

ECONOMIC & BOND MARKET QUARTERLY UPDATE

FOURTH QUARTER 2007

2007 REVIEW

In 2007, we were concerned that the economy was out of balance and vulnerable to exogenous shocks. Early in the year, we publicized a number of forecasts that proved prescient: GDP growth would slow to a rate between 2% and 2.5%; core consumer inflation would remain slightly above 2%; the Fed would ease policy in the latter half of the year; the Lehman Brothers Aggregate Index would post a total return of 7%; and stocks, as measured by the S&P 500, would post a positive but lackluster gain. Internally, we talked about the need to be aware of downward pressure on corporate earnings and the need to continue the high-quality bias adopted in 2006 for our structured product holdings. We were particularly concerned about the subprime sector of the housing market. Extraordinarily poor underwriting standards, erroneous property appraisals, and the sale of inappropriate mortgage products to risky borrowers all pointed to instability.

We could fill pages explaining how the credit market crisis came about in 2007, but here is the condensed version. Expectations of ever-rising home prices, coupled with lax lending standards (a function of the originate-to-distribute lending model), created an unsustainable dynamic that went into reverse when the housing market bubble started to deflate. As default risk rose, demand for subprime bonds evaporated. This blocked the distribution of already-originated subprime bonds, which in turn sharply reduced new origination and made it harder for subprime borrowers with adjustable rate loans to refinance prior to rate increases. Selling the home was a poor second choice



Jane Caron, CFA
Chief Economic Strategist

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CREDIT CRUNCH DEEPENS Fixed Income Sector Review

Corporates

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

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Liability-Driven Investing (LDI) solutions for Retirement Plans can take many forms, and Dwight has been managing liability-specific assignments for over seven years. In addition to offering customized solutions, we offer clients the opportunity to structure long duration strategies benchmarked to various indices including the Lehman Brothers Long Government/Credit Index with the objective to help minimize pension surplus volatility. For more information, contact your client portfolio manager or Greg Prisk at 802-383-4104.

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2007 Review, continued from front cover

▶ because of the weak housing market. In fact, some mortgage holders found themselves upside-down, with mortgages that exceeded the value of their homes. Defaults surged in this environment, perpetuating the crisis (see Figure 1, below).

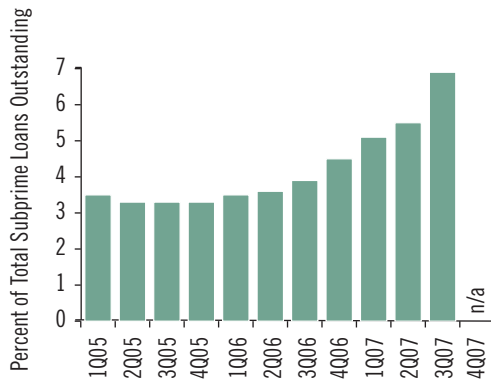
Surging defaults on subprime mortgages led to contagion in the money markets, where structured

issues to market. Furthermore, market conditions were driving down the prices for other assets on their books, raising the risk that they would have to set aside more capital. In this environment, cash became dear (see Figure 2, below).

The hoarding of cash was most evident in surging LIBOR rates, the rate at which banks lend unsecured

Figure 1: Subprime Foreclosure Rate

This Rate is Rising at a Rapid Pace



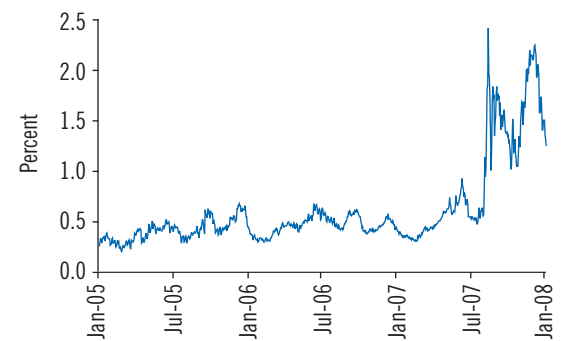
Source: Global Insight and Mortgage Bankers Association

investment vehicles (SIVs) had made a big business of issuing commercial paper to purchase subprime and other bonds—a classic “borrow short and lend long” strategy that was very lucrative for a time. Concerns about credit risks caused buyers for this commercial paper to evaporate, resulting in severe funding difficulties for the SIVs. In turn, the SIVs tapped back-up credit facilities with commercial banks in order to avoid forced asset sales. SIV paper was held in a number of money market accounts, leading to performance problems for some and exacerbating investor angst.

