DWIGHT
ASSET MANAGEMENT COMPANY

QUARTERLY UPDATE

FIXED INCOME MARKET REVIEW

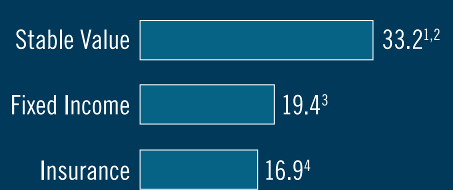
FIRST QUARTER 2005

RELATIONSHIPS PERSPECTIVE SOLUTIONS℠

Dwight Asset Management Company is a registered investment advisor specializing in fixed income, insurance, and stable value investment strategies for institutional clients.

Assets as of 3/31/05: $52.6 Billion[1]

Assets by Product Strategy ($ Billions)



INSIDE THIS ISSUE

1. Includes $2.0 billion in assets under advisement for nondiscretionary consulting relationships. In the bars above, certain assets are included in more than one product strategy.
2. Includes assets also included in the fixed income total managed for stable value clients.
3. Includes assets also included in the stable value and insurance totals.
4. Includes assets also included in the fixed income total.

Please Note: Stable value separate account and commingled fund data is as of 2/28/05.

CORPORATE BONDS: THE FIRST SPREAD PRODUCT*

Frederick Meltzer, Ph.D.
Portfolio Manager
Corporate Bonds

Fundamental to the investment process at Dwight is our expertise in employing "spread product" in the portfolios we manage. "Spread product" is defined as any fixed income instrument that yields more than a comparable U.S. Treasury security. Since 1973, yield (specifically, coupon return and its reinvestment) has contributed in excess of 90% of the total return in bonds. Corporate bonds, the first such yield-advantaged sector in the U.S. fixed income market, deserve attention because of their demonstrated record of producing superior returns relative to comparable Treasury securities. In addition, the corporate bond sector evidences sufficient scale for investment, a variety of cash flow structures, and varying degrees of credit exposure. This sector is constantly developing in terms of both product and investment approaches. At Dwight we devote considerable resources to the successful use of corporate bonds in our client portfolios.

Scale of the Corporate Bond Market

Corporate bonds reflect a relatively long history in the U.S. fixed income market. The first corporate bond issue in the modern era likely dates back to the construction of the transcontinental railroads shortly after the conclusion of the Civil War.[1] One such issuance was that of the Northern Pacific Railroad.[2] The issue was underwritten and offered to the investing public through a "syndicate" of banks and brokers and eventually raised $30 million for the construction of the railroad. Today, by way of contrast, the U.S. corporate bond market stands at over $1.3 trillion and represents some 40% of the global market for corporate bonds, with maturities ranging from one year to as many as 100 years.[3]

Corporate Bond Credit Assessments

Corporate bonds also offer considerable choice regarding exposure to credit risk. Naturally, issuers vary in terms of their perceived ability to repay, which is largely captured in the credit rating assigned to a current or prospective issuer of debt by one of the recognized rating agencies.[4,5] The decision on what level of creditworthiness to hold is a critical element in knowing which bond to own. Bonds with lower perceived creditworthiness, for example, typically carry higher yields (see Fig. 1, page 2). Another element is the industry in which the issuer operates. Issuers in the corporate bond market come from virtually every industry in the U.S. economy. The major industry categories are industrials (manufacturing, transportation, telecom, media, and retail); finance (banks, finance companies, insurance, and brokerage); and utilities. Some industries are regarded as inherently riskier than others and consequent-

*Please see endnotes on p. 7

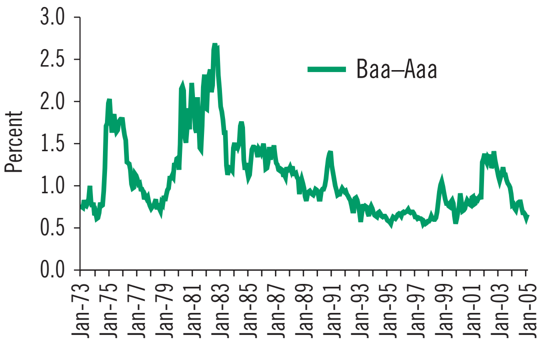
continued on next page

Corporate Bonds, continued from front cover*

ly carry higher yields for similarly rated credits. A good example is the securities brokerage industry, whose bonds typically carry higher yields than similarly rated industrial bonds.

