

DWIGHT ASSET MANAGEMENT COMPANY

WHY USE ABS IN INVESTMENT-GRADE FIXED INCOME PORTFOLIOS?

Asset-backed securities (“ABS”) have become a well-established asset class within the fixed income markets and can play an essential role in providing attractive risk adjusted returns with high credit quality, excellent liquidity, diversity, and minimal event risk in investment-grade fixed income portfolios. Despite some of the risks associated with ABS, such as prepayment or extension risk, the significant credit enhancement and structural support inherent in most ABS transactions offers significant protection against credit rating downgrades, unlike unsecured corporate bonds.

ABS Risk/Return Profile

ABS have offered competitive returns with relatively low volatility versus other investment-grade securities. Historically, ABS have outperformed investment-grade corporates and mortgages, with only commercial mortgage-backed securities offering higher excess returns versus similar duration Treasury securities over the last ten years.

On a risk-adjusted basis, as measured by the Sharpe ratio, ABS outperformed each of these sectors as shown in Table 1.

The stability of credit ratings has been the main driver behind the superior risk-adjusted return per-

formance of ABS. To contrast, investment-grade corporate securities received downgrades at a frequency of 4.3 times that of ABS in 2005 and almost 3 times that of ABS from 1984–2004 as seen in Table 2. Over 91% of ABS bonds maintained their original credit rating compared to under 78% for corporate bonds.



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Table 2: ABS and Corporate Rating Statistics

	ABS 2005	Corp. 2005	ABS 1984– 2004	Corp. 1984– 2005
Downgrade Ratio	1.93%	8.28%	4.74%	13.85%
Stability Ratio	91.90%	77.88%	91.76%	77.64%

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Market Composition

The ABS market gained wide investor acceptance by offering collateral with highly predictable cash flows from well diversified pools of consumer and commercial assets. While the ABS market has expanded to include esoteric asset types, the market consists largely of asset types with well known loss distributions (see Chart 3).

Table 1: Risk-Adjusted Returns

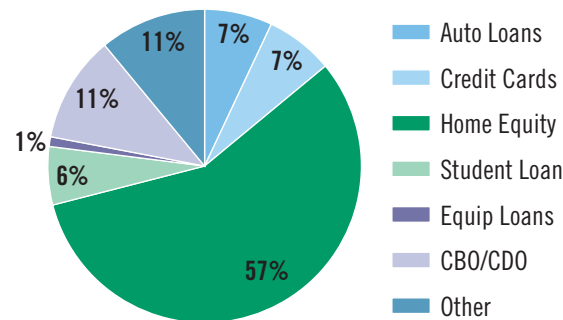
as of August 31, 2006

	ABS	IG Corp	Fixed Rate MBS	CMBS
Average Excess Return				
One Year	0.47%	0.09%	0.39%	0.49%
Five Year	0.77%	0.71%	0.50%	1.22%
Ten Year	0.63%	0.19%	0.36%	0.82%
Risk-Adjusted Return (Sharpe Ratio)				
One Year	1.53%	0.14%	0.43%	0.95%
Five Year	1.18%	0.26%	0.44%	1.30%
Ten Year	0.75%	0.08%	0.32%	0.44%

Excess return represents returns over duration-matched Treasuries.
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Chart 3: ABS YTD Issuance

as of August 31, 2006



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▶ The ABS market allocates cash flow based on rules, which have been defined to allocate (or “tranche”) risk, accommodating different investor preferences. Given overall investor preference for high quality ABS investments, approximately 85% of the market consists of AAA-rated securities.

Highly Liquid Market

ABS issuance began in the early 1980s and evolved into a highly liquid sector with total issuance of over \$1 trillion in 2005, exceeding investment-grade corporate issuance for the year (see Table 4).

Table 4: ABS vs. Investment-Grade Corporate Issuance (\$ Billions)

	Public ABS	%	Private ABS (Primarily 144A)	%	Total ABS	IG Corp
2005	890	81%	213	19%	1,103	627
YTD 2006	461	80%	113	20%	574	552

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Event Risk

The well diversified, segregated collateral pools supporting ABS provide an additional benefit to investors: low risk. Each ABS bond issuance is typically structured through a legal entity separate from the originator and/or servicer of the collateral. The downgrade or bankruptcy of the originator or servicer does not directly affect the credit rating or performance of most ABS bonds. Therefore, any leveraged buyout or excessive stock buybacks of an originator or servicer has minimal effect on the performance of the asset-backed securities. As an example, both Ford and GM corporate bonds have received numerous downgrades while Ford and GM ABS bonds continue to perform well. In fact, many of their subordinated ABS bonds with original ratings below AAA have been upgraded.

Model Risk

Asset-backed securities have grown in scope and complexity, and the need for financial modeling for some transactions has increased. Investors with limited resources to analyze all the rules allocating cash flows must rely on investment banks or rating agencies to develop a risk assessment of a deal. Investors with modeling capabilities and a fundamental research team can independently assess the risk return profile of the deals they purchase. Analytical tools such as INTEX, LehmanLive, and Citigroup YieldBook can be used to model an individual bond’s collateral characteristics as well as the entire pool. These tools allow for stress testing of prepayment, delinquency, and performance among other things. Through this process, portfolio managers can identify securities that are over valued, under valued, or fairly priced to the market using internal and external models.

Summary

Asset-backed securities have grown strongly as an asset class and can provide an attractive alternative source of high-quality, risk-adjusted returns with several other attractive features. The inclusion of ABS in investment-grade portfolios can provide competitive returns with low risk and increased liquidity and diversity. For more information on asset-backed securities, see Dwight’s Primer on Asset-Backed Securities at <http://www.dwight.com/pubs/dwightABS2005.pdf>. ■

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