Commercial banks found themselves called on by the SIVs to meet funding needs, while other players were ringing their doorbells to get replacement funding because parts of the bond market were essentially closed. In addition, banks had to cope with a number of deals that were stuck on their books because it had become impossible to bring new

Figure 2: TED Spread, 3-Month LIBOR/3-Month T-Bill

Money Markets Under Significant Stress



Source: Global Insight

funds to each other. Banks simply refused to lend their cash. This freeze reverberated through the financial markets and impacted the economy. LIBOR rates serve as key reference rates for many loans and contracts. The economy, already struggling with an accelerating downturn in the housing market, surging food and energy prices, and credit restraint, could not shrug off this additional shock.

We first became concerned about a potential recession in July. Our concern grew in the third quarter because of financial market turmoil and a hawkish Fed. In October, we raised the odds for a recession to 60% from 30% because of continued financial market turmoil, the acceleration in the housing market downturn, and surging food and energy prices—shocks that we feared would tip the economy into a recession. At that time, we lowered our 2008 forecast for the federal funds rate from 4% to 3%, a 125 basis point decline from the December

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2008 OUTLOOK

The extraordinary events in the credit markets last year will likely impart lingering ramifications for the U.S. economy through at least the first half of this year. In addition to the drag on the economy emanating from the sharp contraction in residential construction, the tightening in lending standards alluded to in our 2007 Review will likely curtail sales of other big ticket items, most notably autos. In comparison, both housing starts and auto sales were two of the principal engines of the recovery of the U.S. economy following the end of the last recession in November 2001.

Adding to the economic malaise will be the continuing effects of relatively restrictive monetary and fiscal policy that remained intact through most of 2007. Typically a reversal of policy requires 12 to 18 months before becoming effective. On this basis, a broad policy-induced recovery of the U.S. economy could be expected sometime in the latter half of the year.

Domestic economic policy, however, is now only part of the story in an increasingly global economy. Serving to mitigate the effects of the 2007 credit turmoil is the recent decline in the value of the U.S. dollar. Dollar-driven export growth has led to a significant decline in the trade deficit during this past year. More importantly, economic theory suggests that demand for U.S. products will continue to grow should the dollar find a more sustainable level.¹ The recent growth in exports has contributed to a dramatic pickup in activity in export-related industries, as well as in those businesses that support these industries. This activity, when coupled with the domestic policy steps already taken, should improve the chances for a recovery on an accelerated timetable. Given the likelihood of a recession, we expect the U.S. economy to grow on the order of 1% for the year. This would be significantly below the estimated long-run growth potential of the U.S. economy of 2.5% to 2.75%.

The inflation rate is one aspect of the outlook that will likely prove troublesome. Normally a forecast of below-trend GDP growth would be consistent with

some easing of inflationary pressures. The substantial decline in the dollar, however, renders a benign outcome unlikely. As a result, the year-over-year core rate of inflation is likely to tick up from a level of just over 2% at the end of last year to perhaps as high as 2.5% by the end of this year. The combination of an anemic economy, combined with a steady uptick in inflation, suggests that the broad fixed income market, as represented by the Lehman Brothers Aggregate Bond Index, will fail to earn its current coupon of 5% this year. The return from cash, meanwhile, will likely lag behind at under 3%.

While the outlook favors higher interest rates over the course of the year, the opportunity for generating excess return in fixed income may be the best since duration-adjusted excess returns were first calculated in 1988. By way of comparison, the negative excess return of the Lehman Brothers Aggregate in 2007 was 2.1%; the next-worst performance was in 2000, when the Aggregate produced a negative excess return of 1.6%. Our demonstrated expertise in the so-called spread sectors could serve our clients particularly well in 2008. The degree of yield spread compression that should commence once the economy finds its footing is likely to be unprecedented. This should work to the advantage of those investors adroit enough to properly manage their exposure to spread product. ■

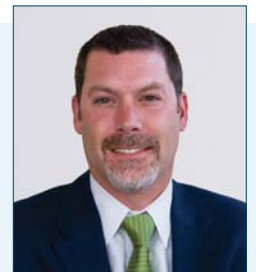
*Written by David Thompson, CFA,
President and Co-Chief Investment Officer, and
David Kilborn, CFA,
Co-Chief Investment Officer*

Endnotes

1. That the decline in the value of the U.S. dollar may have run its course is supported by the dramatic changes in the "Big Mac" index published by The Economist magazine. In the seven years ending mid-2007, the relative price of a McDonald's "Big Mac" sandwich rose 31% in Canada versus the United States and 27% in Euroland, respectively.



