

ALL EYES ON THE HOUSING MARKET

Fixed Income Sector Review

Corporates

Corporate bonds earned 1.48% on a total-return basis for the first quarter, matching the performance of Treasuries, as the yield advantage in corporate bonds was offset by spread widening. For most of the quarter, corporates performed nicely. Spreads tightened by 6 basis points through February, driven by good investor demand and strong credit fundamentals. The market reversed sharply in late February, however, as problems in the subprime mortgage market sparked a global risk-reduction trade. Spreads subsequently widened 10 basis points to end the quarter 4 basis points wider than their year-end close.

Mortgage banks and homebuilders were the hardest-hit sectors, but other parts of the market, such as consumer cyclicals, also weakened as fears about spillover from weak housing markets mounted. Alongside concerns about consumer outlook, event risk continued to build. Eight of the ten biggest LBOs of all time have occurred in the past 12 months, including the record-setting \$45 billion privatization of TXU Energy in February. Prior to TXU, regulated utilities were perceived to be immune to LBO risk. Private equity-buyout funds raised \$215 billion in 2006 and are expected to raise another \$300 billion in 2007. Increasingly, buyout firms are coordinating their efforts to form “clubs” that put ever-larger companies in play. Reduced takeover premiums, combined with cheaper debt and plentiful global liquidity, make LBOs easier. As a result, we continue to minimize exposure to names that our analysts consider potentially attractive LBO candidates, and we actively seek out bonds with change-of-control language and coupon step-up features.

As we begin the second quarter, the corporate bond market remains unsettled, with market partici-

pants about evenly split as to whether the current spread backup represents a buying opportunity or the first leg down in a longer-term bear market. We are now back to September 2006 spread levels, which, at that time, turned out to be a buying opportunity despite ongoing concerns about declining profit growth, a slumping housing market, and rising LBO risk. This time around, in addition to facing those same concerns, the market is faced with rising energy prices and no real signs of recovery in the housing sector. As a result of these additional hurdles, the market will likely remain volatile until we can get more clarity about economic growth, inflation, the Fed, and the overall impact of the subprime meltdown. Despite strong balance sheets, good earnings, and strong overseas demand for corporate bonds, we think that the transition from above-trend to below-trend global growth will lead to wider spreads over time. Therefore, we plan to maintain our underweight to the sector until we think that pricing adequately compensates for the ongoing risks.

Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned 1.57% during the first quarter, roughly in line with the overall Lehman Aggregate return of 1.50%. On a duration-adjusted basis, the return for MBS exactly matched that of U.S. Treasuries, and it modestly outperformed returns of other high-quality spread sectors.

Many of the tailwinds enjoyed by MBS during 2006 continued to be present in varying degrees as 2007 unfolded. Interest rates remained in a relatively tight range throughout the quarter, helping to

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keep volatility in check and encouraging yield-starved investors to add to MBS positions. Overseas investors, who have been the dominant drivers of MBS demand recently, continued to participate, and they were joined by domestic relative-value buyers who viewed MBS as a favorable high-quality alternative to other spread assets. The demand was enough to offset significant net supply of fixed rate MBS, which was driven in large part by the flat yield curve and the refinancing of adjustable rate loans into fixed rate loans.

Despite this, there were some signs of potential trouble for MBS and for spread sectors in general. The stock market swoon at the end of February and concerns over the spreading deterioration in subprime mortgage credit brought some short-term volatility back to the market and caused investors to reassess whether they are being adequately compensated for the risk they are taking. Mixed economic data and increased uncertainty regarding the direction of the Federal Reserve's monetary policy added to the market's skittishness.

During the first quarter, we moved to a modest underweight in MBS, which we continue to maintain as of March 31. While we acknowledge that MBS should perform relatively well if the environment of range-bound interest rates and low volatility persists, we feel that the market may still be underestimating the potential downside for spreads if the environment turns less sanguine.

Commercial Mortgage-Backed Securities

Heavy new issuance of commercial mortgage-backed securities (CMBS) saturated the market and pushed spreads wider during the first quarter, leading to 18 basis points of underperformance relative to duration-adjusted Treasuries during the

period. Total new supply during the first three months of the year exceeded \$60 billion, a new record for quarterly issuance, while concerns about potential spillover from losses in the subprime mortgage markets resulted in a sharp decline in risk appetite among investors. The bid from structured vehicles, such as CDOs and ReREMICs, evaporated as dealers reined in their exposure to this market, causing a dramatic steepening of the credit curve. Spreads on senior AAA-rated classes widened about 5 basis points, while spreads on Baa3/BBB-rated classes doubled, widening some 90 basis points.

Contrary to what spread movement would suggest, however, fundamentals in the market remain sound: commercial mortgage delinquencies remain low; upgrades continue to outnumber downgrades; vacancies are low; finally, new construction has been constrained by high material costs. Nonetheless, increasing leverage and growing concerns about the economic outlook have left investors less optimistic about the prospects for commercial real estate. Meanwhile, the ongoing frenzy of mergers and acquisitions in the REIT market, some of which are being financed in large part through the issuance of secured debt, is likely to keep issuance volume high during the second and third quarters.

Despite our concerns about continued heavy issuance and aggressively underwritten loans, we continue to feel that the sector's convexity advantage over mortgages, coupled with its credit superiority over corporates, makes it an excellent candidate for continued outperformance among investment-grade spread sectors. We prefer the senior-most classes of moderately seasoned deals for their cash flow stability and credit quality, and we intend to maintain our overweight in those securities.

