REDWOOD TRUST INC
Form 424B5
September 22, 2004

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

PROSPECTUS SUPPLEMENT
(To Prospectus dated May 13, 2004)

[REDWOOD LOGO]

Redwood Trust, Inc.

1,000,000 Shares

Common Stock

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

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

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

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

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

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

Prospectus Supplement dated September 21, 2004

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

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PROSPECTUS SUPPLEMENT

PROSPECTUS

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FORWARD-LOOKING STATEMENTS AND NOTICE ABOUT INFORMATION PRESENTED

This prospectus supplement and the accompanying prospectus contain or incorporate by reference certain forward-looking statements. When used, statements which are not historical in nature, including the words anticipate, estimate, should, expect, believe, intend, and sir expressions, are intended to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this prospectus supplement under the caption Risk Factors.

Other risks, uncertainties and factors that could cause actual results to differ materially from those projected are detailed from time to time in reports filed by us with the Securities and Exchange Commission, or SEC, including Forms 10-Q and 10-K.

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

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

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PROSPECTUS SUPPLEMENT SUMMARY

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

The Company

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

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

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

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

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

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

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

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

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

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

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

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

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

Recent Developments

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

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

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

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

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

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

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

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The Offering(1)

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

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

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

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

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

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

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

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

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

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RISK FACTORS

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

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

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

Risks Related To Our Business

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

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

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

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

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

In addition to residential CES, Acacia entities own investment-grade securities (typically rated AAA through BBB, and in a fourth-loss position or better, or otherwise effectively more senior in the credit structure as compared to a residential CES or equivalent held by us) issued by residential securitization entities that were not sponsored by us. Generally, we do not control or influence the underwriting, servicing, management or loss mitigation efforts with respect to these assets. Many of the investment-grade securities Acacia owns are backed by sub-prime loans that have substantially higher risk characteristics than prime-quality loans. These lower-quality loans can be expected to have higher rates of delinquency and loss, and losses to Acacia (and thus Redwood) could occur. Most of Acacia s securities are reported as part of our consolidated securities portfolio on our GAAP consolidated balance sheet. Acacia has also acquired investment-grade residential loan securities from the Sequoia securitization trusts we have sponsored. The probability of incurring a credit loss on

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investment-grade securities is less than the probability of loss from residential CES, as cumulative credit losses within a pool of securitized loans would have to exceed the principal value of the CES (and exhaust any other credit protections) before losses would be allocated to the investment grade securities. If the pools of residential loans underlying these securities were to experience poor credit results, however, these investment-grade securities could have their credit ratings down-graded, could suffer losses in market value, or could experience principal losses. If any of these events occurs, it would likely reduce our returns from the Acacia CDO equity securities we have acquired and may reduce our ability to sponsor Acacia transactions in the future.

Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; decline in the value of homes; special hazards; earthquakes and other natural events; over-leveraging of the borrower; changes in legal protections for lenders; reduction in personal incomes; job loss; and personal events such as divorce or health problems. In addition, if the U.S. economy or the housing market weakens, our credit losses could be increased beyond levels that we have anticipated. The interest rate is adjustable for the bulk of the loans securitized by securitization trusts sponsored by us and for a portion of the loans underlying residential CES we have acquired from securitizations sponsored by others. Accordingly, when short-term interest rates rise, required monthly payments from homeowners will rise under the terms of these adjustable-rate mortgages, and this may increase borrowers delinquencies and defaults. If we incur increased credit losses, our taxable income would be reduced, our GAAP earnings might be reduced, and our cash flows, asset market values, access to short-term borrowings (typically used to acquire assets for securitization), and our ability to securitize assets might be harmed. The amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility, dividend cuts, liquidity issues and solvency issues.

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

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

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

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

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

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

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

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

The timing of credit losses can harm our economic returns.

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

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

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

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

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

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

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

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

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

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

In order to continue our securitization operations, we require access to short-term debt. In times of market dislocation, this type of short-term debt might become unavailable from time to time. We use the assets we buy to collateralize the debt. The debt is recourse to us, and if the market value of the collateral declines we need to use our liquidity to increase the amount of collateral pledged to secure the debt or to reduce the debt amount. Our goal is to sell these assets to a securitization trust; however, if our ability to sponsor a securitization is disrupted, we may need to sell these assets (most likely at a loss) into the secondary mortgage or securities markets, or we would need to extend the term of the short-term debt used to fund these assets.

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