Figure 1

Yield Differential Corporate Bonds Rated Baa–Aaa
1973–2004



Source: Federal Reserve Statistical Release H-15, compiled by Moody's

Cash Flow Structures of Corporate Bonds

Corporate bonds also feature an assortment of payment structures. While the vast majority of corporate bonds pay interest on a semiannual basis, they differ in the manner in which they repay principal. The most significant repayment structures include conventional fixed maturities, callables, puttables, and sinking fund bonds.[6] Structure choices allow an investment manager to tailor exposure in order to take advantage of anticipated changes in interest rate volatility, among other things. Callable bonds, for example, tend to outperform in periods of quiescent markets, while puttable bonds tend to outperform during periods of increasing interest rate volatility. Sinking fund bonds, on the other hand, can be useful either in meeting certain specified liquidity needs for a portfolio or in systematically reducing principal risk to a particular issuer over time.

Performance of the Corporate Bond Market

While corporate bonds clearly possess many desirable attributes, the ultimate motivation for investing is the demonstrated return potential. In this regard, corporate bonds possess a superior demonstrated return history.

Corporate bonds returned 7.70% per year over the 13-year period ending December 31, 2004.[7] This was the best return of any major sector of the U.S. fixed income market. Agencies, for example, returned 6.86% while mortgage-backed securities (MBS) returned 6.72% and asset-backed securities (ABS) returned 6.64%. U.S. Treasury securities, by way of contrast, returned 6.79% over the same period. When measured on a calendar-year basis, corporate bonds have registered the best performance against any of these other sectors in seven of the last 13 years.

Gross returns tell only part of the story, however. The various sector index returns represent different inherent exposures to changes in the general level of interest rates (measured with duration). The cleaner comparison requires an adjustment for duration differences among the major sectors of the fixed income market. On this basis, corporate bonds still compare favorably. Over the same time period, the average quarterly excess return relative to Treasuries adjusted for duration stands at 12 basis points per quarter for corporate bonds, 8 basis points for agencies, and 4 basis points for MBS. Only ABS bested corporates at 16 basis points per quarter.

In addition to issuer and industry-specific risk, the entire corporate bond market has become riskier in recent years. This is a result of two simultaneous developments: a steady erosion in overall creditworthiness and the shift to a more service-oriented economy. The average level of creditworthiness reflected in the Lehman Corporate Index has fallen from AA in 1973 to A as of December 31, 2004. As of year end, fully 40.7% of the Lehman Corporate Index was rated BBB, compared to only 9.5% in 1973 (see Fig. 2, below).

Meanwhile, the utility sector has contracted. At year end, it represented a mere 8% of the Lehman Corporate Index, down from 63% in 1973. Conversely, the finance sector, which represented only 13% of the Index in 1973, has experienced rapid growth and represented 38% of the Index at year end.

*Please see endnotes on p. 7

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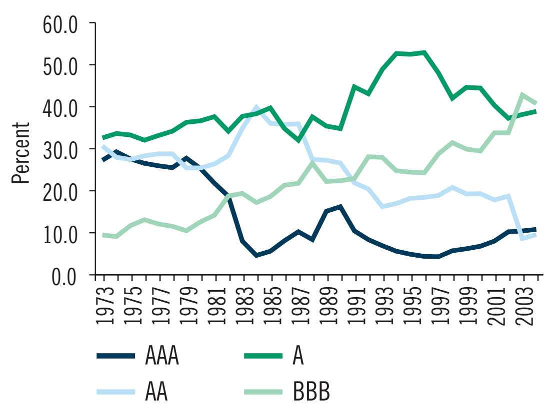
Figure 2

Composition of the Lehman Credit Index by Credit Rating
1973–2004



Source: Lehman Brothers Global Family of Indices

ECONOMIC AND BOND MARKET UPDATE

Our "2005 Outlook" published in our last Quarterly Update stated that while we were confident the economy would perform well in 2005, we were wary about the bond market. Thus, we pulled back from some of the higher-yielding sectors and maintained relatively short portfolio durations versus benchmark indices. This strategy proved quite effective during the first quarter as the Lehman Aggregate Index declined by 0.48% while the Lehman Intermediate Index lost 0.56% of its value. Our total return portfolios generally did much better.