David Thompson, CFA
President and Co-Chief
Investment Officer



David Kilborn, CFA
Co-Chief Investment
Officer

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Fourth-quarter economic data confirmed our fears that a recession was unfolding.

- ▶ 2007 rate of 4.25%. We were inclined to forecast an even lower rate, but the persistence of inflation pressure and the hawkish-sounding FOMC suggested that the Fed would cut rates begrudgingly.

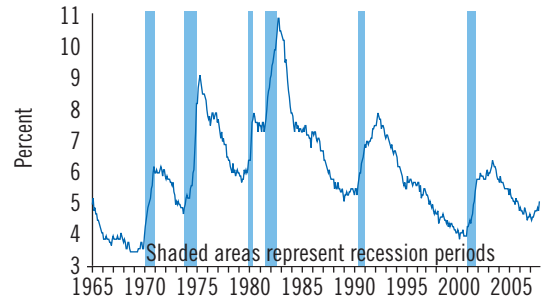
Fourth-quarter economic data confirmed our fears that a recession was unfolding. Indeed, we raised the risk of a recession to 90% and reduced our funds rate forecast by 50 basis points as the calendar turned. Particularly concerning was a decline in the Institute for Supply Management's index for manufacturing purchasing managers' sentiment to 47.7 in December, a level that indicates contracting manufacturing activity (see Figure 3, below). Also, the Bureau of Labor Statistics reported that the unemployment rate jumped 0.3% in December to 5%, well above its 2007 low of 4.4% (see Figure 4). Furthermore, housing data for November were dismal, while December retail sales pointed to a hesitant consumer.

As bond managers, our challenge in 2007 was deciding when individual bonds were priced for a recession, making them attractive long-term purchases even if they underperformed Treasuries or other safe-haven assets for a period of time. Our risk-return analyses showed a number of bonds that were attractively priced, but market volatility could lead to yet cheaper prices. Thus, timing was particularly important in 2007. More buying opportunities

are likely to present themselves in 2008, but we are optimistic that investments we made will lead to good performance in coming years.

*Written by Jane Caron,
CFA
Chief Economic Strategist*

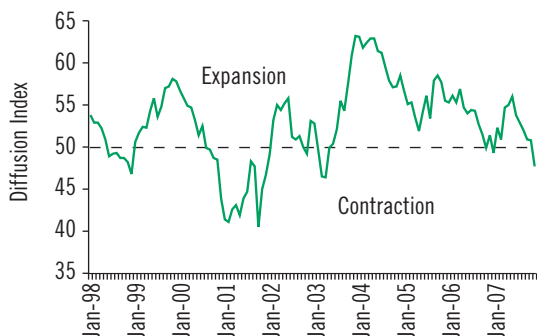
Figure 4: Unemployment Rate
The Latest Increase Foreshadows a Recession



Source: Global Insight and NBER

Figure 3: ISM Manufacturing PMI Index

This Leading Indicator Has Fallen Into Contraction Territory



Source: Global Insight

Dwight Asset Management Company
Total Assets as of 12/31/07:
\$69.5 Billion

Assets by Product Strategy (\$ Billions)

Stable Value		45.3 ¹
Fixed Income		29.4 ²
Insurance		19.8 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 11/30/07.

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.

Fixed Income Sector Review, continued from front cover

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

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

Our underweight to corporates during the quarter again helped the relative performance of our portfolios. In the first quarter of 2008, however, we are beginning to find valuations more compelling. Although corporates will continue to face challenges in a slowing economy, we see the current spread widening and cheap new issuance as a potential opportunity to gradually increase our exposure to the sector.

Mortgage-Backed Securities

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

MBS continued to be plagued in the fourth quarter by the same liquidity constrictions that affected the entire financial market. Credit-related asset write-

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

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

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

Commercial Mortgage-Backed Securities

The commercial mortgage-backed securities (CMBS) market endured another volatile quarter in the last

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Despite the litany of negative financial news and the ineluctable weakening of the housing market, MBS managed to stay ahead of more credit-sensitive fixed income sectors, including ABS, CMBS, and corporate bonds.

