Economic Backdrop

In 2007, defaults on mortgage loans rose significantly, particularly for subprime borrowers. Many of these loans had been packaged into structured securities, which suffered downgrades and loss of value. While much of the exposure to the sector was distributed across global markets, many financial institutions retained extensive investments in the sector. Often this investment was highly leveraged. By late 2007, banks were forced to raise capital to offset the write-downs. The Federal Reserve cut rates and took a number of other steps to assure system liquidity, and events appeared to be playing out in typical, cyclical fashion.

In 2008, the housing downturn grew more severe, exceeding Loomis earlier expectations. Some economists feared the US was in recession, and investors became apprehensive about loans of all types, not just mortgage-related. Concern for the strength of financial institutions increased. Disclosure from these institutions is notoriously murky, which made it difficult for investors to gauge exposures and potential losses. With losses mounting and financial institutions intertwined in an opaque web of credit default swaps (CDS) contracts and other exposures, uncertainty reigned. Banks grew leery about counterparty risk and pulled back from lending to one another, never mind consumers, businesses and municipalities.

As the third quarter hit, a crisis of confidence was picking up steam. Fears over financial institutions hit a new high, reaching as far as Fannie Mae and Freddie Mac, despite their close ties and importance to the federal government. In September, it came to a head. A rapid series of events unfolded, with each seeming to have a more destabilizing effect on the markets than the last. First, the government sponsored enterprises (GSEs) were placed into conservatorship, and their dividends were suspended, creating chaos in the preferred market and wiping out an important source of capital for the banks. Next, Lehman Brothers went bankrupt, and Merrill Lynch, fearing it was next, opted to be acquired by Bank of America. Money market funds with holdings in Lehman commercial paper were stung by losses severe enough to cause massive redemptions and the close of the country's oldest money market fund. The CDS market was in disarray as institutions were hit by collateral calls they had a tough time meeting. This helped take down AIG, one of the largest insurers in the world. In rapid succession, Goldman Sachs and Morgan Stanley decided to transform themselves into commercial banks, while Washington Mutual and Wachovia were each acquired by stronger banks. Through all of this, the Fed and the Treasury were aggressively pumping liquidity into the markets and negotiating deals. This culminated with the so-called "bailout bill" at month-end.

The impact on the fixed income markets has been to drive down the value of bonds issued by financial institutions to unprecedented levels. Additionally, the transformation of the investment banking world has reduced market liquidity. Lower liquidity and higher uncertainty have caused the prices of most other credit-related debt securities to come under severe pressure. In bond terms, yield spreads have risen to historically wide levels. Loomis did not anticipate the crisis of confidence that exploded across the markets in September.

Where is the market today? What do we think?

Loomis expect policy makers to take some form of action to stem the immediate financial crisis, but that action will likely be insufficient to alleviate the stresses in the broader economy. They also expect returns on higher risk investments will improve, but not immediately. Investors need to see evidence that banks are making progress in healing their balance sheets and that future home price declines won't cause more severe problems.

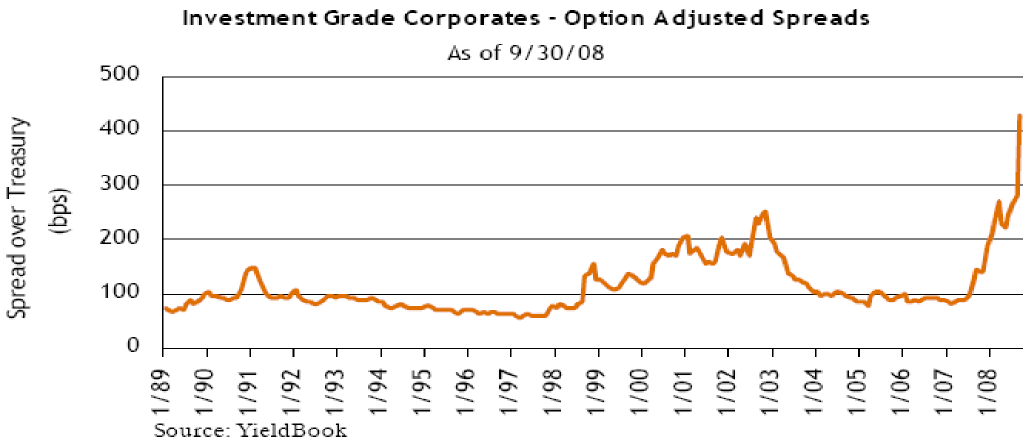
Between the Federal Reserve and Treasury, massive sums have been brought to bear to keep the financial system alive, including an alphabet soup of borrowing programs. Now that we have action out of Washington, hopefully we can turn back attention to the economy. Recession risk has grown, as there could be many headwinds ahead, not the least of which is a tight credit environment. Other concerns are the loss of wealth from home and stock prices, plus the risk that a cold winter will bring an expensive heating season. Home prices are expected to fall through 2009, and most estimates indicate we are about half-way through the total price decline.

