Dear Fellow Shareholders:

To us, the best way to characterize Redwood's economic progress in the third quarter is to call it "mixed."

On the one hand, our strategy of structuring our balance sheet in a way that minimizes liquidity risk paid off, and our prospects in the midst of the mortgage market turmoil are excellent and continue to improve. Net interest income is strong, operating expenses are down, realized credit losses remained very low, and core income and taxable income results are excellent. On the other hand, the amount of our assets for which we have heightened credit concerns, while remaining relatively limited, has grown during the quarter.

Our balance sheet and income statement results as reported under GAAP accounting are not representative of how we view the economics of our company. That is particularly true this quarter, largely due to current GAAP rules which require us to mark-to-market assets that are consolidated for GAAP purposes but do not permit us to mark-to-market the corresponding paired liabilities. The impact of this inconsistent treatment of assets and liabilities consolidated on our GAAP balance sheet and income statement could lead one to draw inaccurate conclusions about the health of our business. We encourage you to read the detailed discussion on the real economics of our business in the pages that follow.

At quarter end, our unrestricted cash exceeds our short-term debt by $271 million. We have no liquidity issues, we have the absolute ability to hold all our current assets to maturity, and we do not need to raise additional capital in order to fund substantial growth in invested assets over the next year.

We continue to expect healthy ongoing cash flows from our existing assets. These assets have substantial upside potential, and we continue to expect to realize a healthy amount of this potential over the next five to ten years.

A relatively small percentage of our assets now look like they will disappoint. The good news is that most of these assets are segregated within securitizations and thus Redwood's exposure is limited. For instance, many of the assets that are of concern are owned by the last four Acacia CDO entities in which we invested. Our net cash investment in these entities is fairly small. Overall, including our investment in Acacia, less than 15% of our equity base is exposed to assets that look like they may underperform our initial expectations. We are not pleased with this, but we realize it could be worse.

The well publicized liquidity crisis has brought some long overdue changes to the residential and commercial mortgage markets. A renewed appreciation for credit risk has new asset spreads at the widest levels we have seen in years. More stringent underwriting is leading to improvements in loan quality, and the overall level of exuberance has greatly subsided. We have started to make attractive investments in new residential transactions and in seasoned assets sold at a discount by forced sellers. We expect to have excellent residential and commercial investment opportunities going forward, both for our balance sheet and for one or more third-party asset management accounts we intend to create and market to generate fee income for Redwood.

Strong taxable income has enabled us to declare a $2.00 per share special dividend for 2007 and we expect to continue our $3.00 per share regular dividend for 2008. In addition to this, while we believe the payment of a special dividend is possible for 2008, the amount will depend largely on the amount of credit losses we actually realize during the year.

Preparing for these current market events over the last two years was not easy. It was not completely clear during this period that selling off risk, reducing growth, and holding large unutilized cash balances would ultimately prove to be a good strategy, but we believe in hindsight that it was.

Moving ahead from here will be more straightforward - we will absorb losses from some of our assets, while also realizing strong cash flows from most of our assets and taking advantage of the ample opportunities in this new mortgage world.

We hope stock market participants will look at our GAAP income and book value results, understand what is to be learned there, and then look at our economic disclosures to get the rest of the picture. We have confidence in the long-term value of our assets and, through our recently authorized stock repurchase program, we are ready to repurchase shares if we believe they are trading at attractive levels.

We have been through several liquidity and credit cycles in the past. Each time we have emerged as a stronger company, and we believe we are well positioned to do so again this time around. Our current liquidity position and our balance sheet are strong, and we believe we are in a good position to continue to develop our businesses and their competitive advantages over time.

Sincerely,

George E. Bull, III
Chairman and CEO

Douglas B. Hansen
President