

ECONOMIC & BOND MARKET QUARTERLY UPDATE

SECOND QUARTER 2007

POSITIONING PORTFOLIOS FOR EVENT RISK IN THE CORPORATE BOND MARKET

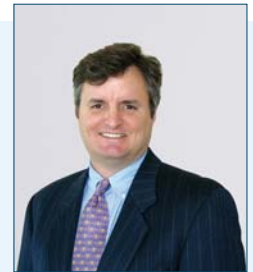
For a three-year period starting in mid-2002, the interests of stockholders and corporate bondholders were nicely aligned. Following the peak in corporate defaults that year, shareholders learned that in a highly levered world, their investments could be completely wiped out in the bankruptcy process. As a result, shareholders encouraged companies to pay down debt as quickly as possible to minimize default risk and thereby improve stock prices. The deleveraging was successful for both stockholders and bondholders as the Dow Jones Industrial Average rose by 13% and the Lehman Brothers U.S. Credit Index outperformed the overall market by 580 basis points during the same period. In this environment, a corporate bond portfolio manager could focus on the same business fundamentals that drive outperformance versus benchmarks in the equity markets.

Leveraged Buyout Risk

Starting in mid-2005, however, we started to be concerned about growing shareholder activism at the expense of bond-

holders (see Dwight's article "[Event Risk Takes Center Stage](#)"). Corporate defaults plunged from all-time highs in 2002 to very low levels by 2005. Shareholders quickly forgot the perils of high debt levels and encouraged companies to redirect the use of free cash to pay dividends and/or buy back stock, rather than to pay down debt. What is now good for stockholders is not necessarily good for bondholders.

Some management teams started to raise debt in order to finance stock repurchases and special dividends. Still others, bowing to pressure from activist shareholders, bought out their public shareholders altogether by increasing their debt load to multiples of preexisting levels. The resulting leveraged buyouts



Michael Cazayoux
Sector Portfolio Manager

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SUBPRIME MARKET CAPTURES HEADLINES

Fixed Income Sector Review

Corporates

The second-quarter total return for corporate bonds was a negative 0.76%, primarily because of higher interest rates and the sector's longer duration. Excess return was almost flat, as spread widening largely offset the sector's yield advantage for the quarter. On a swap-adjusted basis, corporates tightened slightly compared to the other spread-asset sectors, which, with the exception of agencies, have widened. Spreads started off the quarter on a fairly strong basis, recovering somewhat from the widening experienced in March, but then they gave up significant ground in June, widening by 6 basis points as volatility picked up again.

The corporate market's recent and near-term performance has been buffeted by factors largely beyond the sector's control. The near collapse of the Bear Stearns hedge funds has intensified

concerns regarding the potential for spillover effects from losses in subprime mortgages into other levered sectors of the market. Fears of a broader repricing of credit have already spread to the secured bank loan market, in which the financings for some recent LBOs have run into difficulties. U.S. Foodservices, ServiceMaster, and Thomson Learning have had to postpone and

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Positioning Portfolios, continued from front cover

In the current environment, the safest strategy a corporate bond portfolio manager can follow is to target those sectors in which a strong balance sheet is a prerequisite.

► (LBOs) were good for stockholders but were often devastating to existing bondholders. In a typical LBO from last year, HCA, the largest for-profit hospital operator in the country, took itself private in a \$33 billion LBO. Over a five-month period, from the time the rumors first emerged to the time the scale of the leveraging was fully appreciated, their 10-year corporate bonds widened by 340 basis points, which resulted in a 22-point loss for existing bondholders!

The pace of LBOs has spiked up in the last year-and-a-half with \$188 billion worth of LBOs announced just in the first quarter of this year, according to Bloomberg (see Dwight's article "[The New Face of Leverage in the Financial System](#)"). The acceleration has been fueled by global liquidity and the prevalence of cheap financing exemplified by the combination of low interest rates and record tight spreads in the high-yield market. Meanwhile, equities have remained relatively cheap, on a price-to-earnings ratio basis, at a time when nearly every other asset class is trading at a premium. As long as financing remains on favorable terms, earnings stay strong, and stocks stay relatively cheap, the current LBO wave is not likely to ebb.