Fixed Income Sector Review, continued from page 5

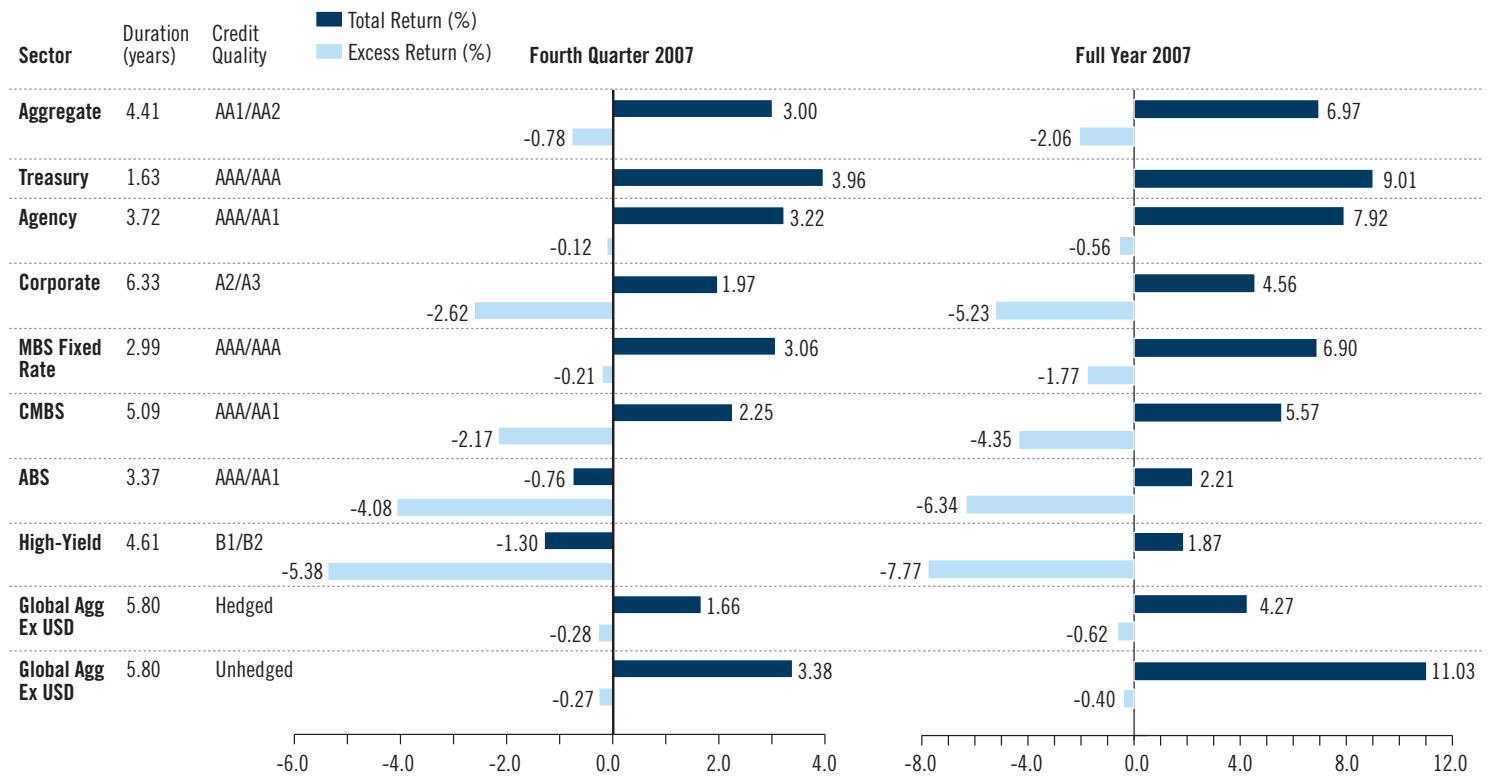
► three months of the year, with significant spread widening leading to notable underperformance relative to the broad market. According to the Lehman Brothers Aggregate Index, CMBS returned 2.25%, lagging duration-matched Treasuries by some 217 basis points. The performance was attributable to continued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

