

## DWIGHT ASSET MANAGEMENT COMPANY LLC

## Fixed Income Sector Review

### GOVERNMENT-RELATED DEBT

U.S. Treasuries and other government-related debt securities fared well in the third quarter as liquidity-fueled demand led to declining inflation and liquidity risk premiums across asset classes. Despite large increases in Treasury issuance, demand from retail and institutional investors proved robust as short-term borrowing rates hovered just above 0% and issuance in non-Treasury sectors remained low. The Fed also continued to support the market with its Treasury purchase program, buying over \$100 billion during the quarter. According to Barclays Capital Aggregate Index data, Treasuries returned 2.10% for the period, with the yield on 10-year notes declining 33 basis points. Treasury Inflation-Protected Securities (TIPS) also performed well, returning 3.08% as 5- and 10-year real yields declined 28 and 23 basis points, respectively, and inflation breakevens ranged from unchanged to more than 30 basis points lower across the curve.

Agency debt continued to benefit from negative net issuance, as well as from the ongoing Fed purchase program through which the Fed purchased approximately \$34 billion in the third quarter, bringing its total purchases to over \$130 billion since the program began in December 2008. Callable agencies also saw strong demand as investors viewed the sector as a cheap alternative to agency collateralized mortgage obligations (CMOs), especially as Fed rhetoric reassured buyers that accommodative policy would remain in place for an extended period and keep short-end volatility low. According to index data compiled by Barclays Capital, agencies returned 2.02% for the period, outperforming Treasuries by 58 basis points on a duration-adjusted basis.

Government-guaranteed bank debt, including securities issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP), followed the performance of agencies and tightened by an average of 10 basis points over Treasuries, producing 41

basis points of excess return. Supranational and sovereign issues also rallied on strong demand from foreign central banks and from domestic investors seeking a high-quality alternative to agencies and corporate credit. Sovereigns, aided by the ongoing global economic recovery, tightened by 53 basis points on average and handed investors 384 basis points of excess return. Supranationals, meanwhile, produced 107 basis points of excess return, ending the period at 44 basis points over Treasuries.

We believe that agencies and other U.S. government-backed debt issues are fully valued at current spreads and expect additional upside to be limited to their incremental income over Treasuries. Nevertheless, we do not anticipate significant spread widening in the near term because investors remain flush with cash and high-grade alternatives are limited. Indeed, with new issuance in non-agency AAA-rated assets down sharply in recent years, investors are presented with few reinvestment options for their AAA portfolios. Longer term, however, with the future of the agencies still unresolved and the Fed's purchase program coming to an end, we believe that currently rich valuations will be vulnerable to a correction.

### CORPORATES

**Investment-Grade Corporates** – The themes of the second quarter carried over into the third as investment-grade corporate bonds posted a total return of 8.12%, outperforming duration-matched Treasuries by 5.56%.

Increased economic clarity, a supportive supply and demand dynamic, and historically attractive valuations combined to drive corporate bonds to their second-best quarter on record. BBB-rated bonds outperformed A-rated bonds by 45 basis points during the quarter as investors acknowledged the increasing likelihood of a sustained recovery by increasing their risk appetites. This positive momentum was intensified by a dearth of new issue supply in the face

## Dwight Sector Specialists

The Sector Review was written by the following sector specialists:



**Derrick Wulf, CFA**  
*Government-Related Debt*



**Todd Henry**  
*Investment-Grade Corporates*



**Ed Meigs, CFA**  
*High-Yield Corporates*



**Keith McCarthy**  
*Municipal Bonds*

of rejuvenated investor demand. Specifically, corporate bond maturity and coupon payments outpaced new issue supply by an average of about \$23 billion per month, according to J.P. Morgan.

The Barclays Capital Credit Index started the quarter at an option-adjusted spread (OAS) of 273 basis points over Treasuries, only slightly below the pre-Lehman Brothers default level of 289 basis points. Spreads recovered through the widest levels of the 2001 recession (241 basis points) to end the quarter at an OAS of 198 basis points. Among the subsectors which outperformed were life insurance and building materials, while media cable and pharmaceuticals were notable laggards.

Throughout the quarter we maintained an overweight allocation to corporate bonds. Within this allocation we believe the banking subsector, with spreads almost 100 basis points in excess of industrials, offers compelling value. We have also started rotating out of utilities and into energy, which offers a better return profile in a sustained growth environment.