Trends in Private Equity

Private equity firms have been steadily raising funds for the past ten years, but until recently they found few opportunities to put money to work. As a result, the funds have accumulated into a considerable war chest that is currently estimated to approach \$600 billion, according to JPMorgan. With the ability to leverage that equity by as much as five times, these firms have the potential to control as much as \$3 trillion worth of LBOs.

These firms, such as Blackstone, KKR, and Carlisle, have recently shown a willingness to pool their resources in order to go after larger targets. Nine of the ten all-time largest LBOs have occurred in just the last two years, with RJR Nabisco the lone exception. In the 1980s, LBO targets were typically

smaller companies. Now, with the proliferation of private equity funds and hedge funds, the competition for smaller takeover targets has become crowded, driving up prices and therefore driving down returns. Currently the private equity firms are teaming up into consortia that have allowed them to make \$30 billion to \$40 billion LBOs somewhat routine. At that size, few companies would be considered too big to be off-limits, and since investment-grade corporate bond issuers are typically the larger, more established companies, this latest wave of LBOs has been particularly pernicious to bondholders.

Portfolio Positioning

In the current environment, the safest strategy a corporate bond portfolio manager can follow is to target those sectors in which a strong balance sheet is a prerequisite. Banks, brokers, and insurance companies are the most obvious sectors because their ongoing financing costs and their sound financial conditions are integral to their business prospects. Electric utilities and other regulated industries also provide a safe haven. Regulated industries typically provide what is considered a vital community service; as such, the regulators are loath to allow them to take on excessive leverage or to pursue any other policy that might lead to risk of insolvency.

In other sectors where LBO risk has been prevalent, greater care must be taken to identify and avoid those individual credits that are the most likely takeover targets. To help in this regard, many broker-dealers have developed programs designed to identify companies that are most at risk. These "LBO screens" look for objective financial data that have been characteristic of takeover targets in the past. They typically flag the following attributes.

- An underperforming stock price, which indicates a vulnerability to shareholder activism

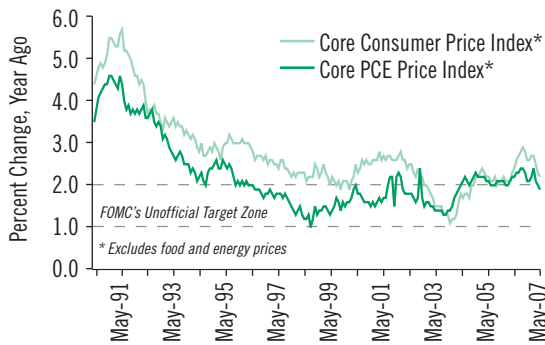
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ECONOMIC UPDATE

Recap—Fed Policy Has Worked Well So Far

The close of the second quarter marked the one-year anniversary of a 5.25% federal funds rate, a policy that worked well. During the last year, real GDP growth slowed to a moderate rate, and core inflation slipped back into the Fed’s comfort zone of 1%–2% (see Figure 1). When the Fed stopped tightening a year ago, inflation was high and still rising, while the economy showed signs of overheating. The housing market was entering a downturn, however, so Fed policy makers gambled that they could step aside.

Figure 1: Core Consumer Inflation
Core Consumer Inflation Still Under Control



Source: Global Insight

One year later, the economy is in decent shape. The housing market is still in a downturn, but real GDP growth should average 2.75% in the final two quarters of 2007, and it should grow between 2.5%–3% next year. Annual core PCE inflation, currently at 1.9%, should end the year little changed before drifting higher in 2008. In such an environment, the Fed can leave policy unchanged.

This placid forecast rests on some key assumptions. First, we assume that the housing market correction will remain a sideshow. We also assume that the current reduction in global liquidity will not turn into a credit crunch. Furthermore, we assume that oil prices will continue to trade in a \$60 to \$80 range. These are very reasonable assumptions, but the impact will be signifi-

cant if any of them prove incorrect.

Economic data in the second quarter showed marked improvement compared to first-quarter reports. The ISM manufacturing index rebounded 6.7 points to 56.0 in June, up from the weak January reading of 49.3. Similarly, the June ISM nonmanufacturing index also rebounded to its highest level in more than a year at 60.7, compared to 52.4 in March. Strength today contrasts with earlier weakness caused by slowing demand and bloated inventories, and this raises the question of whether strength will continue once inventories are rebuilt. Nonetheless, the rebound in the ISM indices have displaced earlier concerns that the economy is in a downturn (see Figure 2).

