

Market Perspectives

Mid-August 2007

A STATE OF DISINTERMEDIATION

What started as a sharp decline in a relatively obscure corner of the U.S. capital markets has morphed into a significant shock to the global financial system. In fact, it is clear that capital markets have recently passed into a state of disintermediation, with investors selling all manner of risk assets and looking to buy U.S. Treasuries. High-yield debt, equities, precious metals, oil, and higher yielding currencies have been caught in the crossfire of fast and furious selling.

Amidst the turmoil, the U.S. dollar has risen despite the bearish economic outlook portended by recent events. The ascendancy of the dollar has acted as a vivid reminder that it remains the world's currency of choice in times of crisis.

The Yen, too, has risen, but for a different reason. During the bountiful investment climate of the past several years, many investors have made use of the "carry trade," whereby they borrow in a low interest rate environment (e.g., Japan, where rates are less than 1%) to invest in higher yielding assets.

As investors unwound the "risk" side of their transactions, they paid-off their loans in countries like Japan. This repatriation of currency was in effect a massive buy-back of Japanese yen, which has led to the currency's sudden sharp rise.

THE MORTGAGE MORASS

The recent global sell-off was triggered by the deadly combination of falling prices, illiquidity and leverage in the U.S. mortgage market, and particularly in the subprime and related segments of that market.

The subprime mortgage market encompasses about 15% of the total \$8 trillion of mortgages in the U.S., with the Alt-A mortgage market comprising another 20%. (The Alt-A market is a slightly better credit than subprime, where the borrower can get a mortgage with little money down or with limited documentation of one's financial standing.)

The vast majority of mortgages are securitized into larger pools, with these supposedly diversified pools then carved into as many as one-hundred tranches, each with its own risk characteristics. The complex models built to value these derivatives assumed certain default rates – assumptions which, due to lax underwriting standards, turned out to be far too low.

A RUN ON ALL THINGS "RISKY"

We believe there are two major elements that have contributed to the recent meltdown: credit quality and liquidity – issues which have both been exacerbated by leverage. Credit quality refers to the credit worthiness or default rate of the underlying collateral (homes). Lack of liquidity has played a role in all financial and ownership transactions related to mortgage origination, sales and servicing.

With respect to credit quality, the default rate of the mortgage market last year in the U.S. was less than two-tenths of one percent, probably a trough. Thus far in 2007, default rates have increased, especially in the 2006 vintage loans. We believe that those mortgages taken out by borrowers with the implicit assumption

Figure 1 Going Down...High-Yield Bonds, Equities, Commodities¹

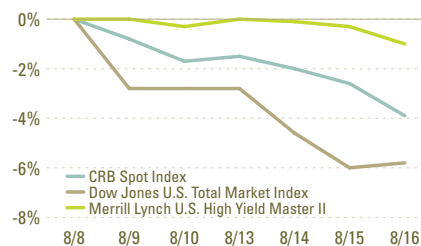
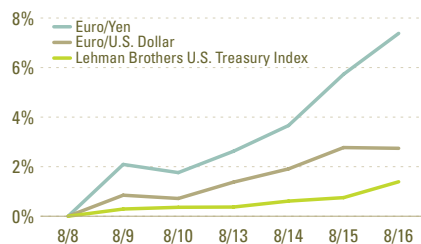


Figure 2 Going Up...Treasuries, U.S. Dollar, Yen¹



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that real estate prices always rise will likely be in default in the next year, putting further upward pressure on default rates. This includes interest-only loans, which were a major factor in the California, Florida, and New York mortgage markets in 2006 and the so-called NINJA (No Income No Job No Assets) loans written by mortgage companies like the now defunct New Century Financial. In addition, recent pronouncements from Countrywide Financial have made it clear that the problems stemming from shaky credit are more widespread and pervasive than many had thought...or perhaps hoped.

With respect to liquidity, the deteriorating credit quality of the subprime mortgage market puts stress on leveraged portfolios holding the underlying paper, particularly hedge funds. In some instances, hedge funds have taken these instruments and levered them 10 to 15 times. Bear Stearns brought the issue to the foreground roughly two months ago when it disclosed that it had been forced to inject over \$3 billion into one of its hedge funds specializing in highly-leveraged subprime collateralized debt obligations (CDOs) while negotiating with other banks to loan money against collateral to another fund.

As the prices on the lower-rated tranches began to drop, investors were forced to sell to meet margin and collateral calls. However, they were selling relatively illiquid securities (how liquid can a tranche that is 1% of a pool be?) into a market where the pricing models were showing obvious flaws. This exacerbated the precipitous drop in prices, and, in many instances, led to a situation in which no market-clearing price could be established.

The market has seen hedge fund sellers finding no buyers – a situation made worse by the market's ability to smell a distressed seller. Since these funds are typically not well capitalized, they do not have the ability to hold such securities until maturity like most insurance companies, for example. A dramatic drop in prices triggered by these liquidity issues has served to influence redemptions. With increased redemptions comes greater stress on the seller and a vicious cycle is created.