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Asset-Backed Securities

All eyes were focused on the housing market during the first three months of 2007, specifically the subprime mortgage market. As early pay defaults (EPDs) on newly originated home equity loans (HELs) rose to unprecedented levels, Wall Street dealers, who had purchased the loans for securitization, demanded that originators buy back hundreds of millions of dollars worth of poorly performing loans. Cash-strapped originators had little choice but to sell their businesses or file for bankruptcy protection. Warehouse providers cut off revolving credit lines to those originating the worst-performing loans, and prices for whole loan packages plummeted. The CDO bid also faded as execution for new deals faced dimming prospects.

The ABX.HE indices, which are currently our best barometer for how investors feel about the subprime mortgage market, widened dramatically. The risk premium investors demanded to own the ABX.HE 06-2 index blew out from roughly 410 basis points at year-end to more than 1600 basis points at the end of the March. With negative headlines hitting the media almost daily, spreads on almost the entire capital structure of the HEL market had widened out past their 52-week wides. The BBB-minus-rated tranches saw some of the most dramatic spread moves, widening from a tight print of 185 basis points over LIBOR, all the way out to 900!

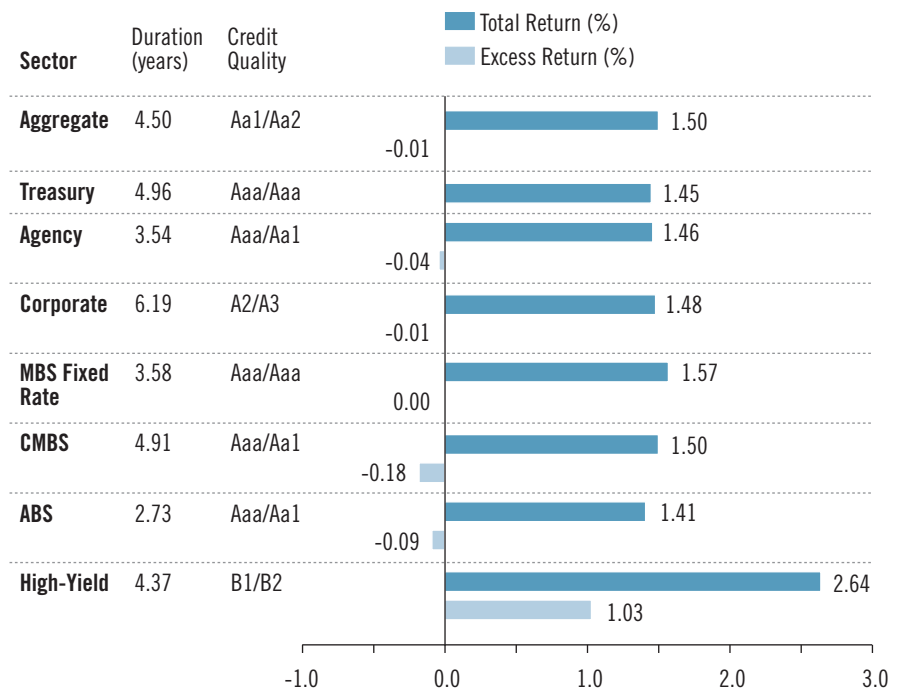
Despite all the turmoil, there is some good to be found here. The remaining players in the subprime mortgage business are tightening credit standards, and as underwriting improves, so should the underlying collateral in deals to come. Also, as the weaker competitors are forced to close shop, risk-based pricing should return to the marketplace. Our strategy of maintaining an overweight to only the highest-quality HELs has definitely paid

off, as we were able to maintain good risk-adjusted carry versus other sectors within ABS and the broader market, while minimizing the shock of spread widening versus the lower parts of the capital structure. Given our high-quality bias, we will also be in a much better position to add risk in our portfolios as spreads and performance on the underlying collateral stabilize.

For the first quarter of 2007, the ABS index underperformed duration-matched treasuries by 9 basis points as most subsectors posted negative returns. For the rest of the year, investor attention will remain

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Figure 1: First Quarter 2007 Sector Statistics*



*Source: Lehman Brothers Global Family of Indices. Excess returns represent returns over duration-matched Treasuries. Credit quality represents market-weighted average credit quality for the indicated sector expressed in Moody's nomenclature.

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The difficulties in the subprime market clearly had an impact on high-yield: homebuilders underperformed significantly for the quarter, down over 2% in March alone, but to date we have not seen the sort of contagion that would take the market down sharply.

focused on the housing market, loan performance, and new supply. Of particular interest to investors will be upcoming resets on adjustable-rate subprime mortgages. Investors will try to determine whether or not borrowers will be “squeezed” by tighter underwriting standards. The CDO world will also be watched closely, as structured vehicles have been the primary buyer of subordinated HELs.

Despite the negative headlines and the spread widening in subprime mortgages, AAA-rated fixed and floating rate HELs offer a good buying opportunity, as we believe these bonds are “money good.” As a result, we will maintain our overweight to high-quality AAA-rated home equity and equipment lease-backed paper while underweighting autos, credit cards, utilities, and manufactured housing.

High-Yield

The high-yield market continued to outperform all major sectors of the investment-grademarkets in the first quarter. With a total return of 2.64%, high-yield generated 103 basis points of excess return for the period. The market picked up in January where it had left off in December, with the riskiest securities significantly outperforming the rest of the index. Momentum slowed throughout the quarter, with spreads finally widening in March, resulting in less-than-coupon returns of only

0.23% for the month. The difficulties in the subprime market clearly had an impact on high-yield: homebuilders underperformed significantly for the quarter, down over 2% in March alone, but to date we have not seen the sort of contagion that would take the market down sharply.

Fundamentals remain very strong as earnings have been aided by weaker commodity prices and continued low interest rates. Defaults remain very low, below 1.5%, with not a single default in the months of February and March. The new issue market remains robust, and issuers are pushing the envelope on favorable debt structures. We continue to see a significant increase in the number of deals coming via the leveraged loan market that have been diverted from the high-yield bond market. These

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