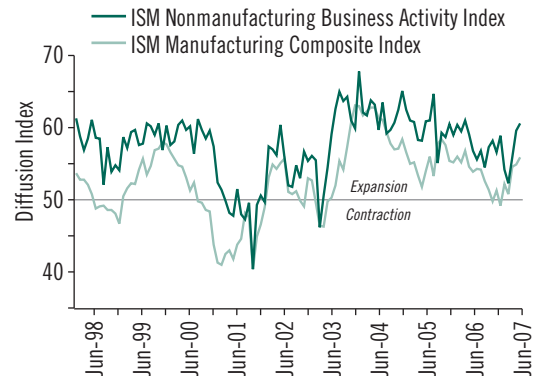
Commercial construction also accelerated in the second quarter because of broad-based demand for hotel rooms, office space, power plants, etc. Real spending on commercial structures probably increased at an annualized pace in excess of 15% in the second quarter, a very impressive yet unsustainable pace. Real capital goods spending also improved in the second quarter but remained muted near a 4% rate. This sector should show more strength in the quarters ahead.

Employment growth, the linchpin of the economy, remained steady in the second quarter, with the average monthly payroll gain near 150,000 and the unemployment rate little changed at 4.5%. Most economists, including us, thought employment growth would be slower in 2007 in light of residential construction layoffs, but such expectations have not



Jane Caron, CFA
Chief Economic Strategist

Figure 2: ISM Purchasing Manager Indices
Impressive Second-Quarter Rebound Bodes Well for GDP Growth



Source: Global Insight

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Economic Update, continued from page 3

- ▶ been fulfilled. Instead, income growth has been strong, and this bodes well for sustained consumption growth.

View—Focus on Housing Sector and Global Liquidity

The one sector of the economy that gives us pause is the housing market. Home sales peaked in the fourth quarter of 2005, and building starts peaked a few months later. Since then, declines have been precipitous: starts have fallen to mid-1990s levels; new home sales are back to 2001 levels; existing home sales are back to 2003 levels. Inventories of homes for sale have surged to levels not seen since the 1990–1991 recession. National home-price inflation, which has already decelerated sharply, appears set for a period of no appreciation or even deflation. The risk of a deeper downturn is significant, particularly if the labor market falters.

The subprime mortgage market is feeling serious pain. Loose lending standards have allowed many

bonds linked to subprime mortgages are down sharply, and this has led to margin calls and forced selling. Such routs occasionally happen in financial markets; they often amount to nothing more than tempests in teapots despite the severe level of angst. This may prove to be the case this time, but we worry that something more sinister is afoot. Perhaps we know too much about this event, given that we have been studying the collateral under these bonds for years.

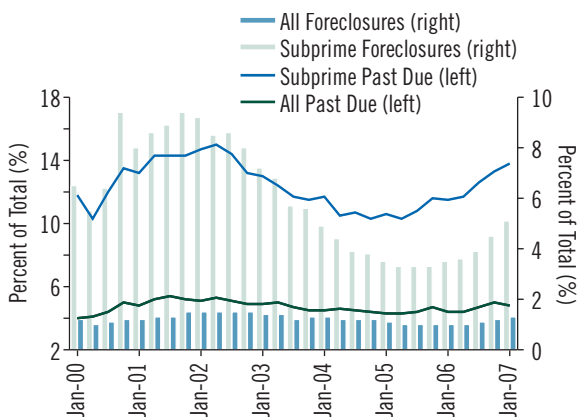
Even if subprime problems fade away unnoticed—which is not our expectation—we think that this event is indicative of the more widespread problem of adjusting to a world of lower liquidity (defined as the availability of funds for investment or consumption). A few years ago, the Fed, along with other major central banks, brought interest rates down to unusually low levels in hopes of stimulating demand. This liquidity rush, coupled with the global savings glut, soaring commodity demand, and the advent of new financial instruments, helped stimulate global markets and economies. Indeed, it became a virtuous circle of easy money, strong growth, low volatility, and soaring returns. The problem is that traditional fixed income yields fell to such low levels that investors lost touch with conscionable levels of risk as they stretched for yield.