Despite a sharp decline in issuance, investors continued to balk at new offerings that were characterized by a

prevalence of interest-only loans and high loan-to-value ratios. Due to the lag time between loan origination and deal issuance, the bulk of loans securitized and offered for sale in the fourth quarter had been originated earlier in the year amid more favorable market conditions, when loan underwriting standards were still very aggressive. But as the liquidity crisis deepened and the economic outlook deteriorated, demand for new issues declined sharply. Many of the new deals languished, with significant portions of lower-rated mezzanine tranches remaining unsold and taking up valuable space on dealer balance sheets. Spreads on CMBX credit default swap (CDS) indices also widened sharply, as some market participants used CDSs to hedge existing

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Figure 5: Fourth Quarter 2007 Sector Statistics*



*Source: Lehman Brothers Global Family of Indices. Excess returns represent returns over duration-matched Treasuries. Credit quality represents market-weighted average credit quality for the indicated sector expressed in Moody's nomenclature. The Lehman Brothers U.S. High Yield Index and Global Agg Ex USD are not components of the investment-grade U.S. Aggregate Index.

Fixed Income Sector Review, continued from page 6

► credit positions or to speculate on further declines in commercial real estate fundamentals. For instance, spreads on CMBX series 3 BBB- more than doubled during the first half of the fourth quarter, hitting a high of over 1100 in November.

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

Asset-Backed Securities

What started out the year as just a subprime problem continues to spill over into the broader market. Credit and liquidity concerns, along with an erosion of capital among financial institutions, fomented unease among investors, pushing spreads near or through their historically widest levels over the last few months of the year. Because this problem has been most felt in the structured products markets, just about any securitized asset has taken a beating. As a result, asset-backed securities (ABS) ended the fourth quarter with a total return of -0.76%, as measured by the Lehman Brothers Aggregate Index. Excess returns were even worse as the average option-adjusted spread in the ABS component of the index widened 98 basis points, leading to 408 basis points of underperformance relative to Treasuries on a duration-adjusted basis. While all subsectors posted negative excess returns, the home equity sector fared the worst, returning a negative 12.23% for the quarter.

Falling home prices, tighter lending standards, waning consumer confidence, and an economy teetering on recession will most likely keep spreads

susceptible to further short-term widening. That said, from a purely fundamental perspective, spread widening in many areas of the ABS market seems overdone, and we believe there may be compelling opportunities at the top of the capital structure for those who are willing to take a long-term view with their investment strategy. Investors should favor having hard collateral, predictable cash flows, and structural protections such as over-collateralization, a reserve account, and protective triggers. Triple-A-rated prime retail autos, for example, are currently trading at historically wide spreads and should provide attractive excess returns over time, even in a recessionary environment.

In the New Year we expect to maintain our overweight to the highest-quality home equity and equipment lease-backed paper. With little or no home equity issuance expected in 2008, however, we expect that overweight to gradually decline as our positions amortize. We also expect to take

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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



Peter Vutz
International, Non-Dollar

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- ▶ advantage of historically wide consumer ABS spreads by reducing our underweight to autos, credit cards, and rate reduction bonds.

High-Yield

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

All told, approximately \$150 billion was issued in the high-yield market in 2007, \$110 billion of which was sold during the first half of the year. The year 2007 was a tale of two markets. The first half witnessed near-record issuance of low-quality, poorly structured paper that fed the LBO machine. Total returns through June 15 were approximately 4.5%. The second half of the year was characterized by the seizing of the CLO market in the aftermath of the subprime mortgage correction. Banks that had underwritten LBO deals that had been agreed on only weeks before were stuck with hundreds of billions of “covenant lite” bonds and loans that were unattractive to institutional investors. As a result, the high-yield primary issuance market was closed for much

of the second half of the year, with intermittent periods of issuance by well-known companies.