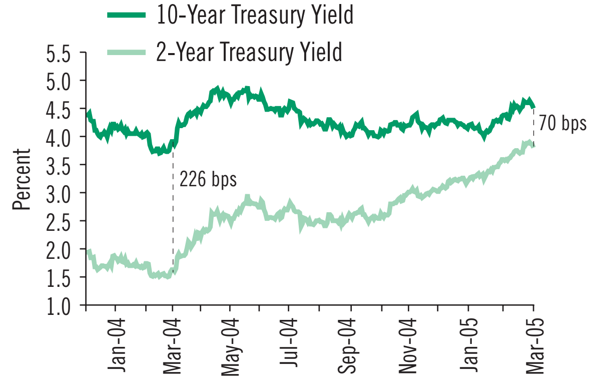
At the start of the year, our fixed income strategy team held the macro view that the economy was accelerating, inflation pressures were increasing, and the markets were underestimating the amount of Fed tightening likely to take place in 2005. Thus, short-term Treasury yields were poised to increase markedly, while long-term Treasury yields were due to rise as well, resulting in a flatter and higher yield curve.

For the first half of the quarter, our macro strategy appeared to be off the mark as long-term Treasury yields headed significantly lower. 10-year Treasury yields fell roughly 25 basis points and even ducked below 4% briefly, while 30-year Treasury bonds, driven by talk of forced pension fund buying, fell more than 45 basis points to 4.4%. Thus, our decision to maintain a relatively short duration was not appearing particularly wise in February. However, our curve call was more than making up for our duration call, given that short-term Treasury rates were rising steadily in response to tighter monetary policy.

During a February appearance on Capitol Hill, Fed Chairman Greenspan grabbed market headlines when he described the decline in long-term rates as a "conundrum." Greenspan's point was that the simple mathematics of the yield curve—long-term rates equal the expected paths of short-term rates plus a risk premium—implies that long-term interest rates should increase as the Fed tightens monetary policy. The staff at the Fed looked at a variety of possible explanations for the market's anomalous behavior but found none satisfying. Our best guess is that investors, in this low-yielding environment, have been compelled to invest in longer maturities in order to find enough yield to meet return hurdles. This strategy has been rewarding as a predictable Fed, still relatively low inflation, and steady demand from abroad has been supportive of bond prices.

Treasury Yields Compress

January 2004–March 2005



Source: Global Insight

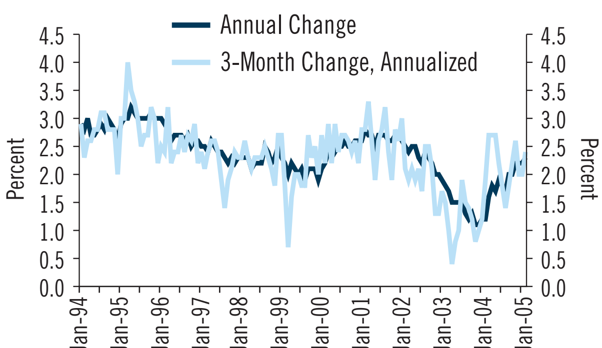
Investors should be wary, however, of spending too much time looking in the rearview mirror. The economic backdrop is changing, with inflation pressures on the rise. The Fed, which has been quite predictable to date, is becoming less so. Moreover, the yield curve is substantially flatter today than it was a year ago or even three months ago, which means the yield pickup today for investing further out the curve is substantially less. Indeed, the spread between 2-year and 10-year Treasuries has fallen by over 150 basis points in the last year, with nearly one-third of this move taking place in the first quarter. Continued foreign demand certainly remains a bright spot for U.S. fixed income markets, but these flows have slowed in recent months.