Starting last year, the tide of global liquidity began to turn. At first, the decline was hardly perceptible, but it became noticeable in 2007 as global central bankers pushed borrowing rates up to levels that are no longer accommodative. Additional policy tightening will push global interest rates into restrictive territory. With inflation at the upper end of most central bankers' tolerance zones, such tightening is likely.

Microliquidity also started to decline this year, as evidenced by events in the subprime, bank loan, and high-yield markets. Microliquidity is dependent on financial participants' willingness to commit capital and assume risk. Increasing volatility, as we saw in the second quarter, tends to weigh heavily on the

Figure 3: National Delinquency Survey

Problems to Date Confined to the Subprime Sector



Source: Global Insight and Department of Energy

people to enter into loans that were beyond their servicing capability. Foreclosures are now increasing rapidly as adjustable rate mortgages reset and owners discover that they cannot sell their houses or refinance without difficulty. The reset calendar is ominous for the next few quarters, and this bodes poorly for the sector (see Figure 3).

Problems in the subprime mortgage market are not spilling over to the prime market or the general economy, but they are causing reverberations in the finance world. Prices for subordinated tranches of

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Fixed Income Sector Review, continued from front cover

► restructure their recent deals as high-yield investors have pushed back against excessively leveraged or poorly structured deals. The resulting wider high-yield spreads have dampened sentiment in the investment-grade corporate sector as well.

We have long highlighted the strong positive technicals as a justification for historically tight corporate spreads. Those circumstances have changed in the last quarter. In addition to the concerns noted above, we have seen a recent surge in corporate new issuance (22% ahead of last year) that has pressured secondary spreads. Subprime concerns have slowed the synthetic CDO market, which had until this point provided a strong underpinning for valuations in the corporate sector. Additionally, we are seeing a pickup in the number and size of leveraged recapitalizations. Home Depot announced one of the largest-ever share repurchases, to be partially financed with \$12 billion of new debt issuance. Their CEO is quoted as saying that “swapping out expensive equity for cheaper debt is a solid strategy for a maturing company.” We are concerned that more companies may come to the same conclusion. Therefore we plan to maintain our underweight to the sector, and we may look for the opportunity to reduce further exposure.

Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned -0.50% during the second quarter of 2007, comparable to the overall Lehman Aggregate return of -0.52%. On a duration-adjusted basis, however, MBS returned 56 basis points less than U.S. Treasuries, the worst relative performance of any investment-grade sector.

During April and May, MBS performance was mixed. Volatility remained low, and demand for spread assets remained strong. These positive catalysts were offset by record levels of net fixed rate MBS supply. The heavy supply continued to be driven primarily by the flat Treasury yield curve, which encouraged borrowers to select 30-year fixed mortgages over adjustable-rate alternatives.

Market conditions turned more ominous in June, however, causing MBS to substantially lag other sectors. The first half of the month witnessed a significant increase in rates, with the 10-year Treasury piercing 5.30% at one point. This, when combined with a steeper yield curve, caused prepayment forecasts to drop and the durations of MBS to extend. The duration extension led to forced selling by active hedgers, such as mortgage servicers, at a time when supply was already difficult for the market to digest. Toward the end of June, the well-publicized difficulties in the subprime market caused an increase in volatility and a general flight to quality that put further pressure on spread assets, including MBS.

We came into the second quarter with an underweight in MBS relative to our benchmarks. Our rationale centered on the deluge of net supply and the fact that persistently low volatility had driven spreads to a level that left little margin for error. Subsequent to the spread widening in June, we returned our MBS weighting to neutral. While we acknowledge that further weakness is possible if market volatility continues to increase, MBS spreads now look more reasonable relative to other sectors. With this in mind, we would be more likely to view additional widening as a buying opportunity in the third quarter.

Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) had another difficult quarter as issuance once again broke records and investors grew increasingly cautious on credit. Over \$75 billion in new CMBS deals were priced during the second quarter, smashing the previous quarter's record of just over \$60 billion. The heavy issuance was fueled both by a favorable lending environment and by a booming commercial property market, where several high-profile REIT acquisitions were financed largely with secured debt.

