

STRATEGY UPDATE

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As you all know, the fixed income markets have gone through unprecedented turmoil over the last several months, leaving the landscape almost unrecognizable even to seasoned investors. Some of the most dramatic changes have occurred within the highest tiers of the credit spectrum—the AAA-rated bonds that were until recently considered the most stable, low-risk investments available. Rating agencies have been forced to respond to a rapidly changing economy and question virtually all of their assumptions. As a result, huge segments of the bond markets have faced downgrades, leading to forced or panic selling by many levered or ratings-constrained investors.

Amid growing political pressure, market signaling, and a complete breakdown in the reliability of traditional forecasting models, rating agencies and many investors have all but thrown in the towel on AAA-rated bonds. Rating agencies have lost much of their credibility with the investor public and are now behaving in an unpredictable, inconsistent, and oftentimes irrational manner. Naturally, the resultant collapse in confidence has had extremely negative implications not only on the credit markets in general, but on the financial system as a whole. As a result markets are now undergoing a violent and painful adjustment process. Meanwhile, the policy response from Washington has been haphazard and uncoordinated at best, as regulators and policymakers have found themselves woefully unprepared for the rapid transformation and upheaval in the credit markets.



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While we could publish volumes on the subject, time constraints and more pressing responsibilities preclude us from doing so. Therefore we'll skip ahead a few chapters to bring everyone up-to-date on some of the ways we have responded to these recent events; particularly within our high-quality mandates which continue to be governed first and foremost by a policy of principal preservation.

MANAGING IN A LIQUIDITY-CONSTRAINED ENVIRONMENT

Prudent portfolio management dictates that notional risk exposure should be reduced when uncertainty and price volatility increase in order to keep net portfolio risk within an acceptable level of risk tolerance. In conventional times, this means an orderly reduction in overweight positions through asset sales. In liquidity-constrained environments, however, asset sales can be anything but orderly. When bid-ask spreads become downright punitive, investment managers must decide whether or not the desire to reduce portfolio risk justifies the transaction costs associated with doing so. After all, is it really prudent to avoid the potential downside of tomorrow by realizing the absolute downside of today? This is a question portfolio managers have been dealing with on a daily basis for several months now.

Our response thus far has been cautious and measured. We have been reviewing all of our holdings on an ongoing basis, both individually and collectively, and have responded accordingly to our assessments thereof. In some cases, this has resulted in the sale of securities with credit characteristics and/or relative-value return prospects that declined to unacceptable levels. In many other cases, this has resulted in a gradual decrease in security and sector exposure through attrition and reinvestment of principal and interest income into lower-risk sectors or subsectors. In recent months, reinvestments have been focused on short, high-quality securities with lower spread-duration and little incremental credit risk, as well as in government-related spread sectors such as agency debentures and the newly created government-

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guaranteed bank debt securities issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP).

FINDING QUALITY AMID THE UNCERTAINTY

Previously, government-related securities rarely found their way into our portfolios, but with ratings uncertainty among virtually all non-government debt issues and a complete lack of new issuance in non-agency MBS, ABS, and CMBS, these agency and TLGP bonds have played an increasingly important role within our high-grade strategies.

Today, these securities collectively represent significant portions of our high-grade assets and will likely remain as core holdings within our high-quality mandates for some time as we plan to be active participants in the primary and secondary markets alike. We anticipate further performance potential as the TLGP asset class matures and enjoys greater sponsorship among the global investment community, and as the agency debt market continues to be supported by open-market purchases from the Federal Reserve. Volatility will likely persist as the markets adjust to a new equilibrium, but we also expect the opportunity to be rewarded for investing in undervalued, high-quality assets along the way.

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