

## CREDIT CRUNCH DEEPENS

### Fixed Income Sector Review

#### Corporates

The fourth quarter was reminiscent of the third quarter in the corporate bond market. Corporates underperformed duration-matched Treasuries by 262 basis points, a showing slightly worse than the third quarter, which itself had been the worst quarterly excess return performance for the corporate market in the last five years. Spreads widened by 53 basis points during the fourth quarter after widening by 48 basis points during the third quarter. As was the case in the third quarter, however, the sector still generated a positive total return of 1.97%, with the decline in interest rates more than offsetting the impact of the spread widening. For the full year, spreads on corporates widened 111 basis points, and the sector generated a total return of 4.56%, underperforming duration-matched Treasuries by 523 basis points.

The weakness during the quarter was driven by many of the same themes that predominated in the third quarter: huge subprime-related asset write-downs; further weakness in the housing market; the forced selling of assets by SIVs; concerns about the impact of the credit crunch and higher energy and commodity costs on the broader economy; fears that the Fed is behind the curve in addressing market concerns; heavy new issue supply; diminished Street liquidity; and forced selling by hedge funds to meet margin calls.

As was the case in the third quarter, financials were once again among the hardest-hit sectors as the banks and brokers continued to struggle with asset quality issues. Homebuilders also continued to significantly underperform relative to other sectors as the housing recession deepened. The consumer cyclical and transportation sectors underperformed as well, as the market grew concerned about rising energy costs and the impact of a potential recession.

Our underweight to corporates during the quarter again helped the relative performance of our portfolios. In the first quarter of 2008, however, we are beginning

to find valuations more compelling. Although corporates will continue to face challenges in a slowing economy, we see the current spread widening and cheap new issuance as a potential opportunity to gradually increase our exposure to the sector.

#### Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned 3.06% during the fourth quarter of 2007 and 6.90% for the full year. On a duration-adjusted basis, MBS returned 21 basis points less than Treasuries during the quarter, bringing annual underperformance to 177 basis points. Despite lagging the return on Treasuries, MBS fared quite well compared to other spread sectors during both the quarter and the year.

MBS continued to be plagued in the fourth quarter by the same liquidity constrictions that affected the entire financial market. Credit-related asset write-downs by financial institutions increased in both size and frequency, causing balance sheet capital to be an ever more precious commodity. The reticence of large banks to hold MBS on their balance sheets helped drive spreads wider throughout the period. This was exacerbated by the fact that foreign investors, who had been a critical source of demand for MBS earlier in the year, reacted to both heightened volatility and a weak U.S. dollar by retreating somewhat from the market. A third blow to the sector came in the form of continued heavy supply in the agency MBS market, as credit constraints closed off most other outlets for mortgage production.

Despite the litany of negative financial news and the ineluctable weakening of the housing market, MBS managed to stay ahead of more credit-sensitive fixed income sectors, including ABS, CMBS, and corporate bonds. The credit guaranty provided by agencies such as Fannie Mae and Freddie Mac gave holders of MBS some comfort, as did the expectation that the housing morass would keep prepayment risk muted, even in the face of rapidly declining interest rates.

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- ▶ Overall, 2007 proved to be a challenging year for the MBS market, as heavy supply in the first half of the year combined with the credit squeeze in the second half kept investors on the defensive. We expect that 2008 will yield somewhat better results for the sector as some semblance of normality gradually returns to the market. Nevertheless, we open the year only slightly overweight to MBS versus our benchmarks. While we still feel that the sector's underperformance has resulted in MBS offering an attractive spread versus Treasuries, the carnage in other high-quality sectors has been far worse. Thus, we feel that our investment capital may be better utilized in those areas rather than in MBS.