Chairman Greenspan's "conundrum" comment certainly got investors thinking about interest rate risk, but a jump in inflation data and tough talk from the FOMC led to significant selling in late February and March, validating our decision to maintain a short duration. In just six weeks, 10-year Treasury yields increased more than 65 basis points to nearly 4.7% before settling back to end the quarter near 4.5%. For the quarter as a whole, 10-year Treasury yields were up 26 basis points. Short-term Treasury notes were hit even harder as investors revised higher their expectations for the year end federal funds rate. For the quarter as a whole, 2-year Treasury yields increased more than 70 basis points to 3.8%. The ▸▸

continued on p. 8

Core Consumer Price Index

January 1994–February 2005



Source: Global Insight

Jane Caron, CFA
Chief Economic Strategist

SECTOR UPDATE

Corporates

Investment-grade corporate bonds got off to a slow start this year, turning in their weakest quarterly performance since 2002. Spreads widened by 8 basis points (Lehman Credit Index), generating negative total and excess returns of -1.13% and -0.62%, respectively. This quarter's performance was led by the auto sector, which widened by over 113 basis points during the period. The sector was devastated when General Motors shocked the market by adjusting its forecast of 2005 cash flow from a positive $2 billion to a negative $2 billion. Credit rating agencies responded by downgrading GM, leaving the company with a Baa3/BBB- rating and negative outlooks from both Moody's and S&P. The realization that GM, the largest investment-grade issuer, would soon be downgraded to junk status and would swamp the considerably smaller high yield market caused its spreads to widen by 200 basis points. GM debt now trades at spreads in excess of 500 basis points over Treasuries, or at levels comparable to CCC-rated credits, because of concerns about the high yield market's ability to absorb so much debt from a single issuer.

...[CMBS] once again proved its merits as an asset class insulated from much of the credit and event risk that impacts the corporate market and from the volatility and prepayment risk that impacts residential mortgages.

The damage was not just limited to autos, however. The rest of the corporate market widened by 3 basis points during the quarter. The weakness was caused by a number of factors, including rising interest rates, which forced hedge funds to unwind some of their leveraged corporate holdings. The corporate market has also had to cope with mounting evidence of rising event risk. Carl Icahn, the old corporate raider, accumulated large stakes in Temple-Inland and Kerr-McGee and subsequently tried to force management to take shareholder-enhancing actions that, not surprisingly, would result in credit impairment. Private equity funds also increased their activity, announcing a leveraged buyout (LBO) of Sungard Data Systems. They were also rumored to be planning a hostile takeover of JC Penney, while several corporate bond issuers announced that they would be willing to be taken private at the right price.

Despite these negative developments, the corporate market remains fundamentally and technically sound. Inflation concerns are largely related to manufacturers' abilities to pass along higher commodity costs—a positive for corporate credit—and rising interest rates will induce buying from "real money" accounts, mainly insurance and pension funds, which have been letting cash build as they wait for the right entry point. Therefore, we view the downside to be limited for the overall market, but we think that investors do need to be more vigilant in assessing how rising levels of event risk may impact the relative value of individual credits. We intend to maintain a modest underweight to corporates but will consider further spread widening as an opportunity to decrease that underweight.

Mortgage-Backed Securities

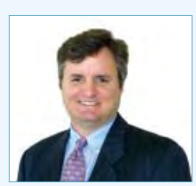
The mortgage-backed securities (MBS) sector returned -0.12% during the first quarter of 2005. While not as impressive as the sector's relative performance in 2004, this still represented a modest excess return of 5 basis points versus duration-matched Treasury securities. The mixed performance of MBS during the quarter was largely driven by macroeconomic and yield curve factors. MBS began the quarter on a strong note, delivering a 0.53% return in January, mostly because of continued low volatility in 5- and 10-year Treasuries. Investors, particularly foreign buyers, remained comfortable purchasing MBS, as the prepayment and extension risks inherent in MBS are less apparent in a stable rate environment.

February and March, however, provided a much different backdrop. Higher producer prices, continuing price pressure in the commodity and oil markets, large budget and trade deficits, ongoing job growth, and the continuation of the Federal Reserve Board's monetary tightening policy all conspired to drive yields significantly higher by quarter end. All yields in the 2 to 10-year section of the Treasury curve sold off by at least 35 basis points between January 31 and March 31, heightening concerns for extension risk in MBS. As a result, investors became much more cautious, and the sector underperformed Treasuries on a duration-adjusted basis in both February and March.

