DWIGHT
ASSET MANAGEMENT COMPANY

ECONOMIC & BOND MARKET QUARTERLY UPDATE

FOURTH QUARTER 2009

2010 Outlook

Just over a year ago, the 10-year Treasury was flirting with a 2% yield and investor enthusiasm for anything other than Treasuries was virtually non-existent. The S&P 500 had returned -37% for the calendar year 2008 and fell even lower through the first quarter of 2009. The global economy was going through a massive deleveraging, confidence in the financial system was at a nadir, and the possibility of the next Great Depression was being widely discussed. However, the catalysts to the mayhem of that period have been well documented. We would like to use this opportunity to discuss the progress that has been made since that bleak period, and more importantly, what we can expect in the year to come.

Central banks and governments around the globe have implemented unprecedented monetary and fiscal easing policies to soften the blow of pervasive deleveraging in the private sector. These measures began to generate their desired effects over the course of 2009, as evidenced by improved valuations across the risk spectrum, dramatically improved liquidity in the structured product universe, and apparent bottoming in such key series as home prices, initial unemployment claims, and auto sales, among others. We had two quarters of positive GDP growth during the second half of 2009, and we are estimating GDP growth for 2010 to be greater than 3%. Despite this overall improvement, however, the economy spent 2009 on life support and remains in a fragile and transitional phase as we enter the new year. A key concern for 2010 is whether the economy can continue to survive as its support system is gradually withdrawn.

Frank Koster
Chief Investment Officer

It is intuitive to think that interest rates should rise in the scenario of a self-sustaining and slowly recovering economy (particularly on the short end of the spectrum, where the fed funds rate is effectively 0% and the 2-year Treasury is yielding a parsimonious 1%), but the

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Fixed Income Sector Review

GOVERNMENT-RELATED DEBT

Steadily improving economic conditions and heavy new issuance put upward pressure on Treasury yields during the fourth quarter, leading to a loss of 1.3% in the Treasury component of the Barclays Capital Aggregate Index. The yield curve also steepened as the Fed reiterated its commitment to holding the target overnight lending rate at the zero-bound for an "extended period" while Congress continued on a path of seemingly unrestrained federal spending. Net of maturities, the Treasury issued over $250 billion in new securities and increased its total debt outstanding by more than $400 billion in the fourth quarter, to finish the year with over $12.3 trillion worth of IOUs. Yields on 2- and 10-year notes rose 19 and 53 basis points, respectively, while the yield on 30-year bonds rose almost 60 basis points, closing at 4.64%, just shy of their highest level of the year.

Meanwhile, with more than $1 trillion of excess reserves sloshing around on the Fed's balance sheet, some investors also began to grow increasingly concerned about the risk of an eventual buildup of inflationary pressures. This view was manifested in a continued widening of TIPS inflation breakevens, which increased from an implied 10-year rate of inflation of 1.75% at the beginning of the period to over 2.4% by the end of December. Moreover, 5-year forward 5-year inflation breakevens, a closely watched gauge of long-term inflation expectations, rose over 30 basis points in the fourth quarter to end the year above 3%.

Agency securities and other government-related debt outperformed Treasuries during the fourth quarter as a scarcity of AAA-rated bonds left investors with limited alternatives for their

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2010 Outlook, *continued from the front page*

Fed may delay this inevitable outcome. Given what has transpired in financial markets in conjunction with the dramatic policy responses put into place, the Fed is essentially out of ammunition. Consequently, the Fed will want to be absolutely certain that the economy is getting around of its own volition before elevating the fed funds rate. While rates will likely be higher a year from now, we expect that this time, the path to higher rates will occur over a more protracted period than during prior economic recovery cycles.

We believe risk assets will generally be rewarded in 2010, given our view of a stabilizing and improving economy, exceptionally high levels of liquidity, and normalizing capital markets. Both investment-grade and high-yield credit should do well, though the spread tightening that has already transpired in these sectors makes it mathematically impossible for them to perform as well as they did in 2009. Nevertheless, we believe that solid positive excess returns for the year are likely. (Historically, the corporate bond market has done exceptionally well in the periods immediately following a recession and has posted several subsequent years of less-spectacular, but still strong, returns—we expect the current cycle to repeat this past performance.) One caveat is that, because the market has improved from the extremely oversold conditions of earlier in the year, it will be important to conduct intensive, bottom-up fundamental research on individual credits. Significant differentials between winners and losers are to be expected in this transitional environment.

