

DWIGHT ASSET MANAGEMENT COMPANY LLC

Fixed Income Sector Review

CORPORATES

After a tumultuous fourth quarter, the corporate bond market began to show some signs of stability in 2009. Investment-grade corporates posted a total return of -1.93% and underperformed duration-matched Treasuries by 21 basis points, ending the quarter at an option-adjusted spread (OAS) of 543 basis points.

Attractive valuations and reduced fears about the state of the financial system drew broad-based interest in corporate credit, causing spreads to tighten meaningfully in the month of January. New issue supply was well received as issuers were not forced to pay as much to bring a new deal to market, though that trend later reversed amid deteriorating economic fundamentals.

Skepticism over the success of evolving federal programs and populist outrage that emanated from Washington weighed heavily on financials. Financials performed poorly as weakness in the latter half of the quarter overwhelmed the strength exhibited in January, resulting in a negative excess return of 662 basis points for the period. Industrials and utilities fared better, however, posting positive excess returns of 331 and 606 basis points, respectively.

Over the course of the first quarter, we transitioned from a modest underweight to a modest overweight position in the corporate sector. We added credit exposure to industrial and utility names, mostly using the primary market as new issue premiums provided very attractive entry levels. We continue to focus on higher-quality credits that have been unduly punished by the current market environment and that are well-positioned to manage through a difficult economic landscape. We maintain an overweight to the banking sector as it provides compelling value and benefits from strong federal support. Going forward we expect to maintain an overweight to corporate bonds, with a watchful eye for early signals of overall economic stability that could provide the incentive to add more cyclically-sensitive names.

MORTGAGE-BACKED SECURITIES

The mortgage-backed securities (MBS) sector exhibited strong performance in the first quarter of 2009, posting a total return of 2.20% and returning 172 basis points relative to duration-matched Treasuries.

The Fed announced at year-end that it would begin a program to purchase \$500 billion in MBS by the end of June. This led to significant, but relatively short-lived, price appreciation as both originators and money managers took profits on their mortgage positions. MBS prices received another boost in March, however, when the Fed announced that it would be extending the program through year-end and buying an additional \$750 billion in MBS. This produced significant outperformance, which we expect to continue into the next quarter. The program also pushed mortgage rates near historic lows, marking the beginnings of a refinancing wave and causing the prepayment speeds on much of the universe of outstanding mortgages to increase.

Non-agency mortgages had a volatile quarter as rating agencies continued to downgrade non-agency bonds more frequently and more aggressively. As a result, many investors were forced to sell downgraded securities into a weakened market. Recent programs announced by the Fed have also benefited the non-agency mortgage sector, though, and prices have since risen substantially.

We expect to maintain our overweight position in MBS until the Fed indicates a plan to slow its purchases. We will look to agency MBS that we expect to prepay at a slower rate than the broader universe to insulate our portfolios from increasing prepayment speeds. With regard to the non-agency sector, we have been selling bonds that have exhibited deteriorating performance and those that are at risk of being downgraded. We continue to hold our core position of seasoned bonds in this sector. As a whole, the MBS sector continues to provide attractive returns. Agency MBS are still attractive relative to other

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- ▶ government-backed securities and non-agency MBS appear attractive relative to other credit sectors.

COMMERCIAL MORTGAGE-BACKED SECURITIES

The deterioration in commercial real estate fundamentals and lockdown of the credit markets drove commercial mortgage-backed securities (CMBS) spreads wider for the first two months of the year. This performance turned around in March, however, as promises of government support helped the sector to considerably outperform. The sector provided a total return of -187 basis points for the quarter and underperformed duration-matched Treasuries by 142 basis points.

The year began with uncertainty, as the new presidential administration put considerable heft behind the residential housing market and banking sectors but left support plans for CMBS vague at best. Meanwhile, several factors weighed heavily on the sector during the quarter as the financial sector experienced massive consolidation, retailers suffered from a reversal of consumer-spending habits, and business and vacation travel dried up. The multi-family sector was also unable to escape the downturn as loans on several properties that were aggressively underwritten and predicated on the ability to raise rents in upcoming years were unable to make debt payments. The greatest burden for the CMBS market, however, was a continued lack of credit. Traditional lenders stayed on the sidelines, making it difficult to buy or sell commercial real estate or even to refinance existing loans. Even performing assets were unable to refinance out of upcoming balloon loans into extended terms.