Over the past year, high-yield spreads have widened over 300 basis points to approximately 575 basis points—the widest level in four years. What started out in June as a technical correction in response to subprime weakness has morphed into a fundamental contraction of credit. The \$240 billion of loans and bonds that banks have retained on their balance sheets consume an inordinate amount of capital that would ordinarily be used to generate more lending and to provide liquidity through capital markets activity. Ironically, the fundamental backdrop in the high-yield market is not entirely negative, as the trailing twelve-month default rate remains well below historical averages at 1.5%. However, despite the attractive default statistics, the market appears to be fairly valued as expectations of lower economic growth will likely lead to an incremental increase in defaults. In addition, the massive level of bond and loan inventory that the banks possess could potentially negatively affect the market. Overall, downside risks currently outweigh upside potential for most high-yield debt issues. Risks include increased Treasury and equity volatility, an increase in default rates, and an ongoing decline in residential real estate values, potentially weighing on overall economic growth. Although market liquidity is currently adequate, any decline could have sharply negative implications for market returns. We continue to believe that certain issues offer value, but that the broader market is likely to experience more spread widening in 2008. Therefore we expect to maintain our bias toward high-quality credits, and we will remain highly selective with new purchases.

Municipal Bonds

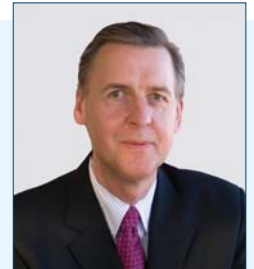
Although the municipal bond market had a negative tone for the fourth quarter, the 1.37% total return for the Lehman Brothers Municipal Bond Index actually

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*The year 2007
was a tale of two
markets.*

Peter Vutz Joins Dwight as International and Non-Dollar Portfolio Manager

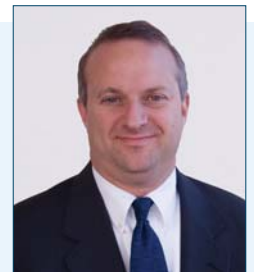
Peter Vutz joined Dwight's Investment Team in November. Peter is responsible for implementing global investment themes within the firm's established investment processes. Prior to joining Dwight, he served as a Senior International Portfolio Manager for Mellon Equity Associates LLP and Head of Global Trading at Federated Global Investment Management. Peter also served as Head of Fixed Income Sales for Commerzbank Capital Markets Corporation in New York and Director of Fixed Income Sales at HSBC Trinkaus & Burkhardt in New York, London, and Düsseldorf. Peter earned a Bachelor of Arts in Banking and Finance from Mercator Business School, Moers, Germany. He spends his spare time on family activities with his wife and two children. Peter enjoys cycling and outdoor sports and loves to listen to a wide spectrum of music.



Peter Vutz
Portfolio Manager

Laurance M. Ring Joins Dwight as Credit Research Analyst for Banking and Finance Sectors

Larry Ring joined Dwight's Credit Research Team in November. Larry is responsible for working with Dwight's high-yield and corporate portfolio managers to analyze and make recommendations to buy and sell bonds of U.S. and foreign banks, thrifts, finance companies and broker-dealers. Prior to joining Dwight, Larry was a credit research analyst with Fidelity Investments, The Vanguard Group, Fitch Investors Services and A.M. Best Company. Larry earned a Bachelor of Science in Business Administration from the University of Illinois and a Masters of Business Administration from the Wharton School, University of Pennsylvania. Larry enjoys skiing, snowmobiling and tennis, and hopes to get back to flying small airplanes.



Laurance M. Ring
Credit Analyst

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

The market continued to struggle with a variety of issues that weighed on the municipal landscape. Contagion from the subprime market, growing concerns about the capital adequacy of bond

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

Municipals will begin 2008 with a plethora of factors weighing on the sector. Issuers will be more

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Issuers will be more reluctant to use insurance, so we should see a considerable decline in the number of issues that come to market with a monoline guaranty.

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

On a positive note for the stability of the market, we expect the U.S. Supreme Court to uphold the status quo by overturning the Kentucky Court of Appeals in *Davis v. Kentucky*, maintaining the state's right to exempt interest income on in-state municipal bonds while taxing the income on out-of-state bonds. We believe the Federal Reserve will continue to reduce the federal funds rate throughout the year, which in turn will lead to a steeper municipal curve, most likely in the range of 150 to 200 basis points. Municipals remain extremely attractive for investors as a solid, high-quality, low-risk sector, and with municipals presently trading at or above 100% of Treasuries, relative value metrics are compelling. Should there be continued dislocation among the insurers, it may present opportunities to buy good-quality credits at attractive yields. We continue to believe that this may present a compelling entry point to initiate a long-term position in municipal securities.