The mortgage market, meanwhile, was at the epicenter of the financial crisis and has necessarily played a critical role in the recovery. Washington's initiatives in this sector have been focused on providing liquidity and have taken many forms, from insuring leverage secured by outstanding mortgages, to loan modification programs and outright purchases of newly created agency mortgages (over $1 trillion to date). These programs have been largely effective in supporting the housing market, with a collateral effect of extremely rich valuations across the agency mortgage sector. The majority of these support initiatives are scheduled to expire over the next several months, and whether the mortgage market can stand on its own remains to be seen. Nevertheless, we are optimistic that the recovery will continue as long as market interest rates do not rise too much or too quickly.

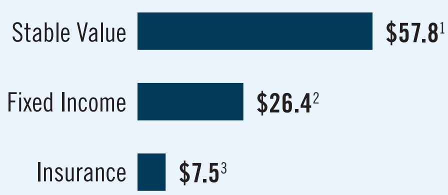
We expect the economy to lurch through this period because many headwinds still remain. Mortgages will have to cheapen as support programs expire, which will cause financing rates for homeowners to increase. This will retard the recovery in home prices. Residential delinquency rates are still increasing (albeit at a decreasing rate) which provides an additional headwind, as does the inventory of foreclosed and unsold homes. In the meantime, the commercial real estate market has been receiving a lot of negative press lately, and delinquency rates are likely to continue to rise there as well. These factors will undoubtedly continue to delay economic progress, but, as the old adage goes, bull markets climb a wall of worry.

Overall, we believe that risk will be broadly rewarded in 2010, perhaps not in spectacular fashion, but in solid, positive returns. We also expect corporate credit to fare well in the year ahead, though intensive fundamental research will be critical to success in this sector. In the context of an improving economy and a contained (though upward-trending) interest rate environment, investors should be relatively happy a year from now, provided they are willing to take their money from underneath the mattress and apply it to capital markets today. ■

Dwight Asset Management Company LLC
Total Assets as of 12/31/09:

$68.8 Billion

Assets by Product Strategy ($ Billions)



1. Includes assets also included in the fixed income total managed for stable value clients.
2. Includes assets also included in the stable value and insurance totals.
3. Includes assets also included in the fixed income total.

Please Note: Stable value separate account and commingled fund data is as of 11/30/09.

International Bond Market Update

The year 2009 will go down in history as the year governments around the globe successfully stared down the Great Recession. However, the cost of rescuing the world was enormous and future generations will have to foot the bill. While our outlook for the U.S. economy is optimistic, we expect an extreme dispersion of growth prospects around the globe.

The People's Republic of China came to the world's rescue in 2009. Not only did the Chinese help to fund our ever-growing budget expenditures here in the United States, but they also stimulated their domestic economy with aggressive investment programs. The Chinese economy is expected to grow at a rate of between 9% and 10% real GDP in 2010. The combination of easy money and an undervalued currency might cause the Chinese economy to overheat, and could also lead to a dangerous speculative asset bubble. Furthermore, there is a risk that politically motivated rhetoric from both U.S. and Chinese officials debating the "fair value" of the renminbi might flare up at any time, leading to threats of retaliatory trade sanctions.

In Japan, we expect an anemic recovery, which is threatened by chronic fears of deflation (the consensus forecasts for 2010 real GDP growth and CPI are 1.4% and -1.3%, respectively). The problem in Japan is further compounded by an aging population, which has created an insufficient demand for consumer products. In the age of the global debt supercycle, all eyes will be on the new government, its budget and any potential action by the rating agencies. While we do not expect it any time soon, we cannot rule out a downgrade of Japanese debt in the future.

The recovery of the eurozone economy continues to be a tale of the "haves" and the "have-nots." We expect Germany to grow by 2.5% (the consensus forecast is 1.9%), but fear that Spain's economy will continue to contract in 2010. Unemployment is expected to stay at high levels of around 10% in Europe (with Spain at an astonishing 20.3%). Inflation appears to be well contained for the time being, but we are concerned that the deterioration in public finances throughout Europe, whether at the federal or the municipal level, will lead to unprecedented increases in indirect taxes such as the fees levied for public services, including trash collection, permits, and parking.