### Commercial Mortgage-Backed Securities

The commercial mortgage-backed securities (CMBS) market endured another volatile quarter in the last three months of the year, with significant spread widening leading to notable underperformance relative to the broad market. According to the Lehman Brothers Aggregate Index, CMBS returned 2.25%, lagging duration-matched Treasuries by some 217 basis points. The performance was attributable to continued stress in the financial markets, as well as concern about a deterioration in credit fundamentals owing to a slowing economic outlook. The average option-adjusted spread in the CMBS component of the index widened 51 basis points in the fourth quarter to end the year at 170 basis points, up from just 62 basis points at the end of 2006.

Despite a sharp decline in issuance, investors continued to balk at new offerings that were characterized by a prevalence of interest-only loans and high loan-to-value ratios. Due to the lag time between loan origination and deal issuance, the bulk of loans securitized and offered for sale in the fourth quarter had been originated earlier in the year amid more favorable market conditions, when loan underwriting standards were still very aggressive. But as the liquidity crisis deepened and the economic outlook deteriorated, demand for new issues declined sharply. Many of the new deals languished,

with significant portions of lower-rated mezzanine tranches remaining unsold and taking up valuable space on dealer balance sheets. Spreads on CMBX credit default swap (CDS) indices also widened sharply, as some market participants used CDSs to hedge existing credit positions or to speculate on further declines in commercial real estate fundamentals. For instance, spreads on CMBX series 3 BBB- more than doubled during the first half of the fourth quarter, hitting a high of over 1100 in November.

We maintained our overweight to CMBS in the fourth quarter and continued to express an up-in-quality bias within our portfolios. We favored senior and super-senior AAA-rated classes, along with more conservatively underwritten seasoned bonds, and we feel strongly that the fundamental risk/return profile of these securities looks attractive relative to more credit-sensitive sectors. We expect to maintain this position into the first quarter of 2008, as we believe that structural credit protections in senior classes are more than sufficient to protect against the expected rise in loan delinquencies.

### Asset-Backed Securities

What started out the year as just a subprime problem continues to spill over into the broader market. Credit and liquidity concerns, along with an erosion of capital among financial institutions, fomented unease among investors, pushing spreads near or through their historically widest levels over the last few months of the year. Because this problem has been most felt in the structured products markets, just about any securitized asset has taken a beating. As a result, asset-backed securities (ABS) ended the fourth quarter with a total return of -0.76%, as measured by the Lehman Brothers Aggregate Index. Excess returns were even worse as the average option-adjusted spread in the ABS component of the index widened 98 basis points, leading to 408 basis points of underperformance relative to Treasuries on a duration-adjusted basis. While all subsectors

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▶ posted negative excess returns, the home equity sector fared the worst, returning a negative 12.23% for the quarter.