While an unemployment rate near 10% and an uptick in merger and acquisition activity gives us pause, we believe that corporate balance sheets remain strong. As market liquidity and spread levels continue to normalize, issuer-specific risk should overtake systemic risk as the key driver of returns. With improving fundamentals and a bullish demand outlook, we expect to maintain our overweight in the sector with an emphasis on credit selection.

**High-Yield Corporates** – The high-yield sector posted a strong 14.22% total return in the third quarter, outperforming duration-matched Treasuries by 12.33%. Outperformance was once again driven by the lowest credit tiers as CCCs returned 26.27%, while the combined BB and B sectors returned a more modest 11.19%. Overall, the high-yield market has tightened back to 764 basis points over Treasuries, the tightest it has been since June 2008.

The new issue market has fully reopened, giving investors greater confidence that companies can refinance debt in an orderly fashion. Despite concerns that a wave of new issuance could put

pressure on the secondary market, the demand for paper remained strong throughout the quarter.

Defaults continued to increase, with the trailing 12-month default rate reaching 14%, including distressed exchanges. Because many of the defaults that occurred this year were well anticipated, they did not negatively impact the overall market. However, several companies have yet to fully address their over-leveraged capital structures and are likely to use either Chapter 11 or distressed exchanges to accomplish that end.

Despite increasing defaults and a tepid economic recovery, we believe that spreads remain compensatory, given identifiable risks. Nevertheless, spreads of lower-quality CCC names have rallied much more relative to higher-quality tiers and offer less compelling risk-adjusted return potential. As a result, we retain our high-quality bias. We also expect to continue to be active participants in the primary market given attractive pricing and deal structure, but will reassess our overall strategy pending changes in the quality and depth of the primary market.

**Municipal Bonds** – The Barclays Capital Municipal Bond Index returned 7.12% in the third quarter, bringing year-to-date performance to an astounding 14%, the highest return in almost 15 years. The sector outperformed the Barclays Capital U.S. Treasury Index by 502 basis points for the quarter and by 16.92% year-to-date.

Strong third-quarter performance was primarily driven by the increased saving rate, concerns about tax hikes amid record federal deficits, the ongoing supply and demand imbalance, and record-setting cash flows into municipal bond funds. The resounding success of the Build America Bond program has led to a significant reduction in tax-exempt issuance. Year-to-date Build America Bonds and taxable issuance has comprised approximately 17% of all municipal supply.

We continue to closely monitor the financial health of municipal issuers as states and local governments struggle with lower income and sales tax receipts. These declining revenues will cause municipalities to continue to make difficult budget

cuts and likely raise taxes. History indicates that revenue collections are likely to continue deteriorating, as municipalities tend to lag the overall economy by several quarters, possibly years after a recession ends. Nevertheless, we remain cautiously optimistic on the municipal sector due to the impending tax hikes and the fundamental strength of municipal credit structures.