When we look at Europe, we also have to address the "Greek Tragedy." The incoming, left-wing government was punished as rating agencies downgraded Greece from A- to BBB- with a negative outlook, and as Greek debt instruments experienced dramatic spread widening. A projected public sector debt-to-GDP ratio of 123% in 2010 and a budget deficit-to-GDP ratio of 12.7% not only violate the European Union stability criteria of 60% for the former and 3% for the latter, they are also a recipe for disaster. Greek debt came under pressure when market participants feared the worst: a path that would ultimately lead to default. The government presented a plan to reduce its debt burden and budget deficit to levels within E.U. criteria by 2012; but only time will tell if the administration will be successful, and we remain skeptical.

The turbulence surrounding Greece weighed on the euro at year-end. Some market participants even debated whether problems in Athens could force the country to abandon the common currency. While we do not underestimate the challenges ahead, we also do not believe that these fears are justified—there is simply too much at stake. The reintroduction of the Greek drachma would cause massive devaluation speculation in Greece that would likely lead to social unrest and put the country at risk of being ostracized by the rest of the European Union. On the flip side, a euro that excludes Greece would almost certainly have the foreign exchange speculators putting a bull's eye on their next target, which would most likely be either Spain or Portugal (whose budget deficits and domestic problems have already triggered downgrades by S&P). Notwithstanding clear language to the contrary in the European charter, we do not expect that other members of the eurozone would be willing to take the risk, and

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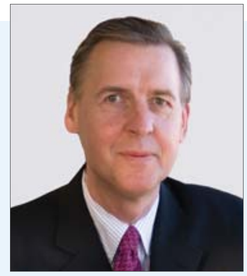

Peter Vutz
Head of Corporate Credit International, Non-Dollar

Economic Update

Jane Caron, CFA
Chief Economic Strategist

While the official arbiter for economic cycles has yet to call the date the Great Recession ended, we believe it happened last June. More importantly, we believe the recovery that took hold during the second half of 2009 will not only be sustained, it will accelerate. Real GDP growth should average about 3.5% in 2010 as the natural forces of the business cycle (pent-up demand and inventory rebuilding, in particular) encourage an acceleration in already-formed positive economic feedback loops.

Our forecast is notably above the Bloomberg consensus forecast of 2.6%, yet we still worry that our forecast is too low given the lagged effects of large-scale fiscal and monetary stimulus and no signs that policymakers are anxious to withdraw it. Indeed, additional fiscal stimulus is likely to be forthcoming, and there are members of the Federal Open Market Committee (FOMC) who believe the Fed may need to extend its large-scale asset purchase program beyond the planned March termination date.

The fact that Washington is still willing and able to extend stimulus is one of the key reasons that we are sanguine about the risks of a sharp deceleration or dip back into recession this year. The Fed is well aware of the high costs associated with a double-dip in growth or extended deflation, so we think the FOMC is operating with an inflationary bias that will remain in place until the Fed is confident that downside risks to growth and inflation are manageable. Congress, meanwhile, is very worried about high unemployment. Indeed, Washington seems far more concerned about the economy's near-term growth prospects (and the November election) than the medium-term consequences of running massive fiscal deficits.

Central to our forecast that real GDP growth will accelerate at an above-consensus rate are the following assumptions: (1) we are not headed into another jobless recovery; (2) the personal saving rate will rise by only a modest amount; (3) business investment spending (apart from structures) will rebound; and (4) the housing market will remain in a recovery mode. We should mention that we are also counting on Lady Luck to keep exogenous shocks at bay. For example, significantly higher commodities prices, natural or unnatural disasters, or a major breakdown in the symbiotic relationship with China could all wreak havoc on the economy and markets. Major policy mistakes could also occur given that massive public support will begin to be removed this year.

A recovery in the labor market is central to a sustained economic recovery. Almost all economists agree that the labor market is steadily improving, but there are mixed opinions about where it will level off. Some economists look for a repeat of the last two recoveries, which were essentially jobless—payrolls were either flat or down in the first year of recovery—while others look for the more typical, V-shaped rebound. Our view is that companies will seek to operate as leanly as possible, but they will still hire at a rate that lifts payrolls by 1–1.5% as final demand picks up near a 3% rate. Hours worked should expand at a faster clip than payroll growth because current staff will be asked to work longer hours to meet increased demand. Our forecast is well short of a "V," but it should generate enough income to support both real consumption growth of about 2–2.5% and a small increase in the saving rate.

While it was a very sharp decline in consumption that initially dialed up the severity of the recession, it was the ensuing collapse in business investment that caused GDP to contract by nearly 5.5% in the final quarter of 2008 and 6.5% in the first quarter of 2009. During this period, companies slashed investment and labor at staggering rates. Now that capacity utilization is rising again at a fairly rapid clip, we look for a rebound in capital goods spending. Investment in structures, however, should remain weak as the lagging commercial real estate correction continues to unfold.

