

DWIGHT ASSET MANAGEMENT COMPANY

EVALUATING/CONSIDERING/UNDERSTANDING SUBPRIME EXPOSURE

Recently, subprime mortgage loans have received quite a bit of press coverage. Concerns about improper lending practices, issuer defaults, and rising borrower default rates have led some to conclude that any security backed by subprime mortgages must be a bad investment. Before painting all investments backed by subprime loans with such a broad brush, it is important to recognize that not all subprime backed securities are performing poorly or are in risk of default. Rather, a large block of highly rated subprime-backed securities continue to provide investors with competitive yields with low credit risk, even under prevailing adverse market conditions for this sector of the mortgage market.

Subprime Is a Sub-sector within Asset-Backed Securities

Asset-backed securities (ABS) are bonds or notes that are backed by the cash flows from a specified pool of underlying assets that can include receivables from credit cards, equipment loans, auto loans, and home equity loans, including “subprime” mortgage loans.

To segregate the risks associated with the cash flows from the collateral, trust structures exist wherein investors have the ability to invest in different tranches that comprise these trusts. The tranches typically have AAA, AA, A, BBB, and Equity class credit ratings depending upon the associated priority on the cash flows from the trust and the amount of collateral supporting each tranche. Each of the classes provides a yield premium over corresponding Treasury bonds. The highest rated classes, such as AAAs, will have a smaller yield premium (or spread) as they have the first priority to cash flows from a particular trust, while the BBB and Equity portions will have the highest spreads

commensurate with the greater risk associated with these securities and the corresponding last priority on the cash flows. (To learn more about ABS please see [Dwight’s Asset-Backed Securities Primer](#).)

Home Equity Loans and Subprime Mortgages

Home equity loans are one of the largest sub-sectors in the ABS sector. The term “subprime” applies to securities collateralized by mortgage loans to homeowners taking out a loan on an existing home, as well as to borrowers buying houses who are classified by lending institutions as subprime borrowers based on an assessment of the borrower’s credit worthiness. Mortgages backed by borrowers with higher credit scores are termed “Prime.”

Dwight’s History with the Subprime Market

Since the inception of the home equity/subprime mortgage market in the 1990s, Dwight Asset Management has maintained a structural overweight to the highest quality components of this sector based on relative value considerations. The sector has added significant value to our clients’ portfolios. Nonetheless, we have been cognizant of the potential risks and have monitored and will continue to monitor market conditions and investor sentiment closely.

During the last ten years, the sector has gone through three significant cycles. The first cycle, 1997/98, witnessed the downfall of the independent issuer due to their flawed business models; the second cycle was the 2000/01 pullback that occurred along with the overall deterioration in the financial markets; and the most recent events, in 2007, stem from lax underwriting standards and a substantial

continued on page 2



Peter Milne
Portfolio Manager,
Asset-Backed Securities



David Kilborn, CFA
Co-Chief Investment
Officer

Subprime Exposure, continued from page 1

► de-leveraging of the origination pipeline.

Dwight's management approach has been consistent during each of these cyclical downturns. In 2006, for example, our investment team identified several major themes that were precursors to the instability in the subprime collateral market today. These included loose or minimal underwriting standards, erroneous property appraisals, and inappropriate products being sold to weak borrowers during an 18-month period when too many mortgage originators chased too few qualified borrowers. Our response was to decrease exposure to the credit sensitive parts of the mortgage market (subprime, as well as commercial and traditional residential) and to maintain a structural overweight to the highest quality part of this sector—AAA rated securities.

Dwight's Current Exposure to the Subprime Market

Across all Dwight-managed portfolios, our subprime exposure is almost exclusively rated AAA by the major rating agencies. The few securities that are not rated AAA were mostly originated in the early part of the decade before loose underwriting standards were initiated. As such, these more seasoned securities have excellent protection and have been receiving periodic upgrades.

Our subprime exposure within our portfolios is split into two different types of subprime securities. Fixed rate bonds represent one-third of total exposure. These bonds have an average duration of around 3.5 years. The remaining two-thirds are short (1 year durations and under) floating rate bonds that are generally considered cash equivalents.

The floating rate positions in our portfolios are shorter-term in nature and have increased protection since origination due to the nature of the way the bonds pay down principal each month.

When evaluating asset-backed collateral, including subprime, the securitization structure is a very

important component to our investment process. To elaborate on this point, please read our write up from March 2007 titled "[Home Equities and the Subprime Mortgage Market—It's Not All Bad.](#)" which includes a section on the structure of subprime securitizations. This article provides an explanation as to why AAA rated securities have been, and we expect will continue to be, excellent investment opportunities, even in a challenging market such as now.

How Has Dwight's Bias Toward High Quality ABS Worked?

During the second week of July, Moody's and S&P downgraded over 800 ABS securities backed by subprime mortgage collateral in one of the largest sweeps by credit rating agencies to re-evaluate credit quality. However, Dwight-managed portfolios did not hold any securities that were downgraded or put on watch for a downgrade.

Conclusion

As the saying goes, "Don't throw the baby out with the bathwater!" Subprime mortgage-backed securities are not necessarily riskier securities than other asset-backed securities. It all depends upon where the securities stand in the capital structure, the tenor of the underlying collateral, and other important considerations. Despite our current high quality bias, we will continue to monitor events as they unfold and search for opportunities to purchase securities further down the capital structure where the underlying fundamentals do not justify their market valuations. ■

*Written by Peter Milne,
Portfolio Manager, Asset-Backed Securities, and
David Kilborn, CFA,
Co-Chief Investment Officer*

This information reflects the viewpoint of Dwight Asset Management Company as of July 2007 and is subject to change. This article was prepared for general informational purposes only, without respect to the investment objectives, financial profile, or risk tolerance of any specific person or entity who may receive it. Investors should seek financial advice regarding the appropriateness of investing in any investment strategy or security discussed or recommended in this article and should understand that statements regarding future performance may not be realized. Investors should note that income, if any, from any investment strategy or security may fluctuate and that underlying principal values may rise or fall. Past performance is not necessarily a guide to future performance.

For more information:

Fixed Income & Stable Value

Greg Prisk
Executive Vice President
802.383.4104
gprisk@dwight.com

David Richardson, CFA
Managing Director
802.383.4024
drichardson@dwight.com

Insurance

Donald Hill
Senior Vice President
802.383.4062
dhill@dwight.com

John Loud

Vice President
802.383.4047
jloud@dwight.com

Consultant Relations

Lisa Trubiano, CFA
Senior Vice President
802.383.4066
ltrubiano@dwight.com

Anicia Mendez

Vice President
802.383.4067
amendez@dwight.com

100 Bank Street
Suite 800
Burlington, VT 05401
802.383.4000

One SW Columbia
Suite 1720
Portland, OR 97258
800.929.4427

www.dwight.com