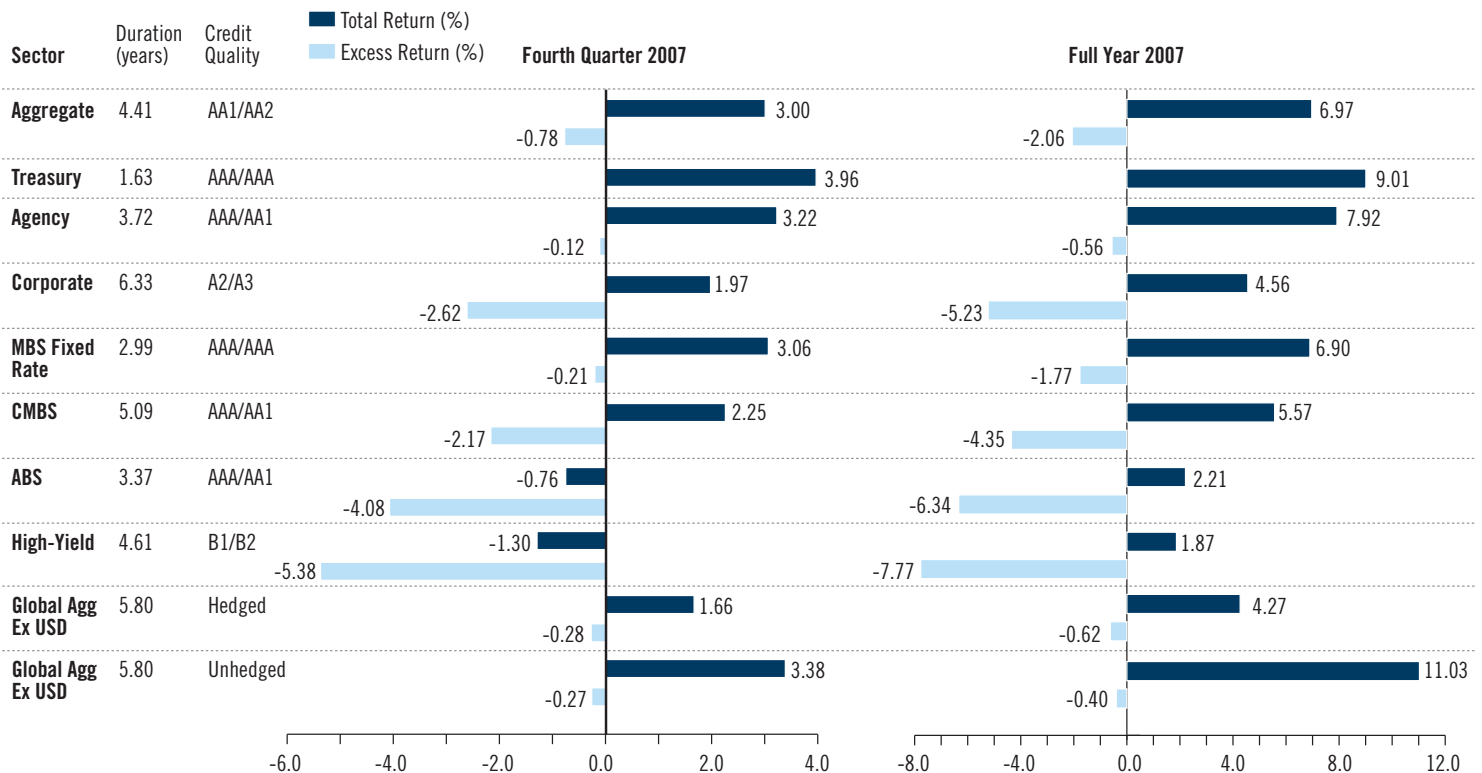
Falling home prices, tighter lending standards, waning consumer confidence, and an economy teetering on recession will most likely keep spreads susceptible to further short-term widening. That said, from a purely fundamental perspective, spread widening in many areas of the ABS market seems overdone, and we believe there may be compelling opportunities at the top of the capital structure for those who are willing to take a long-term view with their investment strategy. Investors should favor having hard collateral, predictable cash flows, and structural protections such as over-collateralization,

a reserve account, and protective triggers. Triple-A-rated prime retail autos, for example, are currently trading at historically wide spreads and should provide attractive excess returns over time, even in a recessionary environment.

In the New Year we expect to maintain our overweight to the highest-quality home equity and equipment lease-backed paper. With little or no home equity issuance expected in 2008, however, we expect that overweight to gradually decline as our positions amortize. We also expect to take advantage of historically wide consumer ABS spreads by reducing our underweight to autos, credit cards, and rate reduction bonds.

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Figure 1: Fourth 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. The Lehman Brothers 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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► **High-Yield**

The high-yield market retreated in the fourth quarter amid concerns that the ongoing credit crunch will lower economic growth and negatively affect corporate earnings. The market returned -1.30% in the final quarter for a less-than-stellar 1.87% total return for the year. Results were much worse when measured against duration-matched Treasuries, as high-yield provided a negative 5.38% excess return. The fourth quarter was characterized by early optimism following signs that the primary market was thawing and that systemic liquidity issues were being addressed. However, that optimism quickly dissipated as weakening economic data fed nervousness that the housing and subprime problems were infecting other areas of the economy. Both Merrill Lynch and Citigroup replaced their CEOs following mounting subprime write-downs. That uncertainty essentially led to the closing of the primary market for new issues in both the leveraged loan and high-yield markets. In fact, the fourth quarter witnessed the lowest issuance of new paper since the last quarter of 2002, when the markets were recovering from the Enron and WorldCom corporate governance scandals.

