CREDIT CRUNCH BITES DOWN ON MARKET
Fixed Income Sector Review

Corporates

Corporates turned in their worst excess return performance in five years, underperforming duration-matched Treasuries by 244 basis points as spreads widened by 48 basis points during the quarter. Despite this, the sector still had a positive total return of 1.82%, as the bond market rally more than offset the spread widening.

Weakness in the corporate market during the early summer accelerated into the third quarter as troubles in subprime mortgages, collateralized debt obligations (CDOs), and housing markets led to increased concerns about a consumer-driven economic slowdown. By late July those concerns had evolved into a full-blown credit crunch. As fear gripped the market, brokers and hedge funds bought credit protection in the credit default swap (CDS) market, driving credit spreads wider. Spreads came under further pressure from heavy new issue supply when declining liquidity in the commercial paper markets prompted companies to term out financing. From late July until the FOMC voted to cut the fed funds rate in mid-September, spreads on the Lehman Brothers Credit Index widened by 59 basis points. The Fed's actions finally helped restore some confidence to the credit markets, and spreads tightened by 11 basis points from their mid-month highs.

Among the major sectors, financials were the hardest hit in the third quarter. With ongoing financing needs and reduced access to commercial paper, brokers and finance companies were forced to come to market at the worst time. Finance companies involved in the mortgage origination business were particularly hard hit as access to the capital markets via securitization disappeared. Countrywide Financial, the nation's largest stand-alone mortgage originator, saw its spreads widen by more than 1000 basis points as the market speculated about an imminent default. Hybrid securities were also hard hit due to their unique sensitivity towards changes in financial market liquidity and volatility. Homebuilder securities also continued to significantly underperform as the housing recession deepened. On the other hand, higher beta credits, those not involved in mortgage origination or home construction, performed surprisingly well as the credit crunch substantially reduced the likelihood of leveraged buyouts (LBOs) and other leveraged event risk.

We had positioned our corporate bond holdings to avoid credits most exposed to event risk: home construction and subprime mortgage origination. As such, and given the high-beta tilt of our holdings, our portfolios were positioned to perform well. Our holdings in hybrid securities, however, experienced greater price volatility than we had anticipated. We remain cautious on the outlook for corporates and currently plan to maintain our underweight to the sector. Although valuations are much more appealing at current spread levels, we are growing increasingly concerned about potential economic deterioration and its impact on credit fundamentals.

Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned 2.64% during the third quarter of 2007, 20 basis points lower than the overall Lehman Brothers Aggregate Index. On a duration-adjusted basis, MBS returned 91 basis points lower than U.S.

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The return of volatility and shrinking risk appetites impacted MBS performance both directly and indirectly in the third quarter.

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Treasuries. While MBS was not spared from the recent market turbulence, the sector did manage a better relative return than more credit-sensitive assets.

The return of volatility and shrinking risk appetites impacted MBS performance both directly and indirectly in the third quarter. As large banks and brokers continued to shrink balance sheets, and as access to financing became more constrained, the market was faced with a glut of secondary supply from forced sellers. Concurrently, general risk aversion drove more investors away from spread assets to the safety of U.S. Treasuries. This forced all spread assets, including MBS, to trade at wider levels.

In the MBS sector, spread widening was exacerbated by the fact that net new agency mortgage supply continued at a record pace. With lending markets becoming constricted, the conforming agency market became one of the few viable outlets for new loan production. We expect this dynamic to remain in place for some time, acting as a potential headwind to the sector.

After beginning the third quarter with a neutral position in MBS relative to our benchmarks, we moved to a modest overweight in August. Though the prospect of heavy forward supply is a concern, we feel that the degree of widening experienced by MBS relative to Treasuries more than compensates for that risk. Further, agency MBS are largely insulated from the credit concerns that have dominated investor sentiment recently. While the current environment makes it difficult to predict the near-term performance of any asset class, we feel that over a longer horizon, MBS should be able to recover most or all of the recent underperformance.

Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) ended a tumultuous third quarter with a total return of 2.81%, as measured by the Lehman Brothers Aggregate Index. While the performance was roughly in line with that of the overall index on a total-return basis, excess returns were sharply negative, as broad-market credit and liquidity concerns brought about significant spread widening. The average option-adjusted spread in the CMBS component of the index widened 37 basis points in the third quarter, which led to 137 basis points of underperformance relative to Treasuries on a duration-adjusted basis. Lower-rated classes experienced the most significant spread widening, reflecting an increased aversion to risk among investors.

While much of the underperformance was attributable to general market unease, there was some concern about the fundamental outlook as well. While loan delinquencies and foreclosures remain low, aggressively underwritten loans may not fare as well in a weakening economy. Slowing job growth would likely lead to a decline in demand for office space, especially in many suburban markets. Retail and hotel properties, which tend to exhibit the greatest cyclicality, would also see performance suffer in an economic downturn, while the decline in the residential housing market over the past year has already begun to put pressure on rents, as real estate investors and speculators have replaced their “For Sale” signs with “For Rent” signs.

We share the market’s concerns about aggressive loan underwriting, and we have been anticipating a deterioration in loan performance for some time now. As a result, we have concentrated our holdings

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in the highest-quality components of the CMBS market, namely “super-senior” classes (AAA-rated classes with an additional cushion of credit support) and high-quality seasoned deals that benefit from more conservative loan underwriting and a few years of property appreciation. Despite our concerns, however, we feel that the prospects for attractive risk-adjusted returns among these high-quality securities remain very compelling, and we expect to maintain our overweight to the sector into the fourth quarter.

Asset-Backed Securities

The third quarter of 2007 was a tough three months for those managing any sector other than Treasuries, but this period was even more brutal for those of us managing asset-backed securities (ABS). What started out as a subprime problem in February turned into a full-blown liquidity crisis as banks adjusted value at risk models, pulled back credit lines, and tightened their balance sheets. The resulting price volatility sent spreads dramatically wider on even the safest AAA-rated bonds, with asset-backed securities taking the most amount of pain.

The Lehman Brothers ABS Index posted its worst quarterly excess return performance on record, underperforming duration-matched Treasuries by 176 basis points, with a total return of 1.41%. Home equities led the index lower with a total return of -0.68%, representing 401 basis points of negative excess return. Spreads were pushed wider even on nonresidential safe haven sectors, such as credit cards and autos, despite the fact that both sectors are backed predominately by prime consumer credit and offer plenty of credit enhancement to investors. Transparency and liquidity started to reappear in September, however, and as a result the Lehman Brothers ABS Index beat all other spread sectors except for CMBS, returning 47 basis points of excess return for the month.

While short-term technicals drove spreads wider in July and August, we firmly believe that this situation has created a great buying opportunity at the top of the capital structure in both residential and nonresidential ABS. While the rating agencies may have missed the boat when initially rating subordinate home equity bonds, we expect that investors positioned in AAA-rated securities will continue to be very well protected by subordina-

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Figure 1: Third Quarter 2007 Sector Statistics*

Sector	Duration (years)	Credit Quality	Total Return (%)	Excess Return (%)
Aggregate	4.62	AA1/AA2	2.84	-0.92
Treasury	5.01	AAA/AAA	3.81	
Agency	3.63	AAA/AA1	3.19	-0.17
Corporate	6.26	A2/A3	1.82	-2.44
MBS Fixed Rate	3.74	AAA/AAA	2.64	-0.91
CMBS	5.11	AAA/AA1	2.81	-1.37
ABS	3.15	AAA/AA1	1.41	-1.76
High-Yield	4.60	B1/B2	0.33	-3.63

*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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tion and other structural features.

We expect to maintain our overweight to the highest-quality home equity and equipment lease-backed paper, as we believe that pricing will stabilize and that such collateral will outperform in the long run. We also intend to take advantage of the recent spread widening in consumer ABS by continuing to decrease our underweight to credit cards, autos, and rate reduction bonds.

High-Yield

The high-yield market provided a paltry 0.33% total return for the quarter, an abysmal negative 363 basis points of excess return. July 2007 was the market's worst month since July 2002, as the market fell 3.14%. Concerns about the fallout from the subprime debacle and the subsequent seizing of the collateralized loan obligations (CLO) market resulted in a significant (and long overdue) repricing of risk. The market stabilized in August, returning over 1%; then it rallied in September with its best month since 2003, returning over 2%. The worst-performing sectors for the quarter were finance, transportation, and consumer cyclicals, with finance down almost 3% for the quarter. Utilities, energy, and capital goods were the top performers.