Residential investment spending should continue to improve in line with a sustained recovery in the housing market. Quite simply, residential investment spending is extraordinarily low from a historical perspective, and this sector is bouncing off the bottom. Public efforts to support the housing market have been unprecedented and are largely to thank for the recovery. Some economists are concerned that the withdrawal of public support will upend the recovery, but we believe moderate growth will persist as long as market interest rates do not rise by a lot more than we expect.

Long-term interest rates have remained low despite shockingly high Treasury issuance because of strong demand from the Fed, foreign central banks, U.S. banks, and other domestic investors. In 2010, the Fed will drop out as a major buyer, but most other sources of demand should stay in place. Treasury coupon supply will increase significantly, however, and this should result in higher interest rates. For example, we expect 10-year yields to rise by more than 100 basis points and approach 5% in 2010 despite slowing inflation and a still highly accommodative Fed.

We look for core consumer inflation to average about 1% in 2010 compared to 1.5% in 2009. While it is impossible to accurately gauge the extent of resource underutilization, it is safe to say that it is massive. Thus, we doubt that 2010 will be a year of marked acceleration in either cost-push or demand-pull inflation. We are a bit concerned, though, about the potential for rising inflation expectations given alarming trends on the fiscal front and efforts by Washington to inhibit Fed independence. Other potential sources of pressure on inflation expectations include risks for renewed dollar weakness and rising commodities prices. The Fed itself could push inflation expectations higher if its policy stance appears to be incongruous with economic activity.

The Fed is now challenged with the task of normalizing monetary policy without overly disrupting the recovery. While the Fed has repeatedly stated that it has the tools to do this, it is clear that the Fed is not entirely sure about how and when to use them. The numerous back-stop liquidity programs can simply be wound down and terminated as they are no longer needed, but the huge amount of excess reserves remaining on the Fed's balance sheet cannot be dealt with as easily. New programs such as large-scale reverse repos and a term deposit facility are being designed to lock up reserves, but the only way to extinguish reserves in a timely manner is to sell assets on the Fed's books. That could cause long-term rates to shoot higher, so the Fed is unlikely to use this tool anytime soon.

We believe the Fed will seek to gain better control of excess reserves during the second quarter. If it is successful, then it will have more time to adjust policy in a gradual fashion, and that would bode well for a sustained expansion. As part of the gradual return to normalcy, we expect the Fed to start lifting the target funds rate this year by 125 to 150 basis points. There are significant risks around this call, however, because this forecast depends on a host of variables, including employment trends, private credit creation, inflation, fiscal policy, and market conditions.

It is the outlook for fiscal policy that is the most uncertain variable in the list. So far, Washington has not even started to put together a credible plan to reduce the pace of debt accumulation. The federal fiscal deficit, after rising from 3% of GDP in 2008 to 10% in 2009, should remain near 10% in 2010 and will unlikely fall below 5% in the foreseeable future. Federal debt, meanwhile, is on track to rise from 41% of GDP in 2008 to 55% in 2009 and 75–100% by 2020.

While we could write pages about the fiscal situation, suffice to say that we can be sure that taxes will be headed higher…much higher. In fact, one of the key risks for the economy after 2010 is a marked deceleration in growth in reaction to higher interest rates and tax burdens. That story we will save for the future, but you can be sure that this subject will be on investors' minds later this year. Thus, one should enjoy these early months of 2010 while the Fed and Washington are still focused on supporting the economy rather than cleaning up their bloated balance sheets. ■

The numerous back-stop liquidity programs can simply be wound down and terminated as they are no longer needed, but the huge amount of excess reserves remaining on the Fed's balance sheet cannot be dealt with as easily.

DWIGHT SECTOR SPECIALISTS

The Sector Review was written by the following sector specialists:

Derrick Wulf, CFA
Government-Related Debt

Scott McIntyre, CFA
Investment-Grade Corporates

Sean Slein, CFA
High-Yield Corporates

Keith McCarthy
Municipal Bonds

Fixed Income Sector Review, *continued from the front page*

high-grade portfolios. Continued large-scale purchases of agency debt and agency mortgage-backed securities by the Fed and scant new issue supply in asset-backed and commercial mortgage-backed securities helped drive spreads on agencies five basis points tighter on average, according to Barclays Capital Aggregate Index data. The modest incremental yield earned on these securities, coupled with the spread tightening over the period, produced excess returns of 37 basis points over Treasuries. Government-guaranteed bank debt issued under the FDIC's Temporary Liquidity Guarantee Program (TLGP) also tightened in spread during the quarter, but remains cheap relative to agencies. Although the TLGP sector does not enjoy the same liquidity as the agency market, its unconditional federal guarantee and spread advantage make it an attractive alternative to Fannie and Freddie debentures.