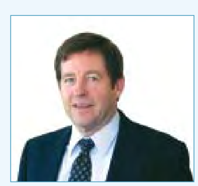
As of March 31, we retained a modest underweight to MBS versus the benchmark indices on a duration- ▸▸

Dwight Sector Specialists

The Sector Update was written by the following sector specialists:



Michael Cazayoux
Corporates



Robert Clancy, FSA
Mortgage-Backed Securities

Derrick Wulf, CFA
Commercial Mortgage-Backed Securities

First Quarter 2005 Sector Statistics*

Sector	Duration (years)	Credit Quality	Total Return (%)	Excess Return (%)
Treasury	5.21	Aaa/Aaa	-0.42	
Agency	3.76	Aaa/Aa1	-0.45	0.05
Corporate	5.89	A2/A3	-1.13	-0.62
MBS Fixed Rate	3.42	Aaa/Aaa	-0.12	0.05
CMBS	4.52	Aaa/Aa1	-0.83	0.15
ABS	2.56	Aaa/Aa1	-0.34	0.09
High Yield	4.77	B1/B2	-1.61	-0.94

*Fixed income sector statistics are based upon and courtesy of Lehman Brothers Global Family of Indices. Excess return represents returns versus an equivalent Treasury return for each duration bucket. Credit quality represents market-weighted average credit quality for the indicated sector expressed in Moody's nomenclature.

Sector Update, continued

adjusted basis. While the sector is still relatively tight on a long-term basis, the recent negative price action has made the MBS sector a more attractive purchase candidate than it was at the end of 2004. During the upcoming quarter, we will attempt to utilize any further weakness in the sector to return portfolio allocations to neutral against the indices.

Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) posted the best excess returns of the major components of the Lehman Aggregate Index during the first quarter, beating duration-matched Treasuries by 15 basis points. Spreads gradually tightened throughout the period until record issuance in March began to weigh on the market. Volatility and widening of spreads in other sectors also caused CMBS spreads to widen, leaving spreads on 10-year AAAs just a basis point or two tighter than their 2004 close and spreads on BBBs about 8 basis points wider. Despite the weakness at the end of March, the sector once again proved its merits as an asset class insulated from much of the credit and event risk that impacts the corporate market and from the volatility and prepayment risk that impacts residential mortgages.

Fundamentals in the commercial mortgage market remained sound during the period, with loan delinquencies on seasoned deals falling to just over 1.5% in March. The broader economic backdrop continued to support the sector, as retail properties benefited from strong consumer spending, office properties saw increased demand arising from continued job growth, and hotel properties continued to benefit from increases in business and leisure travel.

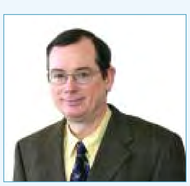
While we remain cautious of spread levels across sectors, we remain constructive on CMBS. From a relative-value perspective, we still favor CMBS over many parts of the structured products and credit markets, and we plan to maintain our structural overweight. We believe that the credit curve could steepen, particularly as investors grow increasingly averse to aggressively underwritten loans and low levels of credit enhancement prevalent in the new issue market, and as they see opportunities to outperform by owning high-quality seasoned deals and selectively buying "super senior" classes of new and recently issued deals.

Asset-Backed Securities

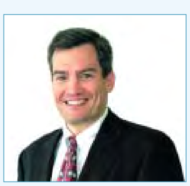
Asset-backed securities (ABS) turned in another good quarter, finishing second to all other spread sectors in the Lehman Aggregate with 9 basis points of excess return versus comparable Treasuries. Manufactured housing and home equities again were the main drivers of performance, returning 70 and 35 basis points in excess returns, respectively. Spreads across the board tightened throughout the quarter as investors continued to look for incremental yield versus other spread product. Top-tier floating-rate BBB-rated home equities, for example, have tightened from LIBOR plus 270 to LIBOR plus 190 amid strong demand from CDOs and other investors.

In the auto loan sector, the market struggled with the uncertainty surrounding GM. Spreads on GM's securitized dealer floor plan shelf (SWIFT) widened approximately 5 basis points for AAA-rated bonds. We believe that securitized auto spreads in general have tightened all they can and are now poised to

Peter Milne
Asset-Backed Securities



Frederick Meltzer, Ph.D.
Agencies



Edward Meigs, CFA
High Yield

Sector Update, continued from p. 5

widen. MBIA also hit the headlines during the first quarter after New York Attorney General Eliot Spitzer and the SEC sought information related to the company's accounting practices. Changes in the market's perception of MBIA could impact the ABS market, as the company insures a number of auto, credit card, and home equity deals, as well as senior tranches in some CDO transactions. Uncertainty about the company's creditworthiness could prompt investors to demand a larger risk premium for securities it insures.

