

ECONOMIC & BOND MARKET QUARTERLY UPDATE

THIRD QUARTER 2006

THE IMPORTANCE OF CREDIT ANALYSIS IN TODAY'S CORPORATE LANDSCAPE

Over the past several years, U.S. corporations have enjoyed a substantial run of global economic expansion, improved earnings growth, and replenished balance sheets. This environment, combined with unprecedented market liquidity and historically low default rates, has created what appears to be a relatively benign credit environment. However, we believe there are three considerations other than traditional balance sheet and income statement analysis that should be at the forefront of investors' minds: financial policy, idiosyncratic risk, and possible defensive postures.

Financial Policy

As the corporate sector struggles to maintain organic earnings growth and shifts its attention away from balance sheet repair, bondholders watch in trepidation as mergers and acquisitions and equity-friendly announcements flood the markets. While this behavior should be a concern to bondholders, it must be considered within the context of the entire corporate structure. Free cash flow directed to stock buybacks may ultimately be a

positive influence as the resulting equity performance could hold corporate raiders at bay. Additionally, free cash flow directed at acquisitions could provide the basis for earnings growth for many years to come. While this systematic risk persists at different levels for different industries, it is important to determine at what level this activity is truly detrimental to the bondholder. In this environment, where balance sheets are healthy and earnings growth is difficult to come by, a balance of both creditor and equity concerns may be warranted. We must understand managers' long-term views and aspirations for their organizations and their industries to understand how they may deploy current and future cash flows.



Scott McIntyre, CFA
*Sector Portfolio Manager,
Corporates*

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SPREAD PRODUCT OUTPERFORMS AS FED PAUSES

Fixed Income Sector Review

Corporates

The biggest negative that continues to haunt the corporate sector is ongoing event risk. HCA, the biggest U.S. hospital operator, agreed to sell itself to a private equity consortium in what will be the biggest LBO on record. Just recently, Harrah's, the world's largest casino company, received an unsolicited takeover offer from another private equity group. The Harrah's bid shows that private equity firms are looking at takeovers of companies previously thought unsuitable for LBOs. Harrah's is considered to be well run and not in need of cost cutting and turnaround efforts. Additionally, its stock has performed well over the last several years, and it trades at a good earnings

multiple. If the Harrah's LBO goes through, a much larger segment of the corporate bond market might be susceptible to LBO risk than we had previously believed.

We added slightly to our corporate position in August but

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The Importance of Credit Analysis, continued from front cover

Market inefficiencies are difficult to find as investors shun the cyclical nature of the economy, the market, and individual companies.

▸ Idiosyncratic Risk

Part of the strong liquidity mentioned previously can be attributed to the emergence of nontraditional investments, such as hedge funds and private equity firms. While these sources can be credited with spread tightening, as money is put to work in traditional cash bonds, they can also be attributed to spread widening, as private money looks to exploit under-leveraged companies with weak equity performance and large cash balances. Companies with this profile often become targets for leveraged buyouts. While Wall Street firms have developed various screening methods to determine which companies may be attractive to private equity firms, determining this type of idiosyncratic event risk often requires a more fluid analysis that incorporates the financial policy of the companies discussed above, as well as an understanding of the cash needs for the company and the cyclical nature of the industry and the specific business. Holding a large cash balance or holding less debt than capacity may not leave a company exposed to a leverage buyout, but determining whether this is truly a risk is an emerging and critical role for credit analysts. Finally, company-specific characteristics, such as family ownership or community presence, may also play a part in these analyses.

Defensive Postures

A final focus in this low-yielding and decelerating growth environment is the consideration of defensive posturing. While pure alpha players such as hedge funds and equity houses search for yield, so too do traditional long-term holders. Inherently, incremental yield has become increasingly difficult to achieve, and many investors reach for yield without full consideration of the underlying fundamentals. As the proverbial tide lifts all boats, downside risks increase as investors get paid less for growing event risk and the potential for a slowing economy. Market inefficiencies are difficult to find as investors shun the cyclical nature of the economy, the market, and individual companies. Thus investors push up the valuations of companies, sometimes regardless of their potential. Selection of companies that offer competitive yield premiums and the potential for fundamental improvement then becomes crucial.

