

Payden & Rygel

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The Role of Fixed Income Today

Why Invest in Bonds?

- Bonds plays a special role in an overall asset allocation program by providing volatility dampening and a regular income stream.
- One should place special emphasis on designing bond portfolios that retain “bond-like” characteristics. Sounds easy...

Information Sources

- Listen to people: client, consultant, traders, strategists
- Comprehensive Process: strategy development, risk analysis, portfolio construction, trade execution, and significant portfolio attribution for ex-poste analysis.

Current Opportunities

- Significant market dislocation in this past year → valuations are at very cheap levels.
- Look for ways to capture yield without having to dip into more esoteric structured bonds whose modeling criteria have undergone catastrophic failures.

Recent Market Dislocations

Every Segment of the Fixed Income Market Has Been Hit Differently:

- Municipals:
Auction Rate, VRDN
 - Coupon spike on resets
 - Monoline insurer debacle

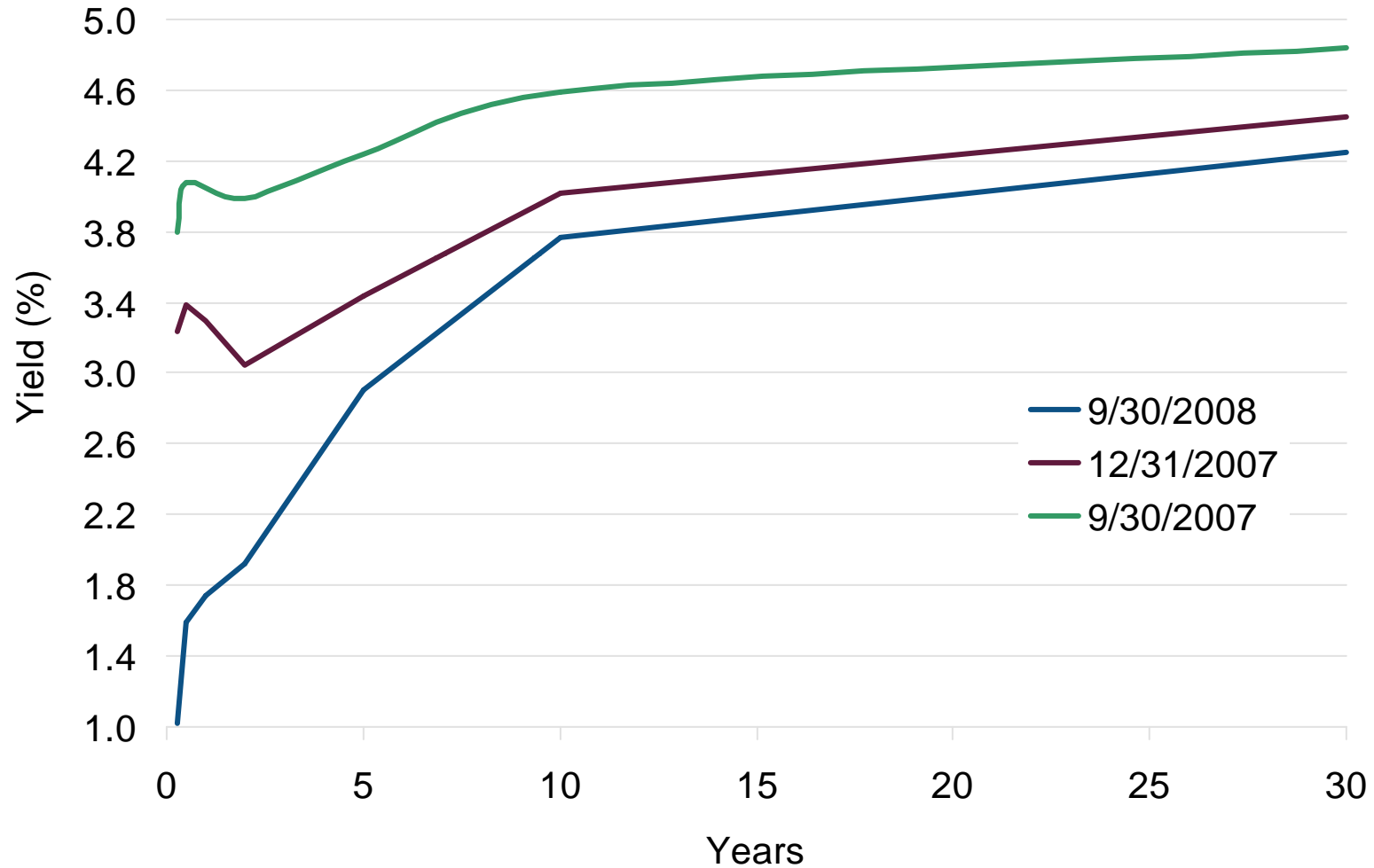
- Money Market Funds:
 - “Breaking the buck”
 - Crisis of confidence