Global Bonds

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

During the fourth quarter of 2007 the contagion from the subprime crisis in the United States continued to spread to the global fixed income and credit markets. The quick intervention of authorities in Germany prevented the near collapse of two German banks with excessive exposure to the U.S.

subprime market. The situation became more dramatic in the United Kingdom, with both the government and Bank of England ("BOE") initially underestimating the risks, leading to a classic run on the deposits at Northern Rock. The subsequent reluctance of banks to lend to each other led to a dramatic widening of credit spreads, and borrowing rates rose dramatically as the year-end approached. The bond markets continued to witness a flight to quality as expressed in a widening of credit spreads, swap spreads, and peripheral markets, with investors preferring the perceived safety of the U.S. Treasuries market and the German treasuries market.

The deterioration in the interbank market forced the BOE and European Central Bank (ECB) to accommodate the market with emergency funding facilities. In addition, the Central Bank of Canada cut its key lending rate on December 4 from 4.5% to 4.25%, and the Bank of England cut its overnight lending rate by 25 basis points (5.75% to 5.5%) on December 6. The ECB found itself in a classic catch-22 scenario. While the primary mandate of the ECB calls for it to ensure price stability, it faced a slowdown in the economic output within the Euro zone, along with a liquidity problem in the financial sector and higher-than-acceptable inflation numbers.

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

One major theme in 2007 was the dramatic appreciation of currencies like the Canadian dollar (plus 16.25% versus the U.S. dollar) and the Euro (plus 13.8% versus the U.S. dollar). Deterioration in the global economic environment, combined with a cycle of interest rate cuts by the major central banks

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in Europe (BOE, ECB, and Swiss National Bank), could signal a partial reversal of the appreciation of the major currencies versus the U.S. dollar. The British pound appears to be especially vulnerable for a major correction of the GBP exchange rate versus the Euro and versus the U.S. dollar, given

risks in the U.K. housing market. With a backdrop of a global slowdown (if not a recession), we could see a further weakening of the Japanese economy as well, which should postpone all talk of possible tightening by the Bank of Japan (BOJ). ■

Written by Dwight Sector Specialists

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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.

Definition of Indices:

The 5-Year Rolling CMT represents the average monthly yield for the most current 5-Year Treasury Notes over the trailing 60 months.

The Citigroup 2-Year U.S. Treasury is a hypothetical 2-year duration Treasury representing a blend of the return of the Citigroup 2-Year and 5-Year U.S. Treasury Indices. The Citigroup 2-Year and 5-Year U.S. Treasury Indices are the return of the 2- and 5-Year U.S. Treasury securities, respectively, issued during the pertinent period, assuming that the return of the most recently issued 2- or 5-Year U.S. Treasury security is in place until replaced by the next succeeding issue of such securities.

The Citigroup 5-Year U.S. Treasury is a hypothetical 5-year duration Treasury representing a blend of the return of the Citigroup 5-Year and 10-Year U.S. Treasury Indices. The Citigroup 5-Year and 10-Year U.S. Treasury Indices are the return of the 5- and 10-Year U.S. Treasury securities, respectively, issued during the pertinent period, assuming that the return of the most recently issued 5- or 10-Year U.S. Treasury security is in place until replaced by the next succeeding issue of such securities.

The Lehman Brothers Aggregate Bond Index is a comprehensive benchmark for U.S. investment-grade fixed income investments. It incorporates securities rated "BBB" or higher from the U.S. Government, Corporate, Mortgage-Backed, Commercial Mortgage-Backed and Asset-Backed markets. This index typically has a duration between 4.0 and 5.0 years.

Notes on Performance:

Dwight Asset Management Company, a wholly owned, indirect subsidiary of Old Mutual plc, is a registered investment adviser providing investment advisory services to stable value and other fixed income investors. In managing fixed income assets, Dwight's strategy focuses on relative value, sector weighting and rotation, security selection, duration and yield curve positioning. The Intermediate, Core, and Core Plus Composite returns for periods prior to 1/1/01 represent accounts that were managed by Dewey Square Investors Corporation ("Dewey Square"), which was merged into Dwight during 2001. The investment personnel of Dewey Square primarily responsible for this performance have not changed since 1997. Dewey Square completed a firmwide verification for the period 1/1/93 through 12/31/00. Dwight completed a firmwide verification for the period from 1/1/93 through 12/31/06. Dwight claims compliance with the Global Investment Performance Standards® (GIPS®). To receive a complete list and description of Dwight Asset Management Company's composites and/or a presentation that adheres to GIPS® Standards, contact Greg Prisk at (802) 383-4104, or write Dwight Asset Management Company, 100 Bank Street, Burlington, VT 05401, or gprisk@dwight.com. Additional information regarding the calculation methodologies used is available upon request. All returns are calculated in U.S. dollars. Returns are presented before fees (gross) unless otherwise indicated, and all except for the 3-month have been annualized. When permitted by investment guidelines, options on securities or indices, futures contracts, options on futures contracts swaps, and options on swaps may be utilized for various reasons, including reducing transaction costs, managing cash flows, maintaining full market exposure (to adjust the characteristics of its investments to approximate those of the benchmark more closely), enhancing returns, and protecting against changes resulting from market conditions.

The Intermediate Composite emphasizes various sectors of the intermediate-term fixed income markets, with each portfolio maintaining an overall average credit rating of at least A. Certain portfolios engage in securities lending to increase the return earned by investors.

The Core Composite emphasizes various sectors of the fixed income markets, with each portfolio maintaining an overall average credit rating of at least AA. Prior to January 1, 2001, the composite was measured against the Lehman Brothers Government/Credit Bond Index. The composite's com-

The Lehman Brothers Intermediate Aggregate Bond Index is a comprehensive benchmark for intermediate-duration U.S. investment-grade fixed income investments. It incorporates securities rated "BBB" or higher from the U.S. Government, Corporate, Mortgage-Backed, Commercial Mortgage-Backed, and Asset-Backed markets. This index typically has a duration between 2.7 and 3.7 years.

The Merrill 1-3 Year Treasury Index is composed of U.S. Treasury securities with maturities between one and three years. This index typically has a duration of between 1.5 and 2.0 years.

The MFR Money Market Index is the all-taxable money fund report average, a product of iMoneyNet, Inc., and is presented net of certain fees and expenses.

The Ryan 5-Year GIC Index is a stable value benchmark calculated from the rolling yields on a hypothetical portfolio of high-quality guaranteed investment contracts. The index is constructed by Ryan Labs, Inc., from market data provided by contract issuers. This index has a duration of 2.5 years.

The Lehman Brothers U.S. Corporate High Yield Bond Index covers the universe of fixed rate, non-investment grade debt. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, and 144-As are also included.

Lehman data courtesy of Lehman Brothers Global Family of Indices.

parative index has been changed to the Lehman Brothers Aggregate Bond Index retroactive to the inception of the composite because this is a more widely used performance benchmark.

The Core Plus Composite emphasizes various sectors of the fixed income markets, with each portfolio maintaining an overall average credit rating of at least A. Portfolios in the composite may invest up to 20% of assets in securities rated below investment grade.

The Short AAA Composite invests in the range of AAA fixed income investments and maintains a portfolio duration within a range of 0.25 years of a target duration of 2 years. Certain portfolios engage in securities lending to increase the return earned by investors. Prior to February 2006, the composite was named the Target 2 Short Duration Composite.

The Core AAA Composite invests in the range of AAA fixed income investments. Certain portfolios engage in securities lending to increase the return earned by investors. Prior to February 2006, the composite was named the Target 5 Core (AAA) Composite.

High-Yield Composite Accounts included in the Composite seek regular and predictable U.S. dollar interest income primarily through a portfolio of high-yield securities, although allocations to investment-grade securities may be made from time to time. The minimum average credit quality for a portfolio to be included in the Composite is B. The benchmark is the Lehman Brothers U.S. Corporate High Yield Bond Index.

The Dwight Stable Value Separate Account Composite* shows the credited returns to all of discretionary separate account clients. Calculations are time and dollar-weighted. The composite excludes non-U.S. plans, commingled funds, and wasting trusts.

Stable Value Commingled Fund* returns represent those of the SEI Stable Asset Fund. Gross returns reflect reinvestment of interest income, and will be reduced by management fees and other expenses, which vary among clients based on various factors (see Form ADV, Part II). Net returns are based on the highest advisory fee rates payable under Dwight's current fee schedule. Past performance is no guarantee of future results.

*These stable value products use book value accounting, and therefore are excluded from the firm's assets for GIPS® purposes because it is not possible for them to strictly comply with GIPS®.