**STRUCTURED PRODUCT**

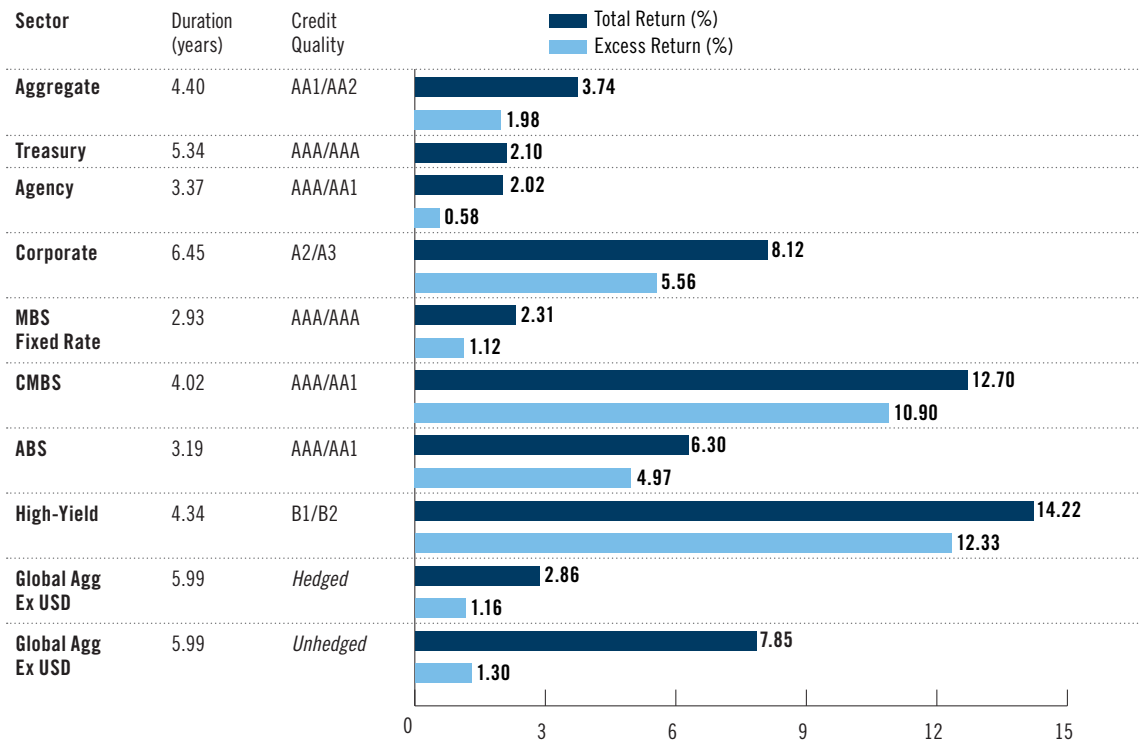
**Mortgage-Backed Securities** – The mortgage-backed securities (MBS) sector returned 2.31% for the third quarter of 2009. On a duration-adjusted basis, MBS outperformed U.S. Treasuries by 112 basis points, marking the third straight quarter of strong relative performance for the sector.

The Fed continued its purchase program in the

third quarter and announced that it would extend the program through the first quarter of 2010. These purchase efforts have been successful in maintaining low mortgage rates, and as a result the Fed now owns a majority of lower coupon bonds. In order to diversify, the Fed began purchasing higher coupon bonds and Ginnie Mae securities during the quarter—an action that has significantly changed the relative-value landscape for agency MBS.

Activity within the non-agency mortgage market was significant, as steady demand and a lack of supply caused prices to appreciate throughout the quarter. In particular, investors had a voracious appetite for seasoned, fixed rate bonds. While there may be little remaining upside for these bonds, the Public-Private Investment Program (PPIP) should have a similar impact on pricing in other sectors of

**Third Quarter 2009 Sector Statistics\***



\*Source: Source: Barclays Capital Indices, POINT. ©2009 Barclays Capital Inc. Used with permission. POINT is a registered trademark of Barclays Capital Inc. 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.

**Dwight Sector Specialists**

The Sector Review was written by the following sector specialists:



**Steve Clancy**

*Mortgage-Backed Securities*



**Jason Golder**

*Commercial Mortgage-Backed Securities*



**Kati Birmingham**

*Asset-Backed Securities*



**Eric Hiatt, CFA**

*Cash*

the non-agency market that are still undervalued.

The Fed has completed the bulk of its purchase program and we are concerned that mortgages will underperform without this large buyer in the market. As a result, we moved to an underweight position in agency MBS during the third quarter. Nevertheless, we believe that Fed purchases will fare well for Ginnie Mae performance in coming months and have thus tactically increased our Ginnie Mae holdings within our mortgage allocation. We continue to hold our core agency position in specific bonds with characteristics that shield them from large prepayments. In non-agency MBS, we have opportunistically sold positions that have appreciated significantly over the last two quarters. We have also sold a few seasoned bonds with nominal yields in the 4–5% range, and continue to hold those positions that we believe have more upside potential.

#### **Commercial Mortgage-Backed Securities** –

The commercial mortgage-backed securities (CMBS) sector continued to rally in the third quarter, providing a total return of 12.70% and outperforming duration-matched Treasuries by 10.90%. The story was similar to that of the second quarter; the sector continued to sustain fundamental deterioration, but also experienced a strong technical bid as a result of general economic optimism, government stimulus, and attractive relative value.

The Term Asset-Backed Securities Loan Facility (TALF), which significantly benefited asset-backed securities earlier in the year, provided a strong boost to the CMBS sector. TALF and non-TALF investors scooped up eligible securities, driving spreads aggressively tighter. As the quarter wore on, the TALF-eligible securities stalled in a range of swaps plus 200–400 basis points. This compelled some investors to reach for yield among downgraded senior tranches, mezzanine and junior AAA bonds, floating rate CMBS, and interest-only securities that were not TALF-eligible. With the Public-Private Investment Program still on the horizon and an economic recovery in sight, investors increased their risk appetite in the third quarter and found the CMBS sector attractive relative to investment-grade

corporates, asset-backed securities, and agency debt.