Those favorable lending conditions, however, were characterized by high loan-to-value ratios and the

Market conditions turned more ominous in June, however, causing MBS to substantially lag other sectors.

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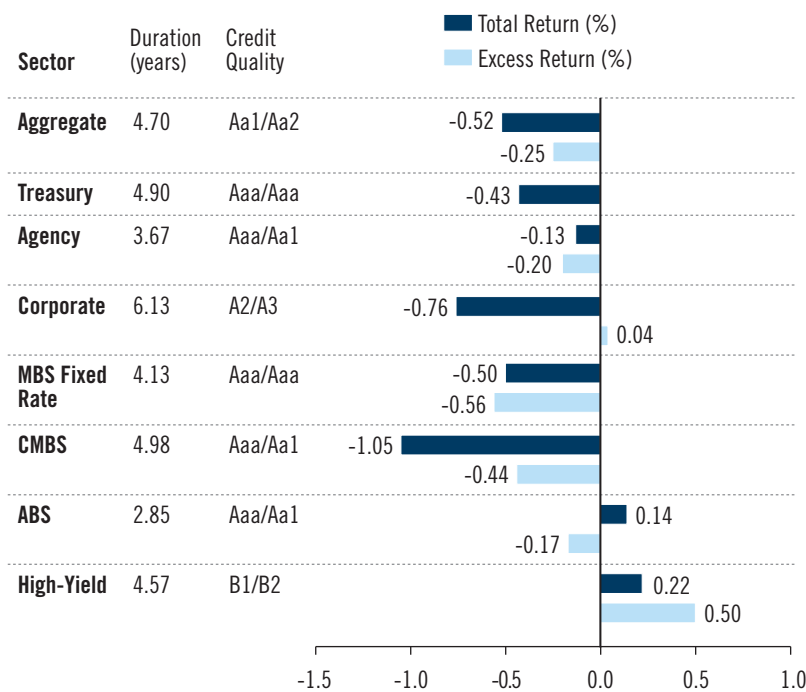
► increasing use of pro forma underwriting. Using pro forma underwriting, originators were able to increase loan amounts by giving properties credit for anticipated future increases in rental income, which in many cases translated into less than one-time debt-service coverage on in-place revenues. Investors balked and drew inevitable comparisons to the subprime mortgage markets, in which high degrees of leverage were largely to blame for the massive increase in defaults in just a short period of time. Many potential buyers viewed the underwriting assumptions as far too optimistic and shied away from new issues in favor of more seasoned deals with lower leverage and more conservative underwriting.

Spreads on the safest, senior-most classes in the CMBS capital structure widened only modestly, but spreads on mezzanine classes saw dramatic widening.

The lowest-rated investment-grade classes in the new issue market widened from approximately 180 basis points over swaps at the end of March, to about 250 basis points by the end of the second quarter. The average option-adjusted spread on the CMBS component of the Lehman Aggregate Index widened by 12 basis points, and the sector underperformed Treasuries by 44 basis points on a duration-adjusted basis. A widening of swap spreads also contributed to the underperformance relative to Treasuries.

We maintained our overweight to the sector but concentrated our holdings almost exclusively in AAA rated classes, especially higher-quality seasoned bonds. We continue to believe that weak underwriting and thin levels of credit support leave the more credit-sensitive classes vulnerable to further spread widening, especially as commercial real estate fundamentals soften in the latter half of this year, and we will maintain our high quality bias. We also intend to maintain our overweight in higher-quality CMBS relative to our underweights in agencies and high-grade corporates.

Figure 4: Second 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.

Asset-Backed Securities

The subprime mortgage market continued to capture headlines in the second quarter as delinquencies and foreclosures continued to rise, originators continued to fail, and hedge funds started closing their doors. In early April, New Century Financial Corporation filed for Chapter 11 bankruptcy protection as early pay defaults mounted and warehouse lines were squeezed. Once the second-largest originator of subprime mortgages in the United States, New Century now has the infamous title of the largest subprime lender to fail. Then, in June, the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund began to collapse. This was a levered hedge fund that invested primarily in bonds backed by subprime and Alt-A collateral. The combination of widening spreads at the beginning of the year and the

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Fixed Income Sector Review, continued from page 6

► leverage inherent in the fund caused poor performance early in the year, which prompted investors to withdraw their capital, forcing Bear to suspend redemptions to avoid a fire sale of assets.