Summary

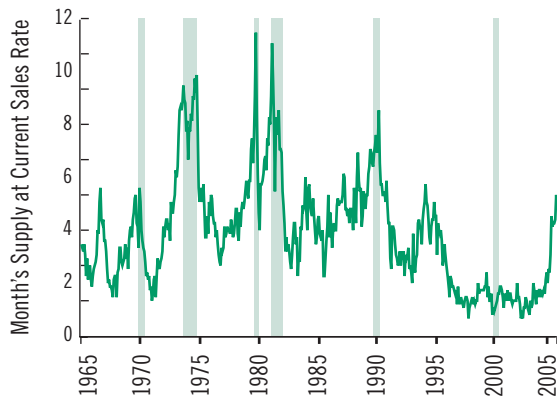
The confluence of historically tight yield spreads, heightened event risk, and the entrance of additional financial players such as hedge funds points to the critical importance of an experienced credit research team. We believe there is an asymmetric risk/reward profile in the current environment. Therefore we believe that the prudent approach is to maintain a cautious stance until the market prices risk more favorably. ■

*Written by Scott McIntyre, CFA
Sector Portfolio Manager, Corporates*

ECONOMIC UPDATE

At the beginning of the year, it was clear that a slow leak had developed in the housing market. In the third quarter, this leak ruptured. Homebuyers, who had been bidding at first sight, suddenly found the patience of Job, while sellers came out in droves in hopes of cashing out at the top

Figure 1: Sales/Inventory Ratio for New Home Sales
This Leading Indicator Has Many Investors Looking for a Recession (Shaded areas represent recession periods)



Source: Global Insight and NBER

of the market. Not surprisingly, this led to a big jump in inventories of homes for sale and substantial price pressure (see Figure 1).

Homebuilders reacted quickly, putting a brake on new construction as cancellations piled up and inventories surged. Media reports about an economy-wrecking rout in the housing market flourished, alerting the entire nation that the long-awaited housing market correction had finally arrived (see Figure 2).

As economists debated whether or not the correction in the housing market would remain orderly, Treasury investors conjectured that weakness in the housing market could spell disaster for the overall economy. Calls for the Fed to stop tightening

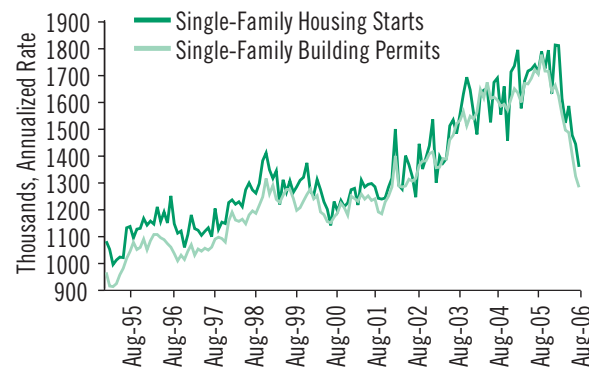
monetary policy gained in volume, and the Fed did indeed stay on the sidelines during the third quarter, keeping the federal funds rate unchanged at 5.25%. Fixed income investors were not satisfied with the notion of a steady Fed, so they started to position for a lower funds rate. In the third quarter, Treasury note yields fell by approximately 50 basis points, while futures markets ended the quarter fully priced for a rate cut (see Figure 3, page 4).

As the rally got underway in July, it seemed as though investors were simply squaring up positions ahead of a possible shift in monetary policy in the third quarter. Investors who had been keeping their portfolio durations short in anticipation of higher yields shifted to a neutral stance, while some pioneers lengthened durations in anticipation of a policy reversal. The rally gained momentum as the quarter progressed, and economic data came in weaker than expected, giving credence to the notion that the Fed would soon ease. By the end of the third quarter, 2-year Treasury yields were nearly 60 basis points below the federal funds rate, reflecting an



Jane Caron, CFA
Chief Economic Strategist

Figure 2: Housing Starts and Building Permits
Homebuilders Put a Brake on New Construction



Source: Global Insight

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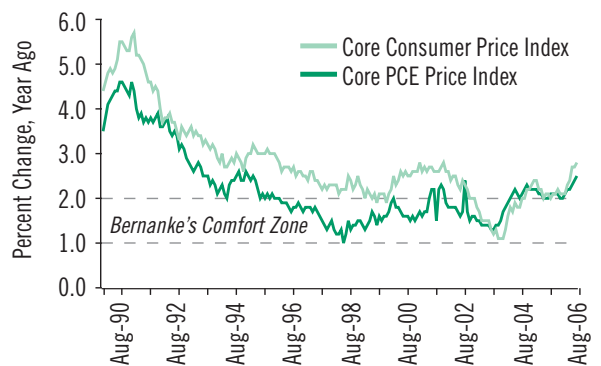
Economic Update, continued from page 3

- ▶ expectation that short-term reinvestment rates would soon decline (see Figure 4).