Given the unresolved questions concerning the future of the housing agencies and the absolute level of spreads, we believe that investors are no longer adequately compensated by owning agency debt and are generally underweight the sector relative to our broad-market benchmarks. We continue to believe that risks are skewed toward higher interest rates in 2010 and are positioned slightly short of our duration benchmarks. While we do not anticipate a rapid rise in inflation in the near term, we believe that real yields are likely to remain biased higher. The factors supporting this view include ongoing improvement in economic conditions, continued heavy debt issuance, an increase in private sector borrowing, and the gradual completion of the Fed's large-scale asset purchase programs and eventual removal of monetary policy accommodation. While the economy remains vulnerable to an exogenous shock, barring any major surprises we anticipate that yields on 10-year Treasuries will breach 4% and possibly rise above 4.5% by the end of the year.

CORPORATE CREDIT

Investment-Grade Corporates – Investment-grade corporate bonds closed out a historic year with a solid quarter, posting a total return of 1.35% and outperforming duration-matched Treasuries by 3.07%. The sector posted a total return of 18.68% for the year and beat Treasuries by 22.76%, with an option-adjusted spread that ended the year 383 basis points tighter at 172 basis points.

Corporates began the quarter on a solid footing as economic data and third-quarter earnings generally came in better than expected. This fundamental backdrop, combined with a dearth of issuance during the earnings black-out period, caused the corporate market to reach new tights in early November. This rally came to a sudden halt later in the month, however, as state-owned Dubai World announced a standstill on near-term maturities, indicating liquidity issues. With the prospect of a default in the Middle East, both the international and domestic debt market paused to re-evaluate risk in their respective markets. Ultimately, a cash injection from Abu Dhabi aimed at easing Dubai World's liquidity concerns and a continuation of the aforementioned fundamental and technical factors helped the rally to regain momentum.

While the market remains in recovery mode from an economic standpoint, valuations are certainly not where they were twelve, six, or even three months ago. This indicates that while value remains in the corporate sector, diligent credit selection and sector rotation will become more important in adding value for 2010. That said, we are maintaining an overweight to corporate bonds with an overweight to the banking, and metals and mining sectors. Primary risks to our view include a disruption in the economic recovery, a dramatic uptick in corporate leverage led by aggressive merger and acquisition activity or shareholder-friendly behavior, and an unexpected increase in new issue supply.

High-Yield Corporates – The high-yield market closed out 2009 with an impressive 6.19% total return for the fourth quarter. Incremental improvement in key economic indicators coupled with an active primary calendar provided the impetus for advancement. Excess returns against duration-matched Treasuries approximated 6.90% as the high-yield sector was able to absorb the late-year increase in Treasury yields. For the year, the Barclays Capital High Yield Index returned a record 58.21%, a far cry from the -26.16% return the sector provided in a panic-stricken 2008.

As increased tolerance for risk returned to the financial markets, the primary market reopened—initially to the highest-quality issuers and eventually to all companies along the credit spectrum. Ready access to the primary markets allowed companies teetering on the precipice of default to restructure their balance sheets and refinance near-term maturities. Increased investor demand for paper allowed companies to term out senior lending facilities and extend bond maturities. With greater flexibility, many companies now have several years to grow into their capital structures as the economy continues to mend. Accordingly, the default rate—which began the year at 5.53% and peaked in November at 13.76%—is expected to decline closer to historical averages and approximate 5% by the end of 2010.

Despite the remarkable rally in high yield, we believe that spreads remain compensatory given our constructive economic view. We will retain our high-quality bias as spreads of lower-quality CCC names have rallied much more relative to higher-quality tiers and offer less compelling risk-adjusted return potential. In addition, we expect to continue to actively participate in the primary market, given attractive pricing and deal structure. Lastly, we will continue to actively reassess our overall strategy pending changes in our economic view and in the quality and depth of the primary market.

Municipal Bonds – The municipal bond market continued to benefit from very limited tax-exempt issuance and strong demand throughout 2009. The Barclays Capital Municipal Bond Index returned -0.96% in the fourth quarter, and put in a phenomenal year-to-date performance of 12.91%. The sector had its best year versus the Barclays Capital U.S. Treasury Index in 2009, outperforming by 34 basis points for the quarter and 16.84% for the year.

