Smith, Graham & Co., Investment Advisors, L.P.

Cyril M. Theccanat
Executive Vice President
Managing Director – Investment Management

Investment Review and Outlook
3rd Quarter 2008

Fixed Income Markets

The turmoil in the financial markets took a turn for the worse in the last month of the third quarter. The precipitating event was the Chapter 11 bankruptcy filing of the fourth largest investment bank, Lehman Brothers, after the Federal Reserve and the U.S. Treasury declined to provide a backstop as was done for Bear Stearns in March, which would have facilitated an orderly acquisition of Lehman by a stronger financial institution. Other market-moving events during the quarter included the U.S. government's appointment of a conservator for Fannie Mae and Freddie Mac, as well as one for the insurance giant AIG, and the seizure of Washington Mutual by the FDIC. The intensifying turmoil in the markets led to a flight to quality which resulted in a sharp decline in Treasury yields. The yield on the 2-year Treasury note fell by 66 bp to 1.96%, while the yield on the 30-year Treasury bond decreased by 21 bp to 4.31%. The Treasury yield curve steepened with the 2-year/30-year yield spread widening by 45 bp to end the quarter at 235 bp.

Fears of spreading systemic risk caused the largest quarterly widening on record for credit spreads. The Lehman Brothers Credit Index widened by 147 bp to end the quarter at 385 bp, which represents a record underperformance versus Treasuries of -884 bp. The sector's underperformance was broad-based as all corporate sectors posted negative excess returns led by the financial sector which recorded an excess return of -1616 bp followed by the utility and industrial sectors with excess returns of -642 bp and -574 bp respectively. While the credit curve steepened during the quarter as long maturity corporate bonds underperformed intermediate issues by -414 bp, the quality curve flattened by 521 bp as the finance-heavy single-A sector underperformed the industrial/utility dominated BBB-rated sector. Reflecting the depressed market tone, issuance of investment grade fixed rate debt fell sharply to $78 billion, which was almost $200 billion lower compared to the second quarter.

The residential mortgage-backed (MBS) sector fared much better than other fixed income sectors following the U.S. Treasury's unprecedented steps of placing Fannie Mae and Freddie Mac into conservatorship. The announcement that the Treasury would purchase agency MBS, allow the GSEs to grow their retained portfolios by $180 billion, and the proposed bailout package that focused on distressed residential mortgage securities provided additional support for the MBS sector. Conventional 30-year mortgages outperformed Treasuries by 23 bp, while their GNMA counterparts lagged by -27 bp in excess return. The need to add spread duration in the MBS sector resulted in discounts outperforming premiums by a wide margin, and in the 30-year sector outperforming the 15-year sector by 65 bp. The asset-backed sector (ABS) underperformed Treasuries by -569 bp. Credit card and auto ABS posted excess returns of -486 bp and -666 bp respectively as consumer credit deteriorated further due to declining home prices and a weaker labor market. The commercial mortgage-backed (CMBS) sector's performance mirrored the credit sector, and CMBS significantly underperformed Treasuries by -809 bp on market concerns about financial institutions' exposures in commercial real estate

Sovereign bond markets in most international developed countries outperformed the United States during the third quarter as concerns grew that the global economy would experience a significant slow down due to the contagion from the U.S. credit crisis. While yields in the United Kingdom, Germany, Australia, and New Zealand declined by more than in the U.S., the decline in Canadian and Japanese yields was less. Notable outperformance in two-year interest

rate differentials relative to the U.S. were +99 bp for Australia and +56 bp for the United Kingdom while Japan and Canada underperformed by -22 bp and -19 bp respectively. During the quarter, the Reserve Bank of New Zealand (RBNZ) and the Reserve Bank of Australia (RBA) initiated their monetary easing cycle and cut interest rates by a total of 75 bp and 25 bp respectively. The European Central Bank (ECB), on the other hand, raised interest rates by 25 bp as inflation worries trumped growth concerns early in the quarter. Reflecting narrowing interest rate differentials, the U.S. dollar was higher against a basket of six major currencies by 9.6%. Most notably, the Australian dollar fell by 17.4%, while the New Zealand dollar declined by 12.1%. The Euro and the British pound both dropped by 10.5%. The Japanese yen was the only currency to post a small gain as it benefitted from risk aversion and the reversal of carry trades.

Outlook

The financial crisis which accelerated and turned into a global crisis since the end of the third quarter has now taken center stage. The specific problems with write-downs and losses at financial institutions over the past several months has spilled over into most other sectors of the economy as credit markets around the globe seized up. The resulting collapse in investor confidence is the crux of this crisis. In our view, the strong and coordinated actions recently taken by central banks and governments world-wide, such as guaranteeing inter-bank lending and capital injections into banks, will be successful in lowering short-term borrowing costs for companies, improving liquidity and reversing negative investor psychology. As a result, the economic recessions that are likely to follow in a number of regions across the globe may be tempered. The broad-based and sharp declines in commodity and energy prices provide a constructive foundation for the outlook on inflation. A moderation in inflation pressures will enable central banks to maintain accommodative monetary policies and focus on managing market liquidity to help facilitate an orderly reduction of leverage in the financial markets. In the United States, the futures markets are now expecting a 1¼% target federal funds rate by the end of this year.

Spreads in the credit sector are at all-time wides. Valuations in many segments of the credit sector are compelling as the measures taken by governments and regulators ease fears about systemic risk. Issue selection will, however, remain important because some businesses are unlikely to return to normalcy even if market conditions improve. In a perverse way, the better relative liquidity in the Agency mortgage-backed securities sector has resulted in wider spreads for the sector as it has been used as a funding source to meet portfolio redemptions. With Fannie Mae and Freddie Mac now operating under a conservatorship, the recent widening in spreads makes this sector quite attractive. However, program, coupon selection and seasoning continue to be important factors to consider. The AAA-rated tranches of the consumer asset-backed sector are cheap following the recent widening in spreads. Maturities in the 1 to 2 year area for high-quality credit card and auto issuers offer significant value. The CMBS sector, especially AAA-rated tranches, is likely to benefit over the next several months as delinquencies and losses remain low.

Economic data from most developed markets indicates that the economic slowdown in these regions has accelerated in recent months. After the end of the quarter, central banks across many regions have also eased monetary policy in a coordinated manner in response to the global financial crisis. As a result, hedged interest rate convergence strategies for currencies with higher yields such as New Zealand and the United Kingdom continue to be attractive for U.S.-based investors. In the currency markets, the U.S. dollar is likely to be supported by favorable interest rate differentials.