March provided a measure of reprieve, though, as new government programs came to the fore and support of the secondary CMBS market tightened spreads considerably. As prices began to “normalize,” the potential for buyers and sellers to find a clearing level for property transactions and the possibility of obtaining reasonable financing rates provided hope that credit might return to the CMBS market.

We expect CMBS loan performance to lag the overall economic cycle and remain weak as the economy begins to recover. Nevertheless, we maintain our overweight position as we continue to

favor the sector as a relative-value investment. We will continue to concentrate on bonds that are higher in the capital structure and those with more seasoning as they provide more stringent underwriting standards and less price depreciation from recent 2007 highs.

ASSET-BACKED SECURITIES

The biggest news surrounding the asset-backed securities (ABS) market during the first quarter was the official launch of the Term Asset-Backed Securities Loan Facility (TALF), which led to both spread tightening and new issuance. The market absorbed more than \$8 billion in TALF-eligible ABS during a one-week period in March, after seeing virtually no issuance during the prior two months. Investors jumped back into the sector in anticipation of the program and ABS outperformed all other spread sectors as a result, posting a total return of 7.56% and outperforming duration-matched Treasuries by 7.66% for the quarter.

Despite deteriorating consumer fundamentals and weaker trust performance, credit cards rallied hard, besting duration-matched Treasuries by 1228 basis points and outperforming all other ABS subsectors. Auto spreads also staged a big rally, as The Manheim Used Vehicle Index gained 8.3%, issuers had access to TALF, and the Obama administration announced that it would stand by new car warranties from GM and Chrysler in the event of a bankruptcy filing.

Home equities continued to drag on the ABS sector, underperforming duration-matched Treasuries by 1113 basis points during the quarter as house prices continued to fall. Cram-down legislation, which would allow bankruptcy judges to modify homeowners’ payment terms, was passed by the House in March and also hurt price performance. On the positive side, the Public-Private Investment Program (PPIP) and TALF 2.0 were announced, but the fact that the programs would accept legacy securities (bonds originally rated AAA that have since been downgraded) was not enough to change negative sentiment.

Our strategy moving into the second quarter will be similar to that of the previous few—while we are seeing some signs of stabilization in economic data,

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▶ we will move forward defensively and favor top-tier, AAA-rated assets with low spread duration. We do not believe that there is enough spread pick up to extend very far along the maturity curve in consumer-based assets; therefore we will look to replace longer maturities with short-dated bonds. Finally, we will continue to let our home equity exposure decline through amortizations and select sales.

HIGH-YIELD

Despite continued economic deterioration and an increase in default activity, the high-yield market performed strongly in the first quarter, providing a total return of 5.98% and outperforming duration-matched Treasuries by 636 basis points. Market participants remained risk averse throughout the quarter as BBs soundly outperformed the lower credit tiers.

Primary market activity remained subdued as new issuance was largely confined to high-quality, well-known companies in fairly stable industries, such as energy. New issues typically came with a significant spread concession to existing paper as well as a sizable price discount. Concessions will likely diminish as the credit markets normalize and risk appetite returns.

Liquidity in the secondary market remains challenged due to the inability and unwillingness of banks and brokers to allocate capital to their sales and trading operations. This has resulted in abnormally-wide bid/ask spreads that have increased transaction costs. The persistence of the credit crunch and resultant lack of an open, affordable new issue market led many investors to remain overweight in higher-quality, shorter-maturity paper. Given the asymmetric demand for higher-quality paper, the market tended to hoard the good names and freely offer distressed credits.