The Treasury market was not the only market to rally in the third quarter; stock indices also achieved impressive gains, while spread sectors in the fixed

Figure 5: Core Consumer Inflation

Core Consumer Inflation is Above the Fed's Comfort Zone



Source: Global Insight

income universe performed quite well. This raises the question of why there appears to be a dichotomy in the markets, with some sectors priced for sustained economic growth and others priced for weakness. We do not know the answer, but the combination of higher equity prices, lower Treasury yields, and attractive lending rates is clearly positive for the economy. Moreover, the decline in commodity prices, energy in particular, bodes very well for GDP growth.

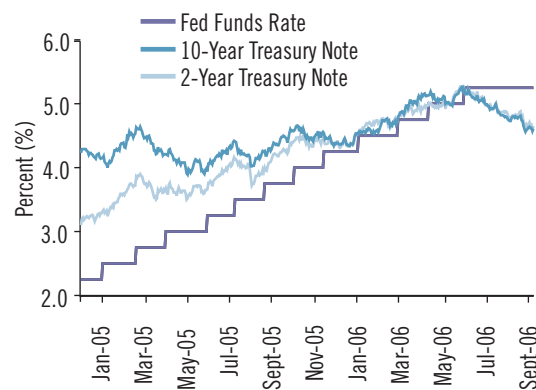
In addition to our expectation that relatively firm GDP growth will forestall Fed easing, our outlook for inflation also points to a steady Fed or even to the possibility of another tightening. We expect core consumer inflation to remain above the Fed's purported comfort zone of 1–2% for at least six months, even if headline consumer inflation falls sharply in response to lower energy prices. Recent comments by Fed officials suggest that they too remain concerned about inflation risks and are uncomfortable with the current level of core inflation (see Figure 5).

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Figure 3: Treasury Yields and The Federal Funds Rate

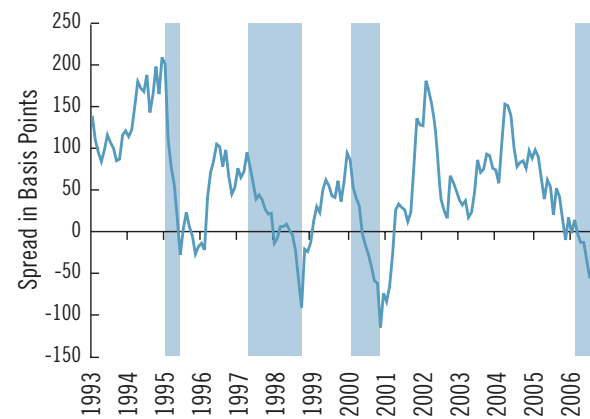
Treasury Yields Fell in Q3 as Fed Voted to Hold Policy Steady



Source: Global Insight

Figure 4: 2-Year Treasury Yield Less Fed Funds Rate

Investors Are Anticipating Looser Monetary Policy (Shaded areas are periods from last tightening date to first ease)



Source: Global Insight

DWIGHT NEWS



Lisa Trubiano, CFA
Consultant Relations

Lisa Trubiano, CFA, Joins Dwight as Senior Consultant Relations Professional

Lisa Trubiano joined Dwight's Business Development Team in August. Lisa is responsible for overseeing relationships with East Coast investment consulting firms. Prior to joining Dwight, Lisa managed The Boston Company's Business Development and Client Service Team, which covered the Mid-Atlantic region. Previously, she served as Account Manager and Consultant Relations Manager for Putnam Investments and as the Senior Marketing Consultant for John Hancock Financial Services. Lisa has an MBA from Babson College, is a Chartered Financial Analyst and a member of the Boston Security Analyst Society. She is an avid skier and golfer and is also active with the Stowe Land Trust and the Vermont Ski Museum.