All told, approximately \$150 billion was issued in the high-yield market in 2007, \$110 billion of which was sold during the first half of the year. The year 2007 was a tale of two markets. The first half witnessed near-record issuance of low-quality, poorly structured paper that fed the LBO machine. Total returns through June 15 were approximately 4.5%. The second half of the year was characterized by

the seizing of the CLO market in the aftermath of the subprime mortgage correction. Banks that had underwritten LBO deals that had been agreed on only weeks before were stuck with hundreds of billions of “covenant lite” bonds and loans that were unattractive to institutional investors. As a result, the high-yield primary issuance market was closed for much of the second half of the year, with intermittent periods of issuance by well-known companies.

Over the past year, high-yield spreads have widened over 300 basis points to approximately 575 basis points—the widest level in four years. What started out in June as a technical correction in response to subprime weakness has morphed into a fundamental contraction of credit. The \$240 billion of loans and bonds that banks have retained on their balance sheets consume an inordinate amount of capital that would ordinarily be used to generate more lending and to provide liquidity through capital markets activity. Ironically, the fundamental backdrop in the high-yield market is not entirely

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▶ negative, as the trailing twelve-month default rate remains well below historical averages at 1.5%. However, despite the attractive default statistics, the market appears to be fairly valued as expectations of lower economic growth will likely lead to an incremental increase in defaults. In addition, the massive level of bond and loan inventory that the banks possess could potentially negatively affect the market. Overall, downside risks currently outweigh upside potential for most high-yield debt issues. Risks include increased Treasury and equity volatility, an increase in default rates, and an ongoing decline in residential real estate values, potentially weighing on overall economic growth. Although market liquidity is currently adequate, any decline could have sharply negative implications for market returns. We continue to believe that certain issues offer value, but that the broader market is likely to experience more spread widening in 2008. Therefore we expect to maintain our bias toward high-quality credits, and we will remain highly selective with new purchases.

## Municipal Bonds

Although the municipal bond market had a negative tone for the fourth quarter, the 1.37% total return for the Lehman Brothers Municipal Bond Index actually compared somewhat favorably, with a return of only 1.96% for the first nine months. For the year, however, the total return of the Lehman Municipal Bond Index at 3.36% underperformed the 9.01% return for the Lehman Brothers U.S. Treasury Index by 565 basis points. Feeling the reverberations from the U.S. housing market meltdown, the curve continued to steepen, with the 2s/30s Municipal Market Data (MMD) AAA spread widening in the quarter by 32 basis points to 135 basis points. By comparison, at year-end 2006 the 2s/30s spread was 55 basis points. New issue volume for the quarter totaled \$102 billion, putting 2007 total volume at a record \$428 billion, surpassing 2005's previous record of \$408 billion.

The market continued to struggle with a variety of issues that weighed on the municipal landscape. Contagion from the subprime market, growing concerns about the capital adequacy of bond insurers, and technical, legal, and tax-related uncertainty led to increased volatility in the fixed income markets and a flight to Treasuries. As a result, municipal bond spreads widened in general, and the market became bifurcated between high-grade bonds and lower-quality names. Lower-quality names turned out to include bonds insured by such companies as XL Capital and FGIC, as these insurers' ratings themselves came under pressure. This in turn led to investors' reverting back to analyzing the underlying credit of municipal bonds. James Grant, editor of Grant's Interest Rate Observer, predicted "a new bull market in credit analysis in the perennially over-insured and under-analyzed realm of municipal finance."