The CMBS sector continues to face uncertainty. Many investors have experienced solid returns for the year and may look to scale back trading activity, which will reduce liquidity in the fourth quarter. While we still favor the sector from a relative-value standpoint, we will monitor our overweight and continue to scale back on risk as we head into 2010. We will look to take advantage of short-term TALF and PPIP rallies, and reduce remaining portfolio volatility from ratings uncertainty and further fundamental deterioration.

**Asset-Backed Securities** – Relatively light supply and unrelenting demand led to further tightening of asset-backed securities (ABS) spreads during the third quarter. The ABS portion of the Barclays Capital Aggregate Index posted a total return of 6.30%, outperforming duration-matched Treasuries by 4.97% for the quarter.

Since the launch of TALF in March of 2009, spreads have compressed significantly within the ABS market. Initially, many of the newly issued deals were absorbed by participants of the TALF program, but in the third quarter, the larger allocation went to unlevered investors. Because TALF money managers were no longer able to achieve the desired levered yields at current spread levels, many took profits on their TALF holdings and began investing in more esoteric bonds and extending further out the maturity curve. These actions should continue to compress spreads on those types of assets going into year-end and signal a renewed sense of confidence in the ABS market. Moreover, the declining use of government support indicates that this market should eventually be able to stand on its own.

Heading into year-end, we expect to reduce our home equity exposure through amortization and select sales. We will be patient in our approach as we expect certain holdings to benefit from new demand arising from the launch of the Public-Private Investment Program.

While the outlook for the general health of the consumer is still bleak, we will opportunistically reinvest in the consumer sector as we believe these

bonds provide a solid risk-adjusted yield. The enhanced credit support provided by issuers and overall tighter underwriting standards should reduce the credit risk that consumer ABS bonds are exposed to. Furthermore, we believe that the strong supply and demand differential in the ABS market should continue to support the rally that we have experienced to date in 2009.

**CASH**

With the Fed holding rates at record-low levels, nearly all corners of the credit market have seen a recent increase in prices that has resulted in lower risk premiums. In the money markets, supply constraints have made it more challenging for investors to find quality issuers that offer a palatable return on investment. After trading with negative yields last year, Treasury bill yields are once again hovering near 0%, with the 3-month bill closing out the month of September at 0.11%.

To be sure, the massive liquidity injection by global central banks has clearly served to supplement a large share of the private credit pullback. The Fed continues to purchase large volumes of Treasury,

agency, and agency-guaranteed mortgage-backed securities. The Fed has also been funding a number of facilities that provide support to the short-term credit markets in the wake of the disruption last fall (for example, the Commercial Paper Funding Facility [CPFF] and the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility [AMLF]). As one might expect, however, these facilities have been relied upon to a lesser degree as markets have improved.

The number of commercial paper issuers has decreased, and banking institutions with alternative funding mechanisms are less inclined to borrow. While these factors have improved liquidity dramatically, they have also contributed to the historically low yields money market investors are now facing. As the economy continues to rebound and the Fed slowly drains liquidity from the market, we expect to see a gradual increase in short-end credit rates. We will continue to monitor the ability of money markets to operate efficiently in the evolving absence of Fed support and ahead of proposed changes to the regulatory framework that governs money market funds. ■

**For more information:**

**Fixed Income, Stable Value & Consultant Relations**

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

Anicia Mendez  
Vice President  
802.383.4067  
amendez@dwright.com

**Cash Management**

John Donohue  
Executive Vice President  
617.391.0229  
jdonohue@dwright.com

Kevin Zimmerman  
Vice President  
617.391.0269  
kzimmerman@dwright.com

**Insurance**

Donald Hill  
Senior Vice President  
802.383.4062  
dhill@dwright.com

John Loud  
Vice President  
802.383.4047  
jloud@dwright.com

100 Bank Street  
Suite 800  
Burlington, VT 05401  
802.383.4000

535 Boylston Street  
Suite 4A  
Boston, MA 02116  
617.391.0043

One SW Columbia  
Suite 1720  
Portland, OR 97258  
800.929.4427

[www.dwright.com](http://www.dwright.com)

This information reflects the viewpoint of Dwight Asset Management Company LLC as of Third Quarter 2009 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.