concentrate almost all the credit risk of all the securitized assets into one or more CES or CDO equity securities. (The CDO securities we acquire and own in our permanent asset portfolio are equity , preference share , and non-investment grade securities. Collectively, we refer to these as CDO equity securities .) To the extent that there is significant prepayment risk or interest rate risk internal to these securitization structures, those risks are generally concentrated in one or more securities, and those are typically the securities we buy.

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

We assume credit risk with respect to residential real estate loans primarily through the ownership of residential CES and similarly structured securities acquired from securitizations sponsored by others and from Sequoia securitizations sponsored by us. These securities have below investment-grade credit ratings due to their high degree of credit risk with respect to the residential real estate loans within the securitizations that issued these securities. Credit losses from any of the loans in the securitized loan pools reduce the principal value of and economic returns from residential CES. Credit losses could also reduce our ability to sponsor new securitizations of residential loans. We generally expect to increase our portfolio of residential CES and our credit exposure to the residential real estate loan pools that underlie these securities.

In addition to residential CES, the Acacia entities we sponsor own investment-grade and other securities (typically rated AAA through B, and in a second-loss position or better, or otherwise effectively more senior in the credit structure as compared to a residential CES or equivalent held by us) issued by residential securitization entities that were not sponsored by us. Generally, we do not control or influence the underwriting, servicing, management or loss mitigation efforts with respect to these assets. Some of the securities Acacia owns are backed by sub-prime loans that have substantially higher risk characteristics than prime-quality loans. We provide a summary of the collateral types under the Securities Portfolio section of our Management s Discussion an Analysis section of this Form 10-K. These lower-quality loans can be expected to have higher rates of delinquency and loss, and losses to Acacia (and thus Redwood) could occur. Most of Acacia s securities are reported as part of our consolidated securities portfolio on our Consolidated Balance Sheets. Acacia has also acquired investment-grade and BB-rated residential loan securities from the Sequoia securitization entities we have sponsored. The probability of incurring a credit loss on these securities is less than the probability of loss from first- or second-loss residential CES, as cumulative credit losses within a pool of securitized loans would have to exceed the principal value of the subordinated CES (and exhaust any other credit protections) before losses would be allocated to the Acacia securities. If the pools of residential loans underlying these securities were to experience poor credit results, however, these Acacia securities could have their credit ratings down-graded, could suffer losses in market value, or could experience principal losses. If any of these events occurs, it would likely reduce our returns from the Acacia CDO equity securities we have acquired and may reduce our ability to sponsor Acacia transactions in the future.

Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; decline in the value of homes; special hazards; earthquakes and other natural events; over-leveraging of the borrower; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market weakens, our credit losses could be increased beyond levels that we have anticipated. The interest rate is adjustable for the bulk of the loans securitized by securitization trusts sponsored by us and for a portion of the loans underlying residential CES we have acquired from securitizations sponsored by others. Accordingly, when short-term interest rates rise, required monthly payments from homeowners will rise under the terms of these adjustable-rate mortgages, and this may

increase borrowers delinquencies and defaults. If we incur increased credit losses, our taxable income would be reduced, our GAAP earnings might be reduced, and our cash flows, asset market values, access to short-term borrowings (typically used to acquire assets for sale to securitization entities), and our ability to securitize assets might be harmed. The amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility, dividend cuts, liquidity issues, and solvency issues.

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

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

The economic returns we expect to earn from most of the residential real estate securities we (or Sequoia or Acacia) own are affected by the rate of prepayment of the underlying residential real estate loans. Adverse changes in the rate of prepayment could reduce our earnings and dividends. They could delay cash payments or reduce the total of cash payments we would otherwise eventually receive. Adverse changes in cash flows would likely reduce an affected asset s market value, which would likely reduce our access to liquidity if we borrowed against that asset and may cause a market value write-down for GAAP purposes, which would reduce our reported earnings. Prepayment rates are not predictable, nor do they change in a predictable manner as a function of interest rate changes. Prepayment rates can change rapidly.

In our permanent asset portfolio, we own IO securities, acquired from many of the Sequoia securitizations of adjustable-rate one- and six-month LIBOR-indexed residential real estate loans that we have sponsored. (These ARMs are consolidated for GAAP purposes and appear on our Consolidated Balance Sheets as loans. Since all the assets and liabilities of these entities are consolidated on our Consolidated Balance Sheets, these IO securities are not shown there.) IO securities do not have a principal balance and do not receive principal payments. They do receive interest payments, generally calculated based on a notional balance of principal. Typically, the notional balance of principal for the IO securities declines as the amount of loans in the securitization declines (although not always in a linear fashion). Therefore, faster prepayments lead to a lower amount of cumulative interest payments (and lower potentially negative economic returns) for the owner of the IO securities. Total cash returned to an IO securities owner could be less than the amount paid for the IO securities if prepayments accelerate rapidly. There are many factors that affect prepayment rates on ARMs. One important factor is the relationship between short-term interest rates and long-term interest rates. When short-term interest rates are slightly less than, equal to, or greater than long-term interest rates (*i.e.*, the yield curve is flat or inverted), prepayment rates on ARMs often increase as borrowers refinance into fixed rate or hybrid rate (a fixed rate period followed by an adjustable rate period) loans. For this and other reasons, prepayment rates on ARMs backing the securities in our portfolio have increased recently, from the 10% to 15% per year range to the 20% to 25% per year range. In general, upon acquisition, we have assumed ARM loans will prepay at a rate of 25% per year over the life of a pool of loans. If the ARMs underlying our IO securities prepay at a rate faster than 25% per year on a sustained basis, our economic returns will be lower than we have assumed. However, a sustained acceleration of ARM prepayments would likely increase our returns from the residential CES we own that are backed by adjustable-rate loans, as these were acquired at a discount. Thus, we believe that as of December 31, 2004 any increase in returns on the CES that we own that are backed by adjustable rate loans would likely offset and may exceed the concurrent reduction in returns over the long term that we would earn from IO securities that we own that are backed by adjustable rate loans. However, the timing of the recognition of these generally offsetting returns would likely not match, as residential CES are longer-lived securities and the recognition of higher returns from faster ARM prepayments may occur at a subsequent point in time.