Dawn Silvia
Insurance Portfolio Management

Dawn Silvia Joins Dwight as Insurance Company Portfolio Manager

Dawn Silvia joined Dwight's Investment Management Team in August. Dawn works closely with Dwight's Sector Portfolio Managers in structuring insurance company portfolios. Prior to joining Dwight, she served as a Portfolio Manager specializing in insurance company assets at Conning Asset Management. Dawn, her husband, and son are active off-road motorcycle riders, and Dawn is a two-time Women's Enduro Champion in the New England Trail Riders' Association series.



Tsana Nobles, FSA
Quantitative Analyst

Tsana Nobles, FSA, Joins Dwight as Quantitative Analyst

Tsana Nobles joined Dwight's Quantitative Analysis Team in September. Tsana performs quantitative analysis for Dwight's insurance clients. She was formerly an Actuary for National Life Insurance Company. Tsana is a Fellow of the Society of Actuaries and a member of the American Academy of Actuaries. Tsana and her family live in a farmhouse on 14 acres. When not working on the house, she enjoys being outdoors in Vermont and spends time hiking, cross country skiing, and snowshoeing.

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Fixed Income Sector Review, continued from front cover

...as the quarter progressed, stubbornly high energy prices and a wobbly housing market led to concerns about a more pronounced slowdown in economic growth.

► continue to maintain an underweight to the sector. We will seek to avoid those names most prone to event risk and will add exposure when spreads widen and/or market conditions improve. Meanwhile, we will continue to seek out bonds that we feel provide superior carry and price-performance potential.

Mortgage-Backed Securities

The mortgage-backed securities (MBS) sector returned 3.63% during the third quarter. While it was 28 basis points better than duration-matched Treasuries, this return was inferior to that achieved

by most other spread sectors.

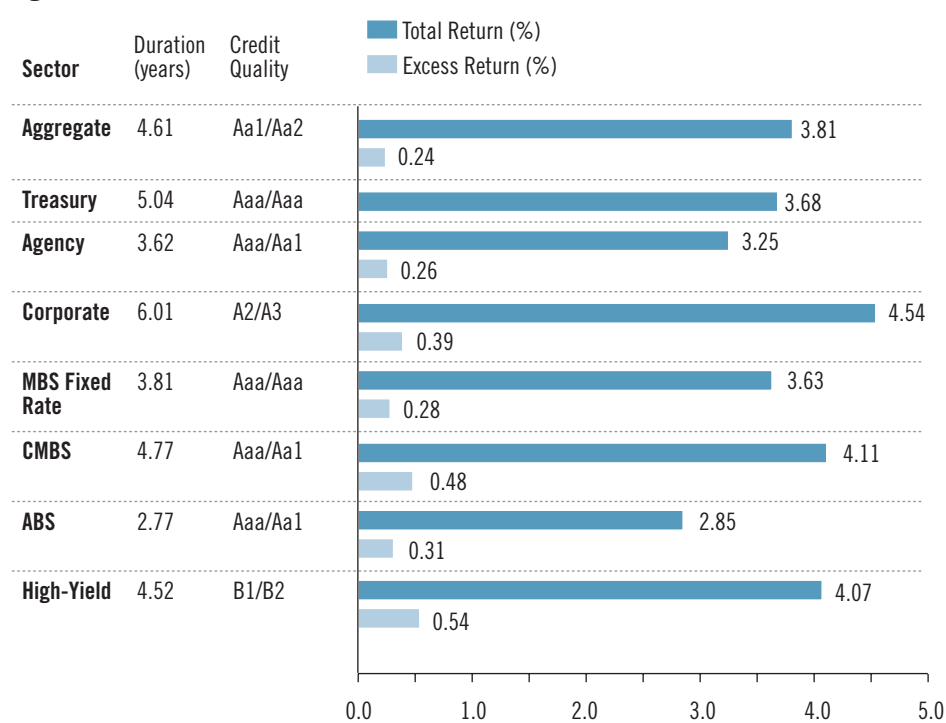
The MBS sector began the quarter on a strong note before fizzling in September. As market participants began to anticipate the end of Fed tightening, MBS enjoyed significant support. Buyers felt that the Fed would be able to remain on the sidelines for an extended period of time, pointing to moderating but still solid economic growth and contained core inflation. The resulting low volatility assisted MBS performance.

However, as the quarter progressed, stubbornly high energy prices and a wobbly housing market led to concerns about a more pronounced slowdown in

economic growth. As rates dropped and uncertainty increased, MBS spreads were unable to keep pace with other investment-grade sectors.