Total issuance for 2009 came in at $409 billion, the second-highest level on record. Tax-exempt issuance was down slightly from 2008 levels, while taxable issuance increased to $85 billion, which includes approximately $64 billion in Build America Bonds. A supply-and-demand imbalance that left a dearth of long paper, the relative safety of the asset class, and continued concerns about impending tax hikes were the primary contributors to municipal bond performance during the year.

The current highest federal tax bracket of 35% will sunset at the end of 2010 and revert back to 39.6%. Many states have already raised taxes, and we expect that to continue into the foreseeable future as states look for ways to close budget gaps. While tax hikes should increase the appeal of tax-exempt municipal debt, we also believe investors will continue to harbor concerns about some of the same issues we have discussed throughout the year, namely the deterioration of state and local government tax receipts, declining property values, headline risk, ratings downgrades, double-digit unemployment, and record federal deficits.

STRUCTURED PRODUCT

Mortgage-Backed Securities – The mortgage-backed securities (MBS) sector returned a meager 0.57% in the fourth quarter of 2009. On a duration-adjusted basis, MBS outperformed Treasuries by 75 basis points, marking the sector's fourth straight quarter of strong relative performance. For the year, mortgages returned 5.89% and outperformed Treasuries by 495 basis points. Mortgage-backed securities had an incomparable year as they began 2009 near their cheapest valuations ever, and finished near their richest.

The Fed continued its purchase program and was the main contributor to MBS performance for both the quarter and the year. As rates rose in December, mortgage supply from originators dried up while

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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

Fixed Income Sector Review, *continued from page 7*

the Fed continued to buy, causing MBS to richen.

Non-agency mortgage prices were relatively stagnant for much of the quarter as most dealers closed their books early and were unwilling to take any risk for the remainder of the period. For the year, however, prices were up massively. The credit crisis peaked around the end of the first quarter, and since then prices have increased 20 to 40 points. Similar to other structured product sectors, supply-and-demand dynamics overwhelmed fundamentals. Despite deteriorating collateral, valuations increased significantly, indicating that investors were running less-draconian scenarios.

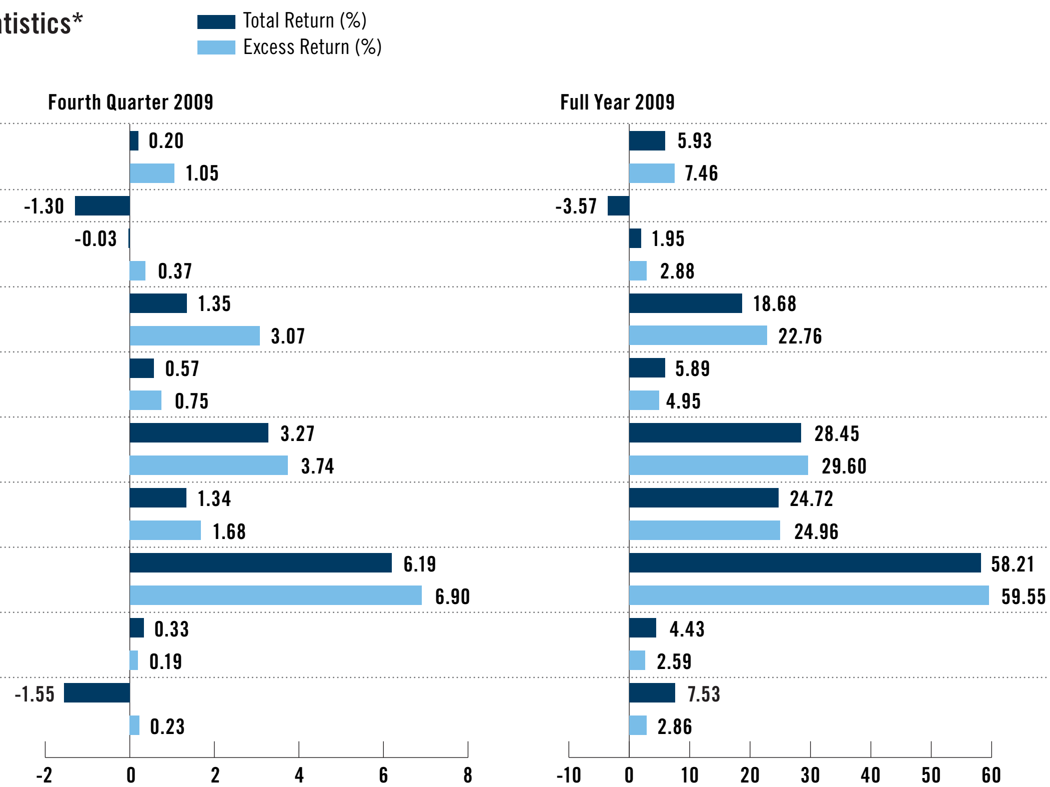
We increased our underweight position in agency MBS during the fourth quarter. With the Federal Reserve nearing the end of its purchase program, we continue to be concerned that mortgages will perform poorly without that backstop. We expect non-agency mortgages to perform well going into 2010, as investors search farther afield for ways to add value.