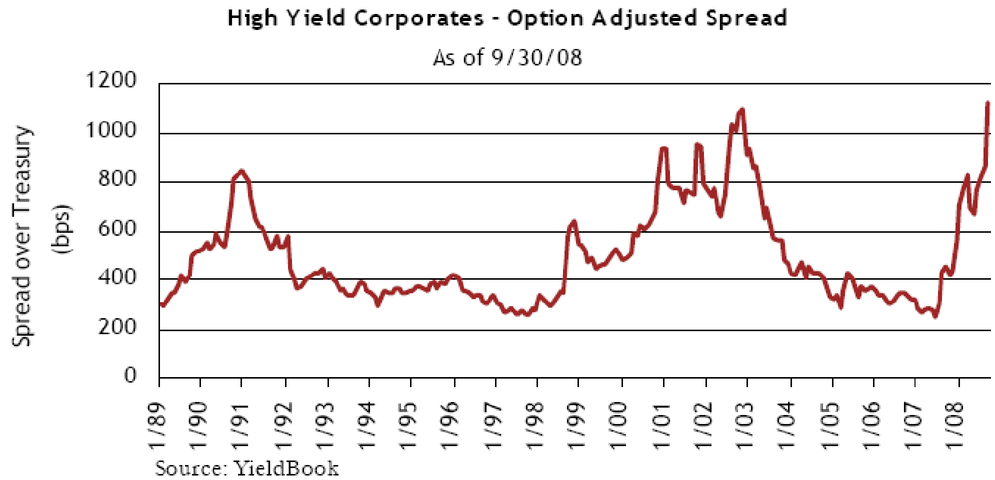
Loomis current official forecast is for a 2% decline in economic growth for the fourth quarter of 2008. The 1Q09 will likely be sluggish at best, and possibly negative. They believe the Fed may need to cut rates by 50-75 basis points by January. The global economy has been slowing, too. The US is not the only country with a financial crisis on its hands. Looking ahead, we see more consolidation, more regulation and tighter lending standards. There will be less credit available in coming quarters than we have been used to.

Our markets continue to work through five overlapping phases of this financial crisis—a housing crisis, a financial crisis, a market crisis, a political crisis, and finally, an economic crisis. None are over yet, but we're making progress. Home prices will continue to decline, but as we work down the excess inventory, those declines will decelerate. The Loomis economist believes housing starts are bottoming and the worst of the construction crisis is almost behind us. The financial and market crisis will likely ease when the right mix of policy responses finally unfolds. The economy could start to turn up by mid-year 2009, though it may take longer—and we're not suggesting it will be robust. Experience with past market cycles shows that once confidence and optimism are restored, markets can turn up quickly as investors recognize that good companies are selling on the cheap. Loomis are working hard to ensure our investments are in a prime position to capture potential upside.

How can the fund benefit?

The following graphs seek to place in a historic context the severe weakness experienced in the credit markets in the recent period. These graphs also point out the significant recoveries following prior periods of spread widening.



