

As concerns in Europe over sovereign debt eased and the focus shifted back to the U.S. economic recovery, Treasury yields declined making riskier, higher yielding assets more attractive. While economic data over the quarter was mixed, growth has remained positive and a double-dip recession appears unlikely at this point. The Federal Reserve remains ready to provide additional policy accommodation if warranted and if predictions regarding the outcome of the mid-term elections are accurate, gridlock in Washington may not be far away. As such, we continue to expect a slow, uneven recovery which should benefit, if negative surprises can be avoided, many spread sectors in the fixed income markets.

While all sectors of the fixed income markets posted positive absolute returns, performance by sectors was mixed. Our overweights in the securitized sectors and corporate bonds were the largest contributors to our outperformance, while our yield curve positioning in Treasuries detracted from performance.

We continue to like corporate bonds with our primary overweight focused in banks and insurance companies. With the details of Financial Reform and Basel III now known investors have a better sense of how this sector will look moving forward and both managements and investors can focus on the fundamentals of the businesses. Our expectation is for these fundamentals to show continued improvement at the same time capital levels have been strengthened over the past couple years. Additionally, issuance in the banking sector is likely to be lower than normal given weak loan demand and robust deposit levels, a positive technical factor for spreads. We have a neutral view on industrial companies as their spreads offer less value, in our opinion, and the degree of shareholder friendly activity in this sector is increasing. These activities, share repurchase programs and dividend increases, tend to come at the expense of bondholders and bear watching closely.

In the securitized sectors, we are overweight commercial mortgage-backed (CMBS), asset-backed (ABS) and agency mortgage-backed (MBS) securities. Within the agency MBS sector we are favoring higher coupon pass-through securities and well structured collateralized mortgage obligations (CMOs). Pre-payment trends in higher coupon MBS have been slower in spite of the decline in interest rates due to a lack of homeowner's equity and tight lending standards. Additionally, we feel there is a chance for this sector to benefit from additional quantitative easing should the Fed reinstate those programs. Our overweight in agency MBS was funded with sales of short maturity ABS and agency debentures, where spreads have reverted to pre-crisis levels. We are focusing our attention in the ABS sector on Aa-rated auto loan and credit card structures where we feel there is still good value to be found. Finally, we have become more cautious in the CMBS sector as the Aaa-rated structures we have favored historically now have greater refinancing risk and we feel valuations are peaking for the near term. As a result, we may look to lighten exposure over the next quarter.

Our large underweight in U.S. Treasuries is unchanged and likely to remain so for the foreseeable future. We do not see value in this sector in spite of the possibility of further quantitative easing as we feel this could benefit other spread sectors more as investors reach for yield in this low interest rate environment. The yield curve continued to flatten in the third quarter as the yield spread between 2-year and 10-year Treasuries narrowed to 202 basis points from 233 at the prior quarter end. This trend may continue if the economic recovery remains slow as investors expectations for any tightening of monetary policy get pushed out well into 2011.

Past performance does not guarantee future results.

Reflects aggregate information for the accounts included in the Core Fixed Income (Broad Market) composite. The composite is not an actual account, and the information provided may vary from one account to another. Portfolio holdings, and therefore characteristics, are subject to change. FOR SEPARATELY MANAGED ACCOUNT INVESTOR USE ONLY