We plan to maintain our overweight to the overall sector but expect to maintain our underweight in manufactured housing, autos, and credit cards while we may take advantage of spread tightening to reduce our overall overweight to home equities. Despite solid consumer fundamentals and mortgage rates that are still positive for the housing market, we feel that home equity spreads have come in a little too far, especially the longer tranches such as the 5-year and last cash flow issues. We will also maintain our structural overweight to equipment lease-backed paper.

Agencies

Debt issued by U.S. agencies outperformed comparable-duration Treasuries by 5 basis points during the first quarter. Spreads on 10-year agencies tightened modestly while spreads on short-maturity agencies widened. The recent rise in interest rate volatility put some pressure on callable agency debt but not enough to cause dramatic underperformance during the period. Negative press continued to dominate the headlines within the sector, as Fed officials continued to support the ideas of increased regulatory oversight and controls on the rate of growth of the agency's portfolios. Despite the negative tone in the news headlines, however, some investors found reason to be optimistic about the prospects for agency spreads. After all, a slowdown in the growth of the agencies' portfolios lessens the need for capital to be raised in the public debt markets. All else being equal, declining supply in agency debt would cause spreads to tighten. Indeed, agency issuance during the first quarter was down significantly from the same period a year ago. Further, heightened credit concerns in the corporate bond market tend to fuel additional demand for agencies, which are viewed by some investors as a high-quality alternative to corporate bonds.

Although we recognize the potential for the agencies to outperform Treasuries in the near term, we continue to believe that better investment opportunities exist outside the sector. Simply put, we do not believe that agency debt offers attractive spreads on a risk-adjusted basis compared to other high-quality spread product in the bond market. Hence, we remain significantly underweight the sector and anticipate that we will maintain our underweight position for the foreseeable future.

High Yield

The high yield market returned -1.6% in the first quarter, underperforming Treasuries by 94 basis points as the market suffered through a dismal March with returns of -2.7%. The loss in March offset a positive February and a flat January, resulting in the worst quarterly performance since 2002. Spreads reached new lows in early March with BB spreads well inside of 200 basis points and B spreads well inside of 300 basis points. These ballooned back out by the end of the month, with the BBs close to 200 basis points and Bs over 300 basis points. The peak of the market coincided with the nadir of new deal credit quality, as CCC-rated names made up a significant portion of the issuance in the quarter. The volume of new issuance fell off significantly as the market softened in March, declining to $25 billion of U.S.-denominated debt for the quarter. The perception of increased interest rate risk resulted in underperformance by BBs (-1.69%), and increased credit risk impacted performance of CCCs, which were down further (-2%). Defaults remained at a cyclical low of only 2.2%, but the distressed ratio (bonds trading at less than 80% of par) increased throughout the quarter. Withdrawals from high yield mutual funds accelerated through the quarter, aggregating $5 billion in total net outflows.

While fundamentals are expected to continue to improve in 2005, uncertainty regarding the timing and effect of a GM downgrade and the rise of event risk may result in continued volatility. Historically, event risk has been positive for the market, as high yield credits typically improve when acquired by larger suitors, but given the tight spreads and the large number of issues with weak covenants (including previously investment-grade issuers), event risk in the current environment may be skewed toward the negative. Despite these concerns, we expect positive nominal performance for the balance of 2005, driven primarily by coupon income and steadily improving credit quality. We intend to

continued on p. 8

Corporate Bonds, continued from p. 2

These secular developments make it imperative for investment managers to pick the right security. Quantitative studies confirm that security selection is more important than either duration or sector/quality allocation decisions in adding excess return.[8] For all these reasons, it is essential that investment managers assemble teams of highly experienced professionals (15 with a credit focus in Dwight's case) with areas of expertise that can help uncover superior relative value.