As of September 30th, we are maintaining a neutral allocation to MBS versus the benchmark indices. We believe that, while MBS should perform relatively well in a stable to modestly rising interest rate environment, spreads are vulnerable to both lower rates and higher volatility. Therefore, we have adopted a defensive position within our allocation to the sector by

Figure 6: Third Quarter 2006 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.

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► overweighting 15-year securities versus their 30-year counterparts.

Commercial Mortgage-Backed Securities

Commercial mortgage-backed securities (CMBS) enjoyed another quarter of strong performance, besting duration-matched Treasuries by 48 basis points, more than any other major investment-grade sector. Investors were once again drawn to the sector's relative stability amid persistent concerns about event risk in corporates and prepayment risk in residential mortgage-backed securities.

A high volume of acquisition and refinancing activity earlier in the year led to heavy new issuance during the third quarter, but demand was more than adequate to absorb the new supply. Fundamentals remained sound, and collateral performance among seasoned deals continued to impress. Spreads on senior triple-A-rated classes spent the quarter within a few basis points of their tightest level of the year. The bottom tier of the investment-grade classes continued to outperform, with triple-B-minus-rated classes tightening to 100 basis points over swaps. CDOs once again led the charge in lower-rated classes, while more traditional buyers favored triple-A-rated securities.

Fundamentals in the sector remained sound, with upgrades far exceeding downgrades and with delinquencies

tracking near their recent lows. Loan underwriting, however, remained very aggressive, fueling investors' persistent concerns about the outlook for recently securitized collateral. We maintained our overweight to the sector during the third quarter but concentrated most of our holdings in higher-rated classes and seasoned deals. We intend to maintain both our overweight and our quality bias into the fourth quarter, as we like the risk-return profile of triple As but feel that lower-rated classes have greater downside risks.

Asset-Backed Securities

Asset-backed securities (ABS) returned 31 basis points over duration-matched treasuries during the third quarter. Spreads in all major ABS subsectors ended the quarter unchanged to slightly wider

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Dwight Sector Specialists

The Sector Update was written by the following sector specialists:



Michael Cazayoux
Corporates



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Mortgage-Backed Securities



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Commercial Mortgage-Backed Securities



Peter Milne
Asset-Backed Securities



Edward Meigs, CFA
High-Yield

Fixed Income Sector Review, continued from page 7

Defaults remain very low, and there is unprecedented liquidity in the market due to the robust private equity and institutional bank loan markets.

- ▶ versus swaps, as deteriorating fundamentals were offset by strong technicals.

The slowdown in the housing market has many investors concerned about a potential decline in the value of the collateral that backs residential ABS. Meanwhile, the credit metrics of more recent vintage subprime home equity loan-backed securities are painting a picture of lax underwriting standards. Despite these negatives, the sector has benefited from a decline in new supply from last year's levels, and issuance is expected to slow further in the fourth quarter. On balance, ratings actions have been favorable as well, and a strong CDO bid for the lower portions of the capital structure in ABS transactions has kept a lid on spreads.

With the outlook for housing uncertain and with ABS spreads still tight, we will continue to overweight triple-A-rated home equities relative to their lower-rated counterparts. We also expect to maintain our overweight in equipment lease-backed securities while underweighting autos, credit cards, utilities, and manufactured housing.

Agencies

Agency debt outperformed Treasuries by 26 basis points in the third quarter, as strong foreign demand and low net issuance led to spread tightening in the sector. Fannie Mae and Freddie Mac's retained mortgage portfolios shrank during the quarter, resulting in a decline in funding needs for the agencies. As swap spreads recovered from their widest levels in almost three years, spreads on five-year Fannie Mae reference notes tightened in from their high of over 40 basis points over Treasuries as well. By the end of September, Fannie Mae five-year spreads had settled in to the low 30s, ending the period 5 basis points tighter than June's closing levels. Ten-year benchmark spreads tightened by 3 basis points during the period, while spreads on

two-year maturities tightened by 2 basis points.

The sector's 26 basis points of excess returns lagged all other major sectors during the period, as higher yielding sectors benefited from greater income returns. We remained significantly underweight agencies throughout the third quarter, and expect to maintain that underweight for the foreseeable future. We feel that investment dollars can be better spent in other high grade markets, such as ABS and CMBS, where investors can earn significantly wider spreads on highly liquid, low risk assets.