As creditors began requesting additional margin on loans collateralized by the fund's holdings in CDOs, subprime mortgages, and other securities, Bear Stearns Asset Management (BSAM) was forced to liquidate some \$3.8 billion in securities to meet margin calls. Although the sales apparently went well, it was not enough to cover all margin requirements sufficiently, and Bear Stearns Co. eventually committed to a \$1.6 billion line of credit to enable the fund to liquidate assets in a more orderly manner. Many market participants feared that a forced liquidation of collateral could snowball into more market-to-market losses, leading to even more redemptions across similar vehicles, which would only aggravate the situation further. As a result, the ABX.HE indices, currently our best barometer for how investors feel about the subprime mortgage market, set new lows during the quarter. After rallying in April through roughly the middle of May, sentiment turned sharply negative, and the -BBB tranches of series 07-1, 06-2, and 06-1 indices closed the quarter down by approximately \$12.75, \$11, and \$6.5, respectively. As of June 29, 2007, an individual wanting to buy protection on the -BBB tranche of the 07-1 index would have to pay 46 points up front and 389 basis points running.

Despite the negative headlines surrounding the subprime mortgage market, the ABS index outperformed all other spread sectors in the Lehman Aggregate Index for the second quarter, returning 14 basis points of total return. When adjusting for duration, the ABS index underperformed Treasuries by 17 basis points, but it still outperformed most other sectors of the investment-grade bond markets.

Moving into the rest of the year, we remain cautious on the housing market and the potential for further subprime contagion in CDOs, other hedge funds, and the broader markets in general. To the extent that we are able to source home equity paper amid a dearth of

supply, we will continue to overweight the -AAA portion of the capital structure in addition to our overweight to equipment-lease-backed paper. However, if we are unable to source bonds, we will start to decrease our underweight to credit cards, autos, and utilities, while maintaining a full underweight to manufactured housing.

High-Yield

The high-yield market stumbled in June amid higher equity and treasury volatility. With a loss of 1.80% for the month, June turned in the worst monthly performance since March 2005, when General Motors' lowered earnings preannouncement sent shivers through the leveraged-credit markets. Heightened concerns of a contagion of subprime mortgage weakness to other leveraged asset classes led to the repricing of risk. However, for the quarter, high-yield

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Dwight Sector Specialists

The Sector Update was written by the following sector specialists:



Michael Cazayoux
Corporates



Josh Kruk, CPA, CFA
Mortgage-Backed Securities



Derrick Wulf, CFA
Commercial Mortgage-Backed Securities



Peter Milne
Asset-Backed Securities



Edward Meigs, CFA
High-Yield



Keith McCarthy
Municipal Bonds

Fixed Income Sector Review, continued from page 7

June was the second most active month for issuance on record for the high-yield market, despite the overall weak market tone.

► returned 0.22% on a nominal basis and 0.50% on a duration-adjusted basis, which bested all sectors of the investment-grade market. Investors were deluged by a heavy primary calendar of mostly lower-quality issues—namely, lower-rated, highly levered, poorly structured LBO financings. For the quarter, lower-quality issues continued to outperform the higher-quality; however, the June market decline took the heaviest toll on the lowest credit tiers. Leading sectors included energy, wireless carriers, pharmaceuticals, and automotive issuers; refining, paper, restaurants, and retail lagged the index.

June was the second most active month for issuance on record for the high-yield market, despite the overall weak market tone. With a total of \$105 billion of issuance so far this year, the market is on pace to easily break last year's record issuance of \$150 billion. As was the case in the first quarter, the bulk of issuance was lower-rated, acquisition-related financing—a far cry from the refinancing wave of issuance seen as recently as early 2006. However, reversing the trend of the first quarter, investors began to push back against issuer-friendly financing structures, such as notes with a PIK/toggle feature and “covenant lite” deals in the leveraged loan market. In fact, several new issues have either been pulled, as in the case of U.S. Foodservice and Catalyst Paper, or structurally modified to enhance covenant protection and pricing.