Corporate Bonds and the Equity Market

Traditionally, corporate bond managers eschewed comparisons to equity management. Bonds, by virtue of their seniority in the claim structure of an issuer, were viewed as insulated from the relatively short-term financial vicissitudes affecting an issuer that so often influence equity valuations.

Modern theories of corporate finance and the introduction of "event risk" starting in the late 1980s have resulted in breaking down the distinction between equity and bond valuations.[9] As a result, quantitative models of credit risk have emerged where at least one of the explanatory variables is the variability of an issuer's equity price.[10] Because the models are quantitatively driven, they can be run continuously in real time. This allows for the direct application of the results of these models to the continuous pricing of credit risk, which in turn has facilitated the development of credit derivative products such as credit default swaps (CDS). A CDS allows an investor to assume synthetically created credit exposure to, or against, a particular issuer or group of issuers. Our preference is to favor credit exposure either to baskets of issuers or to a credit index.

At Dwight we constantly canvass the market for innovative and effective approaches to credit exposure. Our demonstrated preference for basket or index products in large part reflects our philosophy that fundamental credit analysis is particularly effective in the selection of actual securities. We believe quantitative approaches to credit assessment are best suited to constructing baskets or indices of synthetic exposures that can be tailored to meeting our expectations on a more macro level.

Modern theories of corporate finance and the introduction of "event risk" starting in the late 1980s have resulted in breaking down the distinction between equity and bond valuations.

Conclusion

Corporate bonds deserve a place in fixed portfolios, based on the long-term value opportunity they possess. This important component of the fixed income market has evolved highly since the 19th century in size, types of structure and products, and credit quality. Commensurate with this growth and complexity is the need to dedicate significant and focused resources to this huge component of the capital markets. The appetite for corporate bonds—the yield premium demanded from corporate bonds versus Treasuries—is dynamic and generally reflective of a particular macroeconomic horizon. Despite our optimistic views for GDP growth for the balance of 2005, it is our opinion that conservative prudence is in order, given the low yield premiums (high prices) offered by the sector. Our expectation for the remainder of the year is that selective buying opportunities will drive our overall exposure to the sector. ■

Written by Frederick Meltzer, Ph.D.
Investment Grade Corporates, Agencies

Endnotes

1. We define the "modern era" as one in which the issuance carries no governmental guarantee and is underwritten and distributed through a "syndicate" of financial intermediaries using an offering memorandum.
2. Interestingly, Vermont played a significant role in the early development of the corporate bond market. The ownership and board of the Northern Pacific Railroad was dominated by a group of individuals referred to as the "Vermont Clique." These individuals appealed to Jay Cooke to act as the financial advisor and underwriter of the above-mentioned bond issuance. Jay Cooke & Co. was prominent at that time as the exclusive agent to the U.S. Treasury in financing the Civil War. Cooke himself is generally credited with coining the term "syndicate" as it applies to the marketing of bonds.
3. For the purposes of this piece we will confine our discussion to the universe of bonds eligible for inclusion in the Lehman Brothers Corporate Bond Index (Lehman Corporate Index), which includes investment grade bonds issued by U.S. corporations. Unless otherwise indicated, all information in this piece is as of December 31, 2004.
4. Investment-grade bonds are rated according to one of four major rating categories. Listed in descending order of creditworthiness, these categories are AAA, AA, A, and BBB.
5. Currently, three of the nationally recognized statistical rating organizations (NRSROs) each evaluate most of the corporate bonds issued in the U.S.: Moody's, Standard & Poor's, and Fitch.
6. Callable bonds (such as the Northern Pacific Railroad bonds) are redeemable prior to maturity at the issuer's option at specified times. Puttable bonds can be presented for payment to the issuer by the bondholder at specified times prior to maturity. Sinking fund bonds feature partial principal redemption prior to maturity on a specified amortization schedule.
7. The comparison period dates back to when the latest sector was added to the Lehman Brothers Aggregate Bond Index.
8. "Value of Security Selection vs. Asset Allocation in Credit Markets: Part II—An 'Imperfect Foresight' Study," June 2000, Lehman Brothers
9. Event risk is defined as "the likelihood that the rating of a bond will drop due to an event, such as the taking on of additional debt or a recapitalization by a company." One of the earliest and best-known examples of event risk was the leveraged buyout (LBO) of RJR in 1988. This LBO formed the basis for the book "Barbarians at the Gate" by Bryan Burrough and John Helyar.
10. The best-known quantitative model was developed by KMV and was subsequently purchased by Moody's, the aforementioned NRSRO. Fundamentally, all these models tend to be quite similar. They typically depend on three factors: the relative size of an issuer within its industry; financial leverage on the balance sheet; and the volatility of the issuer's equity price. Normalized values for each factor are developed and integrated to produce a credit score usually ranging from a one, the least creditworthy, to a 100, the most creditworthy.