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

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

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

The credit performance of residential loans underlying residential CES directly affects our results for the CES we own in our permanent asset portfolio, and indirectly affects our results for CES owned by Acacia securitization entities from which we have acquired CDO equity ABS (consisting of equity, preference share, non-investment grade and similar concentrated credit risk securities) for our permanent asset portfolio. The total amount of residential real estate loans underlying residential CES (acquired from securitizations sponsored by others) owned in our permanent asset portfolio was $126 billion at December 31, 2004. This was a large amount of potential credit risk relative to our equity capital base of $864 million at December 31, 2004. Our total potential credit loss from the underlying residential real estate loans is limited to our total investment in residential CES and Acacia CDO equity securities. This total potential loss, however, is large relative to our equity capital base and, if realized, would harm our results from operations.

The timing of credit losses can harm our economic returns.

The timing of credit losses can be a material factor in our economic returns from residential CES. If losses occur quickly, in the first few years after a securitization is completed, they will have a larger negative impact on our returns. In addition, larger levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of the principal and interest that is due to us. This would lower our economic returns.

Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or losses on our investments.

Despite our efforts to manage credit risk, there are many aspects of credit that we cannot control, and there can be no assurance that our quality control and loss mitigation operations will be successful in limiting future delinquencies, defaults, and losses. Our underwriting reviews may not be effective. The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies. Loan servicing companies may not cooperate with our loss mitigation efforts, or such efforts may otherwise be ineffective. Various service providers to securitizations, such as trustees, bond insurance providers, and custodians, may not perform in a manner that promotes our interests. The value of the homes collateralizing residential loans may decline. The frequency of default, and the loss severity on loans upon default, may be greater than we anticipated. Interest-only loans, negative amortization loans, adjustable-rate loans, loans with balances over $1 million, reduced documentation loans, sub-prime loans, HELOCs, second lien loans, and loans that are partially collateralized by non-real estate assets may have special risks. If loans become real estate owned (REO), servicing companies will have to manage these properties and may not be able to sell them. Changes in consumer behavior, bankruptcy laws, and other laws may exacerbate loan losses. In some states and circumstances, the securitizations in which we invest have recourse against the borrower s other assets and income in the event of loan default; however, in most cases, the value of the underlying property will be the sole source of funds for any recoveries. Expanded loss mitigation efforts in the event that defaults increase could increase our operating costs.

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

As of December 31, 2004, approximately 43% of the residential real estate loans that underlie the residential CES we owned were secured by property in California. An overall decline in the economy or the residential real estate market, or the occurrence of a natural disaster that is not covered by standard homeowners insurance policies, such as an earthquake, could decrease the value of residential properties in California. This, in turn, would increase the risk of delinquency, default or foreclosure on real estate loans underlying our residential CES portfolio. This could adversely affect our credit loss experience and other aspects of our business, including our ability to securitize real estate loans. As of December 31, 2004, approximately 44% of our commercial real estate loans and 18% of loans underlying commercial CES were secured by properties located in California.

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

We receive monthly payments from most of our assets, consisting of principal and interest. In addition, each month some of our residential CES are called (effectively sold). Principal payments and calls reduce the size of our current portfolio and generate cash for us. We also sell assets from time to time as part of our portfolio management and capital recycling strategies. In order to maintain our portfolio size and our earnings, we need to reinvest a portion of the cash flows we receive from principal, interest, calls, and sales into new earning assets.

We believe the assets we are acquiring today are unlikely to generate economic returns or GAAP yields at the same levels as our current assets have generated.

Assets in our permanent portfolio are currently generating attractive yields. We acquired most of these assets in a period of reduced competition and lower asset prices relative to market conditions today. In addition, business conditions have been generally attractive over the last few years, with favorable credit, prepayment, and interest rate trends. As a result, our cash flows and the timing of cash flows we have received from our current assets have been more favorable than we initially expected. Under the effective yield method of accounting that we use for GAAP accounting purposes for most of our assets, we generally recognize yields on assets based in part on our initial assumptions. A portion of the cash flows we receive that exceeds our initial assumptions reduces our basis in these assets. As a result of these various factors, our basis for GAAP income statement amortization purposes for many of our current assets is lower than their current market values. Assets with a lower GAAP basis generate higher GAAP yields, yields that are not necessarily available on newly acquired assets. Business conditions, including credit results, prepayment patterns, and interest rate trends in the future are unlikely to be as favorable as they have been for the last few years. As a result, the new assets we acquire at current market values are unlikely to generate GAAP yields or economic returns as attractive as our current assets. A reduction in the supply of newly originated real estate loans resulting from higher interest rates, and increased competition from banks, hedge funds, and others, could further exacerbate this situation.

If the assets we acquire today earn lower GAAP yields than the assets we currently own, our reported earnings per share will likely decline over time as the older assets pay down, are called, or are sold.

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

In order to continue our securitization operations, we require access to short-term debt to finance inventory accumulation prior to sale to securitization entities. In times of market dislocation, this type of short-term debt might become unavailable from time to time. We use the inventory of assets we buy