Despite negative macroeconomic headwinds, lower earnings, and higher defaults, high yield will likely range trade with a positive bias for the balance of the year. We expect the primary market to continue its slow recovery as underwriters repair their balance sheets and rebuild capital levels. Healthier companies have already engaged in open-market purchases of their own debt at attractive yields. Accordingly, we expect companies that are credit challenged to be more proactive in debt reduction, and as a result, actual

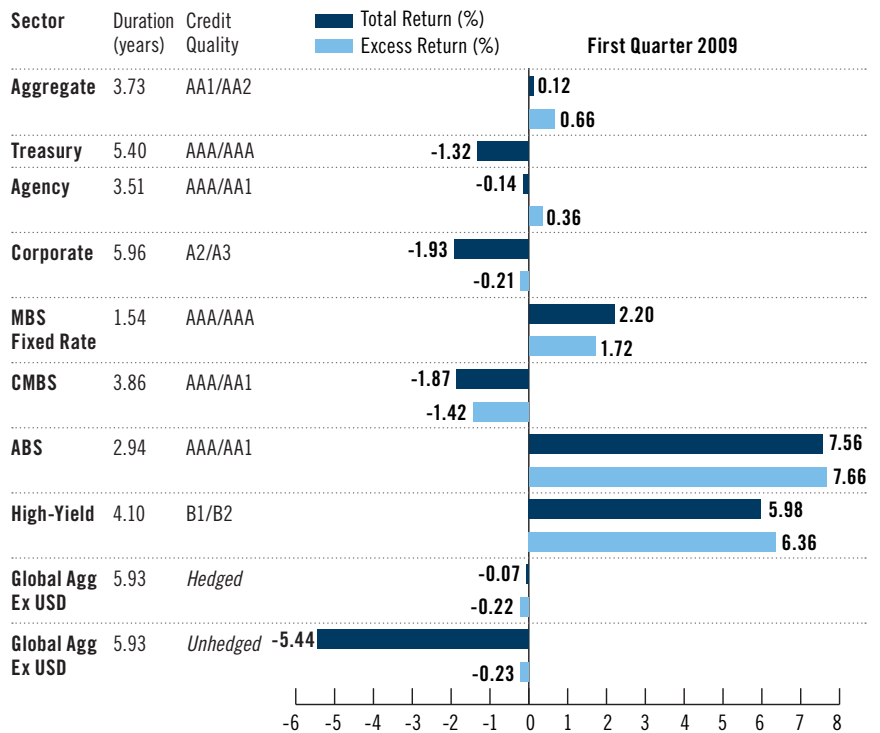
default levels may undershoot the levels implied by market spreads. Given compensatory market spreads and our view that the economy will begin to recover in the second half of 2009, we will look to increase spread duration and reach a bit lower in the credit spectrum. We will reassess this strategy, however, if the primary market fails to reopen, economic fundamentals fail to improve, or if we witness another wave of financial deleveraging.

MUNICIPAL BONDS

Municipal bonds exhibited their strongest quarterly performance in almost five years, returning 4.22% in the first quarter of 2009. New issue volume for the quarter totaled \$84 billion, down just 0.2% from the first quarter of 2008.

Despite a much better tone, the municipal market *continued on the following page*

Figure 1: First Quarter 2009 Sector Statistics*



*Source: Barclays Capital 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. The Barclays Capital U.S. High Yield Index and Global Agg. Ex USD are not components of the investment-grade U.S. Aggregate Index.

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► remains bifurcated between high-grade and all other credits. The spread between AAA and BBB+ general obligation (GO) bonds stands at 240 basis points, or about 170 basis points wider than one year ago. Continued credit fears, slowing government revenue growth, and volatility continue to weigh on all but the most solid credits. Absent a substantial improvement in the economy, state deficits are likely to grow dramatically over the next few years.

Over the next several months, some of the \$135 billion from the stimulus package should begin to flow to the states. This infusion should help to alleviate stress on municipalities and reduce budget deficits. Another program designed to assist states that was

introduced during the quarter is the Build America Bond (BAB) program. BABs are tax credit bonds that allow state and local governments to access taxable debt markets. They provide a 35%-interest subsidy, payable to the issuer by the Treasury on the interest payment date, and will lower net borrowing costs.

We remain cautious and continue our focus on high-grade GOs and essential service revenue bonds. Municipal bonds are still trading at relatively cheap levels and should continue to provide attractive risk-adjusted returns. Additional issuance in the taxable markets under the BAB program may also provide opportunities for taxable investors to diversify their portfolios with high-quality municipal credits. ■

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