Despite the recent market weakness, we believe that the market remains overvalued. 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 that potentially weighs on overall economic growth. The near collapse of the two Bear Stearns hedge funds has cast a pall on the leveraged credit markets, as participants fear contagion either within the subprime mortgage markets, or outside these markets as banks and brokers reassess the risks in their securities lending portfolios. 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 we also 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 Municipal Bond Index for the second quarter of 2007 was -0.67% , compared with a return of 0.81% for the first quarter. During the past six months, municipals have underperformed Treasuries by 87 basis points. Total return for the year was more favorable in the short end of the curve with returns of 1.57% in the 1-Year Municipal Index, compared to -0.58% for the Long-Term Municipal Index. The lower-rated sectors of the municipal market continue to outperform the investment-grade sectors.

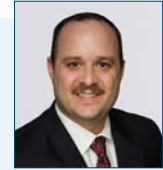
New issue volume for the quarter totaled approximately \$123.1 billion, putting year-to-date total volume at \$230.3 billion, 28% higher than the first six months in 2006 and 9.7% ahead of 2005's record of \$408.3 billion. Given this record pace, total volume for 2007 will likely set a new record. Municipal fund flows continue to remain positive, with AMG Data Services reporting 49 consecutive weeks of inflows into municipal bond mutual funds.

Municipals began the quarter with a flatter curve, with longer maturities offering very little value relative to Treasuries. However, with the subprime turmoil and future uncertainty about inflation, we saw the curve steepen from 58 basis points in April to 78 basis points at the end of June. Municipal bond buying surged, especially among retail investors as long-end rates increased. There was also noticeable activity being generated by tender option bond programs and tax-swapping, with investors selling longer 4.50% coupons and buying 5% structures.

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Andrew Apostol Joins Dwight as Client Portfolio Manager

Andy Apostol joined Dwight’s Client Portfolio Management Team in May. Andy’s extensive experience in the stable value market will help continue Dwight’s tradition of developing strong client relationships. Prior to joining Dwight, Andy spent the last 16 years as a Senior Account Manager for INVESCO’s stable value and fixed income business. He began his investment career in 1991 at Wyatt Asset Services where he worked as a consultant on stable value investments, pension plan liability transfers, and annuities. Andy earned a Bachelor of Science degree from the University of Oregon. He enjoys golfing, antique repair, furniture refinishing, and home improvement projects.



Andrew Apostol
Client Portfolio Manager

Steven Clancy Joins Dwight as Portfolio Manager, Mortgage-Backed Securities

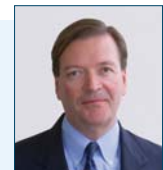
Steve Clancy joined Dwight’s Investment Team in May. Steve specializes in mortgage-backed securities. Prior to joining Dwight, Steve was a Trader on the CMO Trading Desk at Nomura Securities Inc. While at Nomura, Steve was involved in structuring and trading new issue Agency and private label CMO transactions in both the fixed rate and floating rate markets. Steve earned a Bachelor of Arts degree from Cornell University. In his spare time, he enjoys skiing, tennis, and wine collecting.



Steven Clancy
Portfolio Manager

Donald Hill Joins Dwight as Head of Insurance Business Development

Donald Hill joined Dwight’s Business Development Team in June. His more than 34 years of experience in the investment industry have been focused primarily in the insurance sector. Most recently, he was Senior Sales/Client Relations Manager for Babson Capital Management, and before that worked at Putnam Investments, First Boston, and Chancellor/Citigroup. Don earned a Bachelor of Arts degree from the University of Connecticut. He plays tennis and golf and enjoys sailing with his wife and two sons.



Donald Hill
Insurance Business Development

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► creation of liquidity. If volatility settles down again, liquidity should pick up. We sense a sea change, however, in investors’ willingness to accept risk: they are now demanding to get compensated for it. This is evidenced by wider swap spreads and the renormalization of the Treasury curve, where 10-year yields now command a term premium over 2-year yields. This change in attitude, along with increased volatility, is reducing microliquidity.