Municipals will begin 2008 with a plethora of factors weighing on the sector. Issuers will be more reluctant to use insurance, so we should see a considerable decline in the number of issues that come to market with a monoline guaranty. New issue volume for the year is expected to be in line with 2007's record volume of \$428 billion. A slowing economy and lower tax receipts could lead to pressure on municipal credit quality, including increased budget gaps and pressure to increase taxes.

On a positive note for the stability of the market, we expect the U.S. Supreme Court to uphold the status quo by overturning the Kentucky Court of Appeals in *Davis v. Kentucky*, maintaining the state's right to exempt interest income on in-state municipal bonds while taxing the income on out-of-state bonds. We believe the Federal Reserve will continue to reduce the federal funds rate throughout the year, which in turn will lead to a steeper municipal curve, most likely in the range of 150 to 200 basis points. Municipals remain extremely attractive for investors as a solid, high-quality,

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► low-risk sector, and with municipals presently trading at or above 100% of Treasuries, relative value metrics are compelling. Should there be continued dislocation among the insurers, it may present opportunities to buy good-quality credits at attractive yields. We continue to believe that this may present a compelling entry point to initiate a long-term position in municipal securities.

## Global Bonds

The Lehman Brothers Global Aggregate ex-U.S. dollar returned 3.38% for the quarter and 11.03% for the full year (both on a total-return basis) on an unhedged basis versus the U.S. dollar. On a hedged basis the index returned 1.66% for the quarter and 4.27% for the full year.

During the fourth quarter of 2007 the contagion from the subprime crisis in the United States continued to spread to the global fixed income and credit markets. The quick intervention of authorities in Germany prevented the near collapse of two German banks with excessive exposure to the U.S. subprime market. The situation became more dramatic in the United Kingdom, with both the government and Bank of England (“BOE”) initially underestimating the risks, leading to a classic run on the deposits at Northern Rock. The subsequent reluctance of banks to lend to each other led to a dramatic widening of credit spreads, and borrowing rates rose dramatically as the year-end approached. The bond markets continued to witness a flight to quality as expressed in a widening of credit spreads, swap spreads, and peripheral markets, with investors preferring the perceived safety of the U.S. Treasuries market and the German treasuries market.

The deterioration in the interbank market forced the BOE and European Central Bank (ECB) to accommodate the market with emergency funding facilities. In addition, the Central Bank of Canada cut its key lending rate on December 4 from 4.5% to 4.25%, and the Bank of England cut its overnight lending rate by 25 basis points (5.75% to 5.5%) on

December 6. The ECB found itself in a classic catch-22 scenario. While the primary mandate of the ECB calls for it to ensure price stability, it faced a slowdown in the economic output within the Euro zone, along with a liquidity problem in the financial sector and higher-than-acceptable inflation numbers.

Despite the hawkish rhetoric from the ECB, we believe that economic realities will force the Central Bank to cut rates during the second half of the year; this should cause a steepening of the Euro zone yield curve. The deterioration in the U.K. housing market might force the BOE into further rate cuts and should provide investment opportunities in the U.K. Treasury (Gilt) market.

One major theme in 2007 was the dramatic appreciation of currencies like the Canadian dollar (plus 16.25% versus the U.S. dollar) and the Euro (plus 13.8% versus the U.S. dollar). Deterioration in the global economic environment, combined with a cycle of interest rate cuts by the major central banks in Europe (BOE, ECB, and Swiss National Bank), could signal a partial reversal of the appreciation of the major currencies versus the U.S. dollar. The British pound appears to be especially vulnerable for a major correction of the GBP exchange rate versus the Euro and versus the U.S. dollar, given risks in the U.K. housing market. With a backdrop of a global slowdown (if not a recession), we could see a further weakening of the Japanese economy as well, which should postpone all talk of possible tightening by the Bank of Japan (BOJ). ■

*Written by Dwight Sector Specialists*

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