Commercial Mortgage-Backed Securities – The commercial mortgage-backed securities (CMBS) sector finished the year on a positive note, providing a total return of 3.27% and outperforming duration-matched Treasuries by 3.74% in the fourth quarter. The CMBS sector was the top-performing sector in the Barclays Capital Aggregate Index for the year, posting total and excess returns of 28.45% and 29.6%, respectively.

The big news of the quarter was the re-emergence of the CMBS new issue market. In mid-November, Goldman Sachs brought a deal to market resembling those that originated the securitized commercial

Fourth Quarter 2009 Sector Statistics*

Sector	Duration (years)	Credit Quality	Fourth Quarter 2009 Total Return (%)	Fourth Quarter 2009 Excess Return (%)	Full Year 2009 Total Return (%)	Full Year 2009 Excess Return (%)
Aggregate	4.57	AA1/AA2	0.20	1.05	5.93	7.46
Treasury	5.13	AAA/AAA	-1.30		-3.57	
Agency	3.26	AAA/AA1	-0.03	0.37	1.95	2.88
Corporate	6.35	A2/A3	1.35	3.07	18.68	22.76
MBS Fixed Rate	3.57	AAA/AAA	0.57	0.75	5.89	4.95
CMBS	3.95	AA1/AA2	3.27	3.74	28.45	29.60
ABS	3.31	AAA/AA1	1.34	1.68	24.72	24.96
High-Yield	4.30	B1/B2	6.19	6.90	58.21	59.55
Global Agg Ex USD	5.91	*Hedged*	0.33	0.19	4.43	2.59
Global Agg Ex USD	5.91	*Unhedged*	-1.55	0.23	7.53	2.86



*Source: Barclays Capital Indices, POINT. ©2010 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.

real estate market in the 1990s—a single borrower with a small number of relatively large but very conservatively underwritten loans. The solid deal structure and improved loan underwriting brought buyers to the table and the bonds traded well. Other broker-dealers followed suit with similar deals, and more are said to be in the pipeline for 2010.

Government programs continued to provide a backstop to the CMBS sector. However, lack of clarity from the Fed and Treasury concerning acceptable collateral and compressed spread levels contributed to diminished utilization of both the Public-Private Investment Program (PPIP) and the Term Asset-Backed Securities Loan Facility (TALF).

During 2009 we saw strength in technical factors drive spreads in the CMBS market tighter in spite of deteriorating fundamentals. While we believe the sector's positive carry and relative value are compelling, it appears that there will be a steepening of the credit curve as investors increasingly favor performing loans and well-structured deals, leading to a division between the "haves" and the "have-nots." Our bias toward solidly underwritten, earlier-vintage deals and bonds that sit at the top of the credit structure should benefit from this steepening. We will continue to keep a slight overweight in the sector and monitor sector fundamentals in an effort to minimize portfolio risk.

Asset-Backed Securities – The asset-backed securities (ABS) sector of the Barclays Capital Aggregate Index posted a total return of 1.34% and outperformed duration-matched Treasuries by 1.68% for the fourth quarter of 2009. The sector showed significant improvement during the year, posting a total return of 24.72% and outperforming duration-matched Treasuries by 24.96%. Outperformance was widespread among ABS subsectors; however, the auto and credit card market were the primary contributors to overall returns.

The initiation of the Federal Reserve's TALF program was instrumental to the improvement of the consumer ABS sector. This program revitalized the new issue market and brought interest back to the sector. TALF managers and money managers alike were pleased with the increased credit enhancement, solid underwriting, and overall structural strength of the ABS deals. As spreads tightened and the volatility of the market decreased, investors aggressively returned to the ABS market, allowing it to become one of the top performers in the Barclays Capital Aggregate Index for 2009.