Given the lack of bids for subprime tranches, investors attempted to liquidate higher-quality mortgage securities to meet their capital requirements. Unfortunately, this forced selling led spreads to widen significantly in the higher-rated tranches, even when there was no appreciable up-tick in predicted default rates.

We believe well-capitalized companies should not have to sell their holdings of these securities into a panic-driven market. For example, an insurance company may promise an investor in a fixed annuity a 4.5% return and use a AA or AAA rated subprime mortgage that returns 6% to offset that requirement. As long as the cash flows are not interrupted, there is no "real" financial impact if it is held to maturity. (This fact notwithstanding, even for an insurance company, a mark to the market of a security may result in a short-term negative effect to shareholder's equity and solvency capital, although only in rare instances is there reason to believe that this would result in a fundamental impairment of the business model.)

In conclusion, we believe that the prevailing subprime market meltdown is indicative of the pressures put on hedge funds that are highly leveraged and have a short-term focus. These funds, as well as a large number of quantitative and "market-neutral" funds, are being subjected to a demonstration of damaging volatility. On the flip side, intriguing opportunities are now emerging throughout the market for long-term value investors.

ENTER THE FED

Just when it seemed the week couldn't prove any more dramatic, on Friday, August 17th, the U.S. Federal Reserve took the unusual step of lowering the discount rate by 50 basis points and announcing it would allow for the provision of term financing for as long as 30 days, renewable by the borrower. The discount rate is the rate at which the Fed lends reserves to banks, and it differs from the Fed Funds rate, which is the rate at which banks lend reserves to each other. Since the Fed action is not likely to significantly impact prevailing market interest rates, the Fed is defusing its impact on the broader economy and in essence making a non-statement regarding the state of its inflation-fighting policy. Instead, the reduction in the discount rate is specifically targeted toward easing liquidity problems in the banking system, thereby relieving pressure on the beleaguered state of credit apportionment that has arisen in the U.S. in the face of intense concerns over home lending and consumer credit quality. By reducing the penalty rate on discount window lending from 100 basis points over the Fed Funds rate, where it has stood uninterrupted for 27 years, to 50 basis points, the Fed is giving banks the ability to lend and injecting much needed capital into the system.

The impact of the Fed's move on the global markets was immediately apparent. A sharp "gap up" in U.S. equity markets, a 10 basis point spike in the 10-year Treasury yield, and a pause in the furious unwinding of the Yen carry trade greeted investors already wearied by volatility unseen since the waning days of October 2002. Whether the Fed's recent actions will be enough to stabilize the global market in a more lasting manner remains to be seen. Market pundits have taken to endless debate over the prospect of a forthcoming cut in the Federal Funds rate orchestrated by "Helicopter Ben."

BRANDYWINE GLOBAL SUBPRIME EXPOSURE

With respect to our Fixed Income Portfolios, we have fielded several inquiries from clients seeking to determine whether we have any exposure to mortgage securities or other credits that could potentially leave them exposed to the ongoing crisis in the subprime space. The answer is no, we have not. Our Global and International Fixed Income Portfolios are predominantly government credits; prior to the recent collapse, we held only a handful of government agencies in

countries where spreads warrant. We hold absolutely no mortgage paper.

As a value investor, we have always sought to take advantage of extremes in market behavior and limit our purchases of mortgages and corporates to periods when spreads are wide from an historical perspective. Since spreads have been at historically tight levels for several years now, we have avoided the high yield sector for about as long. We view the current wider spreads (some 107 bps wider in the month of July) as a potential opportunity to participate in the higher yielding sectors of the market and possibly even in mortgages when that sector eventually stabilizes.

In the risk aversion panic of the past several weeks, we have been actively purchasing high-grade corporate bonds. For most of our fixed income client base, any corporate bond holdings will be recent purchases. We believe recent sellers of these securities are simply seeking alternate sources of liquidity with the hopes of riding out the current fear in the market. (It is worth noting that spreads have not widened further since the bulk of purchases were made.)

We are monitoring emerging market positions in our opportunistic portfolios. In the current risk averse climate, these holdings are subject to increased volatility for reasons unrelated to their underlying fundamentals. Please note that on the flip side, our U.S. Treasury bonds, a large relative overweight in the same portfolio, benefit from this flight to quality. We are mindful of the fact that emerging markets are sensitive to changes in expectations for global growth, and our current assessment is that a severe pullback in global growth is unlikely. We believe the more likely scenario is that the compelling equity market valuations created by the recent volatility brings buyers to the table, helping to stabilize markets. However, looking ahead, we do expect continued volatility as the market struggles to assess the full impact of the subprime situation.

For the patient equity investor, volatility can be beneficial if one is able to purchase stocks of well-managed, well-funded companies at low prices in times of stress. We will continue to seek to purchase companies with sound business models selling at discounted valuation levels, while remaining intensely focused on evaluating all portfolio companies to make sure we fully understand their risk profiles. The current scare, we believe, has in many cases impacted prices more than fundamentals, creating some very interesting buying opportunities for the long-term value investor.

¹Source: Thomson Datastream

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