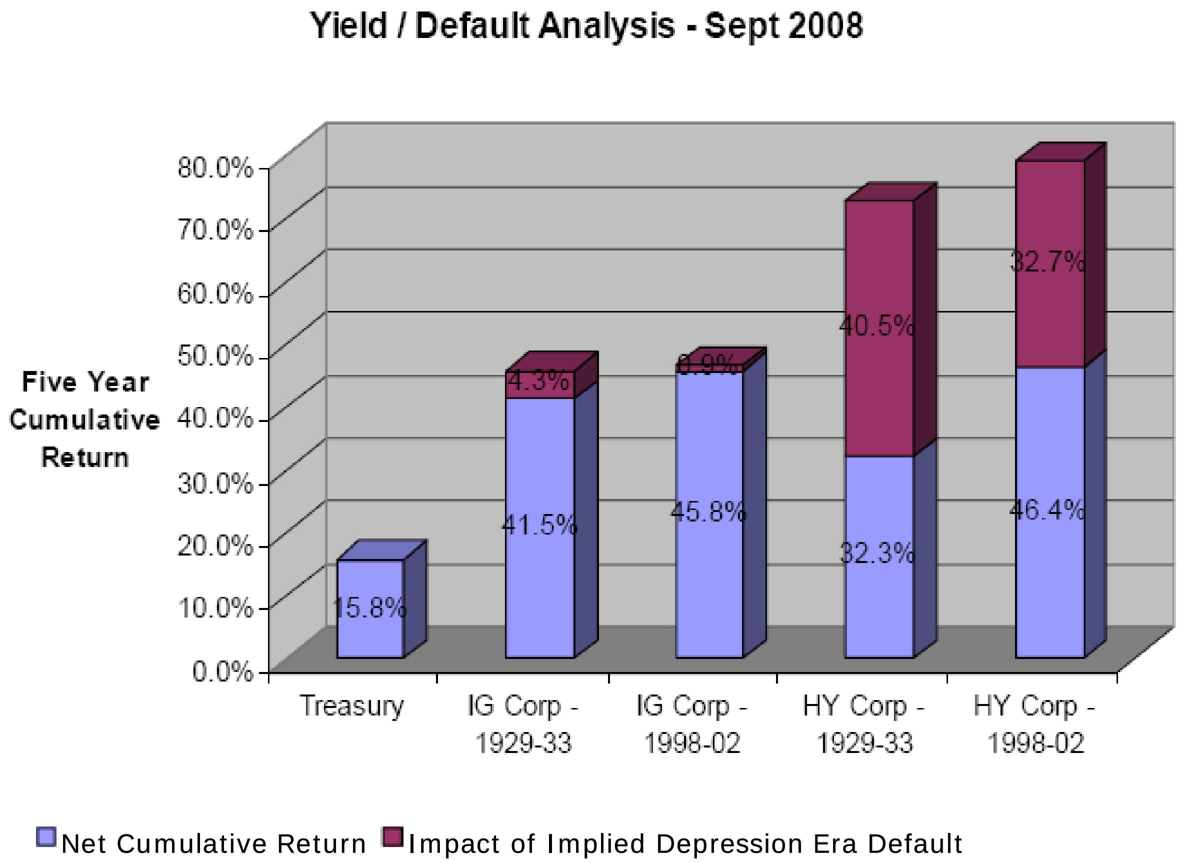


Past performance is no guarantee of future results

The yield-spread advantage offered by these market segments is at historic levels. Related on these yield levels, assuming one can minimize defaults, the potential return level to US Treasury securities today could be significant.

At the end of September, the yield advantage offered by investment grade and high yield indices relative to the *Lehman US Treasury Index* were 4.87% and 10.95%, respectively. Our analysis indicates that even if over the next five years we face defaults consistent with the worst historic periods of defaults on record (1929–1933 and 1998-2002), these sectors has the potential to provide significant return advantages relative to Treasurys.

As shown in the following graphic, at current yields, the Lehman US Treasury Index would generate a cumulative 15.8% return over a five-year period. This would compare to the net results for investment grade and high yield corporates of 41.5% and 32.3% after applying 1929-33 default rates, and 45.8% and 46.4% after applying 1998-2002 default rates. Higher rates of default would certainly eat into this return advantage, and on conversely lower default rates could increase the advantage.



This analysis indicates that corporate bonds currently offer the potential for positive risk-adjusted returns. Loomis Sayles strategy is to capture as much of this yield as possible and attempt to limit defaults so that they can take advantage of performance opportunities.

How is the portfolio positioned and why?

History offers few comparatives for the conditions in today's fixed income markets. Yield spreads are wide, market liquidity is extremely limited and investor uncertainty dominates. It is in just such periods that buyers are offered the opportunity to make attractive long term investments.

Loomis Sayles continue to work diligently to identify those companies and securities that they expect to survive and flourish in the emerging financial market landscape and fully participate in a market recovery. Their most significant investments are in securities issued by companies in the industrial sector of the investment grade and high yield markets. Additionally, they see the US dollar increasingly challenged to maintain its recent strength. The current proposals to resolve the financial crisis are likely to double the US government's budget deficit next year, exacerbating the country's financing needs and supporting the longer-term trend toward further dollar adjustment against other major currencies. Loomis see most of this adjustment relative to Latin American, Canadian and Asian currencies. This draws them to a near 30% allocation to non-US dollar denominated securities.

The following provides Loomis Sayles outlook and positioning views on several key portfolio decisions.

Drivers	Outlook	Portfolio Positioning
Interest Rate & Duration	Economic tensions to keep a lid on rate increases over the next several quarters. For now, weak domestic and global economic conditions take precedence over inflation concerns.	Though Shortened since December, expect to maintain duration of +1 to +2 years longer than respective benchmarks.
Investment Grade Credit	Financials have been especially punished, as survivor banks nurse capital and attempt to recapitalize. Spread likely to remain volatile as credit crisis ripples through economy. BBB-rated credit may offer come of the best values relative to risk, especially as much of the bad news has already been built into spreads.	Opportunistically deploy reserves where fundamentals indicate attractive values. Among financials, identify key survivors; among industrials and utilities, mix defensive cash generating firm with credits that stand to benefit from longer-term economic recovery.
High Yield	High yield market has held up relatively well since the credit crunch began. More recently, technical pressures have pushed spreads wider. Expect that defaults will rise as tightened lending constrains corporate expansion.	Exercise caution on highly levered issuers that may face impaired access to capital. Very selectively identify unduly punished “fallen angels”, including specific lower quality credits where longer-term fundamentals justify added credit risk.
Non-dollar/Currency	Any US dollar strength in the neat-term is unlikely to be sustained. Secular global growth and rising US budget deficits point to a falling dollar environment over the long term.	Non-dollar holdings continue to act as risk diversifiers in the portfolios. Growth in Latin America and Asia likely to support further appreciation vis-à-vis the dollar, and commodity currencies are valuable hedges against future inflation.
Overall	Residential real estate prices are central; weathering the housing crisis of confidence remains a key prerequisite to economic recovery and to a successful restart of the financial sector. The policy response needs to unclog stalled credit markets. Liquidity will be key in navigating the bumpy road.	Over time, attractive price and yields present opportunities to leverage prudent security selection in both investment grade and high yield credit. Position portfolios for longer-term economic recovery over the next 18 to 24 months. Maintain liquid reserves as flight-to-quality hedge.

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