High-Yield

The high-yield market performed extremely well throughout the third quarter, generating 54 basis points of excess return and a total return of 4.07%. All rating categories had positive performance each month during the quarter, with double Bs the strongest performers for the quarter, as they tend to be more sensitive to movements in Treasuries.

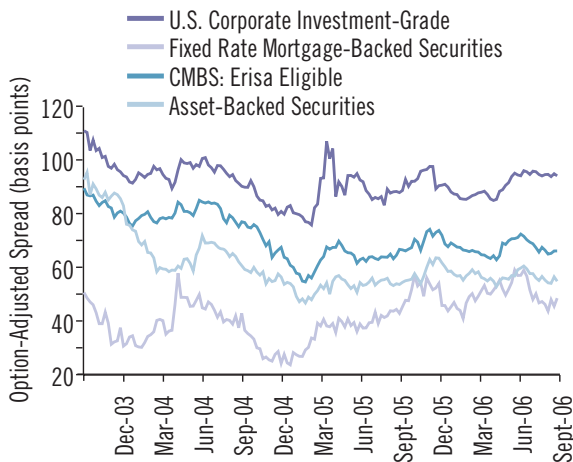
Technical factors supported the market through the summer as new issuance declined from over \$14 billion dollars in June to less than \$5 billion in July. Ten billion dollars came to market in the first half of August, putting some pressure on the market, but the market took its customary mid-August-through-Labor Day break, with no new issuance to speak of in a three-week period. A surge of new issues were expected in September, but the total was only \$8 billion. Mutual fund flows also provided technical support to the market, with inflows of \$400 million in the third quarter, the first positive quarter in 2006.

We thought that the volatility we saw at the end of the second quarter would continue into the third quarter as the market became more risk averse.

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Fixed Income Sector Review, continued from page 8

Figure 7: Option-Adjusted Spread—Lehman Indices



Source: Lehman Brothers Global Family of Indices. Copyright 2006. Used with permission.

► Instead, volatility declined throughout the third quarter as the riskiest sectors all remain well bid. Defaults remain very low, and there is unprecedented liquidity in the market due to the robust private equity and institutional bank loan markets. However, we continue to believe that the market is being priced to perfection and that the downside risks outweigh upside potential for high-yield debt. Risks include increased Treasury and equity volatility, growing default rates, and a deceleration in economic growth. We believe that certain individual issues offer value, but we intend to maintain our bias toward high-quality credits and remain highly selective with new purchases. ■

Written by Dwight Sector Specialists

Dwight Asset Management Company
Total Assets as of 9/30/06:
\$57.2 Billion

Assets by Product Strategy (\$ Billions)

Stable Value	33.3 ¹
Fixed Income	23.2 ²
Insurance	19.7 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 8/31/06.

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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► Risks to our outlook for a steady Fed include a deeper-than-expected downturn in the housing market and/or an exogenous shock that disrupts consumer and business confidence. While we believe that housing market weakness on its own will not undercut overall growth, it does make the economy vulnerable to shocks. For signs of stress in the economy, we will be closely watching the labor market, which we think is the linchpin. While it is true that the September payroll gain, at 51,000 jobs, was well below the recent trend rate, this outcome does not match other labor market data that still show strength. For example, the unemployment rate declined to a cyclical low of 4.6% in September.

With the economy in decent shape and the Fed on hold, we are feeling rather bearish about the current level of Treasury prices, and we expect to position for higher interest rates in early October. In recent quarters, we have generally held a neutral position in our total return portfolios regarding interest rate risk, but the very low quarter-end level for Treasury yields simply cannot be justified by current fundamentals—only by wishful thinking. ■

*Written by Jane Caron, CFA
Chief Economic Strategist*

Dwight News, continued from page 5



Kenneth Frey
Credit Research

Ken Frey, CFA, Joins Dwight as Credit Research Analyst

Ken Frey joined Dwight's Credit Research Team in August. He is responsible for analyzing and making recommendations to buy and sell energy, chemical, and REIT bonds. Prior to joining Dwight, he served as Director of Fixed Income Research at Nationwide, Credit Analyst at both State Street Research and The Boston Company, and Senior Investment Officer, Fixed Income Private Placements at New England Mutual Life Insurance. Ken is a member of the Boston Security Analysts Society and AIMR. Ken is also an avid skier and a shareholder in the Mad River Glen Ski Cooperative in Fayston, Vermont.