ABS consumer products ended the year very quietly, as issuance was muted and many investors were satisfied with their current positioning. The subprime market continued its recovery from lows earlier in the year, a trend partially driven by the Public-Private Investment Program contributing to positive sentiment and the Street building up inventories in anticipation of increased investor demand. Lack of supply, combined with increased investor interest, outweighed deteriorating fundamentals.

Going into 2010, we expect the volume of issuance to be flat to slightly lower than the 2009 level. TALF concludes in March and issuers may look for alternative sources of funding. Supply will likely remain constrained, which could lead to further tightening of spreads. We will opportunistically reinvest in the consumer sector, concentrating on top-tier, AAA-rated classes with low spread duration. While we are comfortable with our current subprime positioning, we will continue to sell bonds that we believe to be overvalued relative to weakening fundamentals.

CASH

In the money market sector, year-end supply constraints sent short Treasury yields into negative territory. The federal effective rate, the average rate at which depository institutions lend balances to one another, closed out the year at a record low of 0.05%. Some investors were forced to pay depositors to take their late day funds so as to avoid even stiffer

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As spreads tightened and the volatility of the market decreased, investors aggressively returned to the ABS market, allowing it to become one of the top performers in the Barclays Capital Aggregate Index for 2009.

For more information:

Fixed Income, Stable Value & Consultant Relations
Lisa Trubiano, CFA
Senior Vice President
802.383.4066
ltrubiano@dwight.com

Anicia Mendez
Vice President
802.383.4067
amendez@dwight.com

Liquidity Management
John Donohue
Executive Vice President
617.391.0229
jdonohue@dwight.com

Kevin Zimmerman
Vice President
617.391.0269
kzimmerman@dwight.com

Insurance
Donald Hill
Senior Vice President
802.383.4062
dhill@dwight.com

John Loud
Vice President
802.383.4047
jloud@dwight.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.dwight.com

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penalties for uninvested cash imposed by clearing banks. This abundance of liquidity is clearly evident by observing the spread between LIBOR and the overnight indexed swap (OIS) rate, which is a measure of the willingness of banks to lend. This LIBOR-OIS spread, which widened to over 350 basis points in the wake of the Lehman collapse, closed the year at a meager 9 basis points. This places us well below the 25 basis point threshold widely considered normal.

As evidenced by the broad-based asset inflation that emerged in the second half of the year, investors have once again embraced the risk trade. What is difficult to discern, however, is how much of the rebound in the economy is the result of government spending and subsidy versus real demand. The debate surrounding an exit strategy for the Federal Reserve is sure to heat up this coming year as the Fed tries to stay ahead of the curve. In the meantime, the Fed has been quick to reassure anyone who will listen that it has "no shortage of tools" for firming policy…when the time is right. ■

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suspect that they will be supportive if necessary. Failing to do so would lead to a situation in which a euro issued in Spain, for example, could be worth less than one issued in Germany, and we do not believe this is a viable option.

Last but not least, the United Kingdom should finally have its long-anticipated elections in May. The prospect of a hung parliament makes the markets shudder, given the number of challenges the country is already facing. The economy is expected to grow modestly with a consensus forecast of 1.2%, but the United Kingdom is already experiencing a mild upturn in inflation that should be slightly concerning for the Bank of England. The public sector finances are worrying the financial markets and the rating agencies. While its coveted AAA rating seems to be safe for now, we believe that the United Kingdom is in real danger of losing it unless the incoming government is willing to make some unpopular choices to rein in its budget deficit.

The bet on virtually indifferent spread tightening has largely run its course, and security selection will be the key theme in 2010. The market will continue to pay close attention to the action of rating agencies and the perceived credit quality of government borrowers. Central banks are expected to carefully signal their intentions to mop up excess liquidity. Nevertheless, we continue to be concerned that central banks around the globe will not be able to strike the fine balance of effectively draining 2009's massive liquidity injection without pricking the next speculative asset bubble or endangering the recovery by tightening to soon. The global debt supercycle suggests that interest rates are going to continue their upward trend, driven by the massive supply of government bonds worldwide.

We expect the dollar to modestly appreciate versus most currencies due to the improving economic prospects in the United States. However, the recent dollar strength should not be seen as a ringing endorsement of American policies, but rather the result of the greenback profiting from troubles in other countries and currencies. Any further unexpected deterioration of our finances, such as massive expansion of entitlement programs, would undermine the potential for the dollar's recovery. ■

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