Sector Update, continued from p. 6

be both cautious and opportunistic in our approach to the sector as we continue to closely monitor the economy for signs of slowing growth. We will also continue to limit exposure to the most interest-rate-sensitive names.

Guaranteed Investment Contracts

GICs outperformed traditional fixed income investments during the first quarter, as rising interest rates caused price declines to offset yield income in unwrapped bond portfolios. GIC spreads widened a bit, following the movement in credit spreads within insurance and financial sectors during the period. The Ryan 3- and 5-year GIC indices returned 0.79% and 1.24%, respectively. While these returns marked the 16th consecutive quarterly decline, and the lowest ever recorded by the Ryan indices, they were well ahead of most fixed income and money market funds during the period. Indeed, GIC portfolios continued to outperform most ultrashort bond and money market funds by a comfortable margin, providing investors with attractive relative yields while maintaining principal protection. Those levels of outperformance may very well decline in 2005, however, as a flatter yield curve and rising short-term interest rates continue to shrink the yield advantage of GICs over money market instruments.

We believe that stable value products will remain attractive to investors seeking principal protection, stability, and current income throughout the rest of the year. Within the universe of benefit-responsive investment products, we continue to favor wrapped fixed income investments backed by high-quality fixed income portfolios over traditional GICs, based on higher liquidity and asset diversification. ■

Written by Dwight Sector Specialists

Economic and Bond Market Update, continued from p. 3

damage would have been even greater were it not for an unexpected slowing of employment growth. Nonfarm payroll growth averaged just 159,000 jobs per month in Q1, down significantly from 190,000 in the previous quarter.

As we head into the second quarter, GDP growth appears to be slowing in response to higher energy prices. Second-quarter GDP growth could slow to just a 3% rate following roughly 3.5% growth in the first quarter and 3.8% growth in the fourth quarter of last year. An important question for investors and the Fed is whether or not the economy reaccelerates in the second half of the year. We believe that it will. Thus, we expect the Fed will continue to tighten monetary policy in 25 basis-point increments at each of the next six FOMC meetings such that the federal funds rate is 4.25% by year end.

During the first quarter, investors marked higher their forecasts for the federal funds rate, and the consensus forecast is now in line with our view. Thus, we took the opportunity in late March to lock in some first-quarter profits by buying back some duration in our total return portfolios, leaving us about 10% short of our benchmarks' durations. At the same time, we removed some of our curve flattening bias by purchasing short-term Treasury notes. Thus, we are closer to neutral today than we were at the start of the quarter, although our bias continues to be defensive. We expect the remainder of 2005 to be a challenging year for fixed income investors, but those who can make the correct macro call, backed up by careful security selection, should do well. ■

Written by Jane Caron, CFA
Chief Economic Strategist

NEW FACES AT DWIGHT

Natasha Kassian, Vice President—Assistant General Counsel & Risk Management Officer

Natasha Kassian joined Dwight's Legal and Compliance Team during the first quarter of 2005. Natasha has nine years of investment advisory experience in New York, including work at UBS and Morgan Stanley, where she served as Director and Associate General Counsel and Vice President and Assistant General Counsel, respectively. Natasha received her JD from St. John's School of Law and is a member of the New York and Massachusetts state bars.

George E. Lee, CFA, Vice President—Quantitative Analyst

Formerly an Economics Instructor at New York University, George Lee joined Dwight's Quantitative Analysis Team during the first quarter of 2005. George has 16 years of financial services experience. He joined Dwight from KDP Asset Management, Inc., where he served as a Quantitative Analyst and a High Yield Bond Analyst.

See http://www.dwight.com/newsletter for more information about Dwight's Quantitative Analysis Team.

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