So far, the shift in liquidity has been damaging to a few market participants and individual subprime homeowners, but it has not damaged the overall economy. As long as the reduction of global liquidity occurs at a slow, controlled pace, the economy should adjust without serious consequences. The risk, however, is that the reduction in liquidity might turn into a credit crunch. This could happen if central banks unexpectedly increase their pace of tightening, or if the microsuppliers of capital and

leverage suddenly cut off the supply. Either event would have damaging repercussions to U.S. economic growth.

In such situations, the Fed prides itself on riding to the rescue. The Fed has long practiced a laissez-faire policy when it comes to market risk. They have used “buyer-beware” clauses in speeches to remind market participants about risk, but the Fed has not made a practice of trying to stop reckless behavior. Instead, they prefer to pick up the pieces after a crash.

We think that the economy is on a moderate growth path that is consistent with contained inflation and a steady Fed. The risks to this outlook favor a policy easing over a policy tightening, but with inflation still at the upper end of the Fed’s comfort zone, the hurdle for a policy easing is high. It would take a serious market event to bring in the Fed at this time, which is not likely in our view. ■

*Written by Jane Caron, CFA
Chief Economic Strategist*

A final layer of event-risk protection lies in the language of the individual securities themselves.

Portfolio Positioning, continued from page 2

- ▶ • Low enterprise value relative to cash flow, which makes an LBO more affordable
- Low leverage, which makes room for new debt capacity
- High and stable cash flows, which are supportive of higher leverage
- High cash balances, which can be used to provide partial financing

While these LBO screens are certainly a useful tool for portfolio positioning, they are not foolproof, and they often steer investors away from credits that actually could be good investments. Many of the criteria that flag a company as a takeover target, like low leverage and stable cash flows, are ironically the same things that are typically viewed favorably from a credit standpoint. This highlights the importance of considerations beyond traditional balance sheet and income statement analysis (see Dwight’s article “[The Importance of Credit Analysis in Today’s Corporate Landscape](#)”). It is important to understand a company’s culture. Has it displayed a tolerance for leverage in the past? Have any of its top managers ever worked at a highly leveraged company?

A final layer of event-risk protection lies in the language of the individual securities themselves. Increasingly, corporate bond investors have been pressuring companies to include protective covenants in their recent new bond deals. The most common type is “change-of-control” language, which allows the holder to redeem the bond in the event of an LBO. A second form of covenant protection, coupon “step-up” language, requires the coupon to increase by 25 basis points for each ratings-notch downgrade by both Moody’s and S&P. Both types of covenant language provide significant protection, and both are important to have when positioning the portfolio in sectors and in credits with significant event risk. As the language evolves for new issues, the corporate bond universe will increasingly develop into a market of haves and have-nots, where performance will be determined

as much on a bond-by-bond basis as it is on a credit-by-credit basis.




Conclusion

Event risk has become the primary challenge facing investment-grade corporate bond portfolio managers. This is not likely to change anytime soon, as long as public equities remain relatively inexpensive and interest rates remain relatively low. In this environment, corporate bond managers who are able to position their portfolios to avoid LBOs will likely be poised to outperform their benchmarks. ■

*Written by Michael Cazayoux
Sector Portfolio Manager*

Dwight Asset Management Company Total Assets as of 6/30/07: \$62.3 Billion

Assets by Product Strategy (\$ Billions)

Stable Value		38.0 ¹
Fixed Income		24.4 ²
Insurance		20.2 ³

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 5/31/07.

This Quarterly Update is 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 this report. Investors should seek financial advice regarding the appropriateness of investing in any investment strategy or security discussed or recommended in this update 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.

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- ▶ Lastly, the United States Supreme Court on May 21st agreed to review Davis v. Kentucky, a case which centers on the ability of a state to exempt from state income tax the interest on its own municipal bonds, while taxing the interest on municipal bonds issued by other states. In January of 2006, the Kentucky Court of Appeals ruled that Kentucky was unconstitutionally discriminating against interstate commerce by taxing income from out-of-state bonds while exempting earnings from in-state bonds. If the Supreme Court upholds the lower court's decision, each state would have to determine whether to tax (likely on a retroactive basis with significant legal and political burdens) or to exempt interest income earned on all municipal bonds. Between now and the Supreme Court ruling (expected in 2008), there may be buying opportunities for potentially discounted specialty state bonds. ■

Written by Dwight Sector Specialists

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