The new issue market was closed for most of the third quarter. Total issuance for July and August combined was a little over $4 billion, down from over $22 billion in June alone. September saw $6 billion in new deals as the market adjusted to the new structures being offered by the dealers. Earlier this year, under very different market conditions, dealers had committed to provide some $350 billion of financing for leveraged transactions. With the repricing of the market, this financing was at below-market rates, and consequently the dealers were left with most of the paper on, or potentially on, their balance sheets. Several deals that were completed or partially completed before the summer saw significant price declines throughout June and July. Underwriters had committed to the bank portion of the financing with very lenient covenant structures that the

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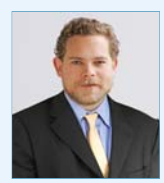

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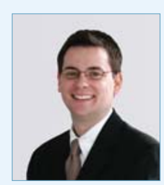

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Municipal Bonds

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market refused to absorb. This massive technical overhang weighed on the market throughout the quarter, although recent deal flow is reducing this pressure. Some deals have been restructured or canceled, as private equity players recognize they have paid too much, (Sallie Mae, Axciom, Harman International), but others have been able to come to market using an incremental approach. Instead of bringing the entire deal, they bring a portion at a discount, hoping to bring each subsequent piece at a slightly higher price until the financing is complete. In a rising market, this technique is effective; in a softer market it may prove problematic.

While the market has weakened over the last quarter, we believe it remains overvalued. The supply overhang has begun to be absorbed, but we believe this technical pressure may result in a repricing of the market if deeper discounts are necessary to clear the backlog. The potential for slower economic growth has increased, and with this problem comes the risk of increased defaults. Other risks include increased Treasury and equity volatility, along with the continuing decline in residential real estate values. Although market liquidity is currently adequate, any decline could have sharply negative implications for market returns, as we saw in July and early August. We continue to believe that certain issues offer value, but we feel that the broader market is likely to experience more spread widening in 2007. Therefore, we intend to maintain our bias toward high-quality credits, and we will remain highly selective with new purchases.

Municipal Bonds

The total return for the Lehman Brothers Municipal Bond Index was 1.82% in the third quarter, compared with a return of 0.15% for the first half of the year. Year-to-date, the total return of the Lehman Brothers Municipal Bond Index was 1.97%, compared with a return of 4.86% for the Lehman Brothers Treasury Index. During the past twelve months the Municipals Index underperformed the Treasury Index by 253 basis points. The performance relative to Treasuries was driven primarily by the lower yield of the municipal bond market and was exacerbated by flight-to-quality buying in the U.S. Treasury market. Technicals also weighed on the municipal debt markets, as new issue volume for the quarter totaled approximately $87.9 billion, putting year-to-date supply at $322.6 billion, 20.9% higher than 2006.

The decline in the housing sector and events in the subprime market spilled over into the municipal market, where overleveraged investment pools, hedge funds, and arbitrage accounts desperately tried to reduce exposure, which led to a dramatic underperformance in municipal bonds. Municipals began the quarter with a flatter curve, but because of the dramatic decline, we saw the curve steepen from 78 basis points at the end of June to 103 basis points at the end of September. Municipal bond yields exceeded 90% of U.S. Treasury yields in the 10-year part of the curve, and they reached approximately 100% in the 30-year part of the curve. This opportunity in municipals is a rare occurrence because, in addition to their tax exemption, municipals are considered a high-quality, low-risk sector, second only to U.S. government securities in safety. The illiquidity and relative cheapness of municipal bonds witnessed in the third quarter offered an attractive entry point for investors. The liquidity crunch that had persisted for most of the quarter recovered somewhat toward the end of September, as we saw real money buyers, as well

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as nontraditional buyers, step back in to support the municipal market and take advantage of this relative cheapness.

We look for municipal issuance to continue at a record pace, likely topping $400 billion, and quite possibly topping 2005's record issuance of $408 billion. And while recent disruptions have presented investors with attractive buying opportunities, a deterioration of the economic outlook could very likely lead to continued steepening in the municipal curve, possibly by 25 to 50 basis points. ■

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