- Low Duration:
 - Over-use of mortgage product
 - Very disappointing returns

- Credit:
 - Bear Stearns, Lehman, Merrill Lynch
 - Wachovia, Washington Mutual, Countrywide
 - FNMA, FHLMC

Bond Market Environment

US Treasury Yield Curve



Bond Market Environment

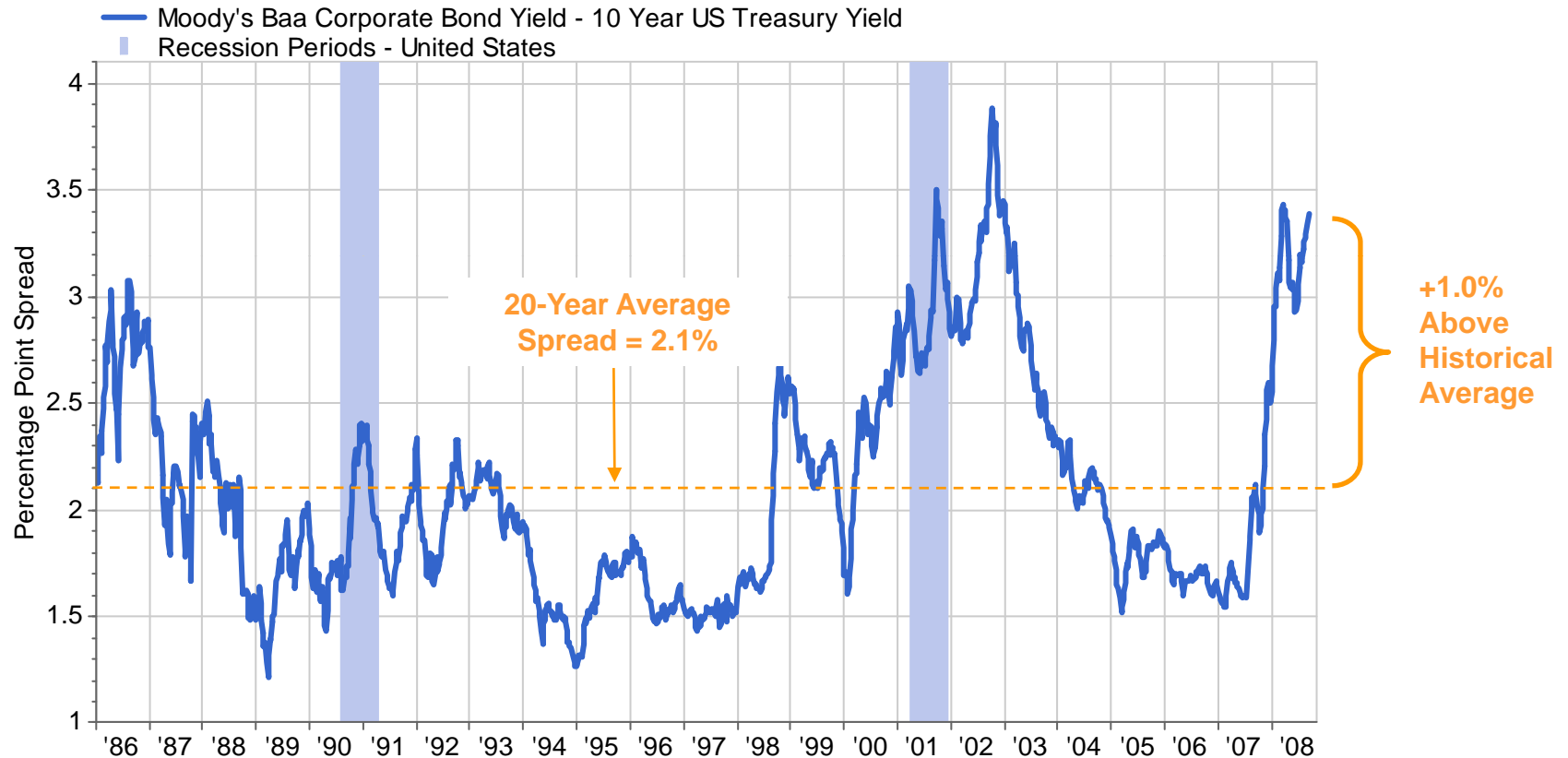
Swap Spreads Indicate Risk Aversion



Source: Bloomberg

Corporate Bonds Are Beginning to Offer Better Value

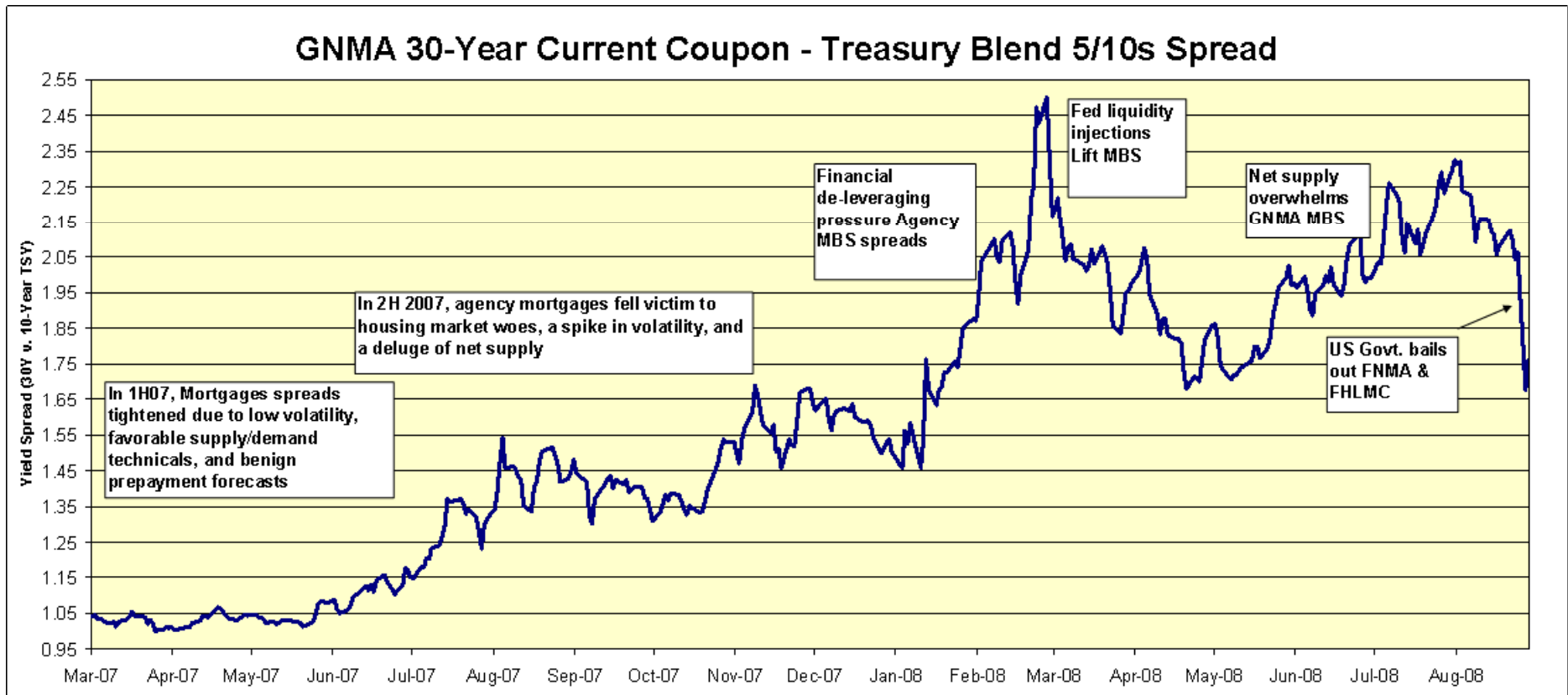
Risk Premium: Moody's Baa Corporate Bond Yield minus 10-Year US Treasury Bond Yield



Source: Federal Reserve

The re-pricing of risk in financial markets is creating pockets of value in the corporate bond market. Although historical trends suggest that credit spreads could increase further, corporate bond yields are beginning to look more attractive.

GNMA Mortgage Opportunities: Historical Wide Spreads offer Long-term Fundamental Upside



What's in a Core Bond Benchmark?

Lehman Aggregate:

Treasury	22.5%
Agency	11.0%
Mortgage Agency	39.5%
Commercial Mortgages	4.7%
Asset-Backed	0.8%
Corporates	18.7%
Sovereign/Supranational	2.8%
	<hr/> 100.0%

← Mostly FNMA & FHLMC

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- Mortgages have become the dominant portion of the investable U.S. Market

Top Corporate Names in Lehman Aggregate:

<u>Company</u>	<u>% of Index</u>
G.E.	0.68%
J.P. Morgan	0.58%
Citibank	0.54%
Goldman Sacks	0.51%
AT&T	0.49%
Bank of America	0.41%
Morgan Stanley	0.39%
HSBC	0.35%
AIG	0.33%
Merrill Lynch	0.30%

The Market's Perception of Inflation?

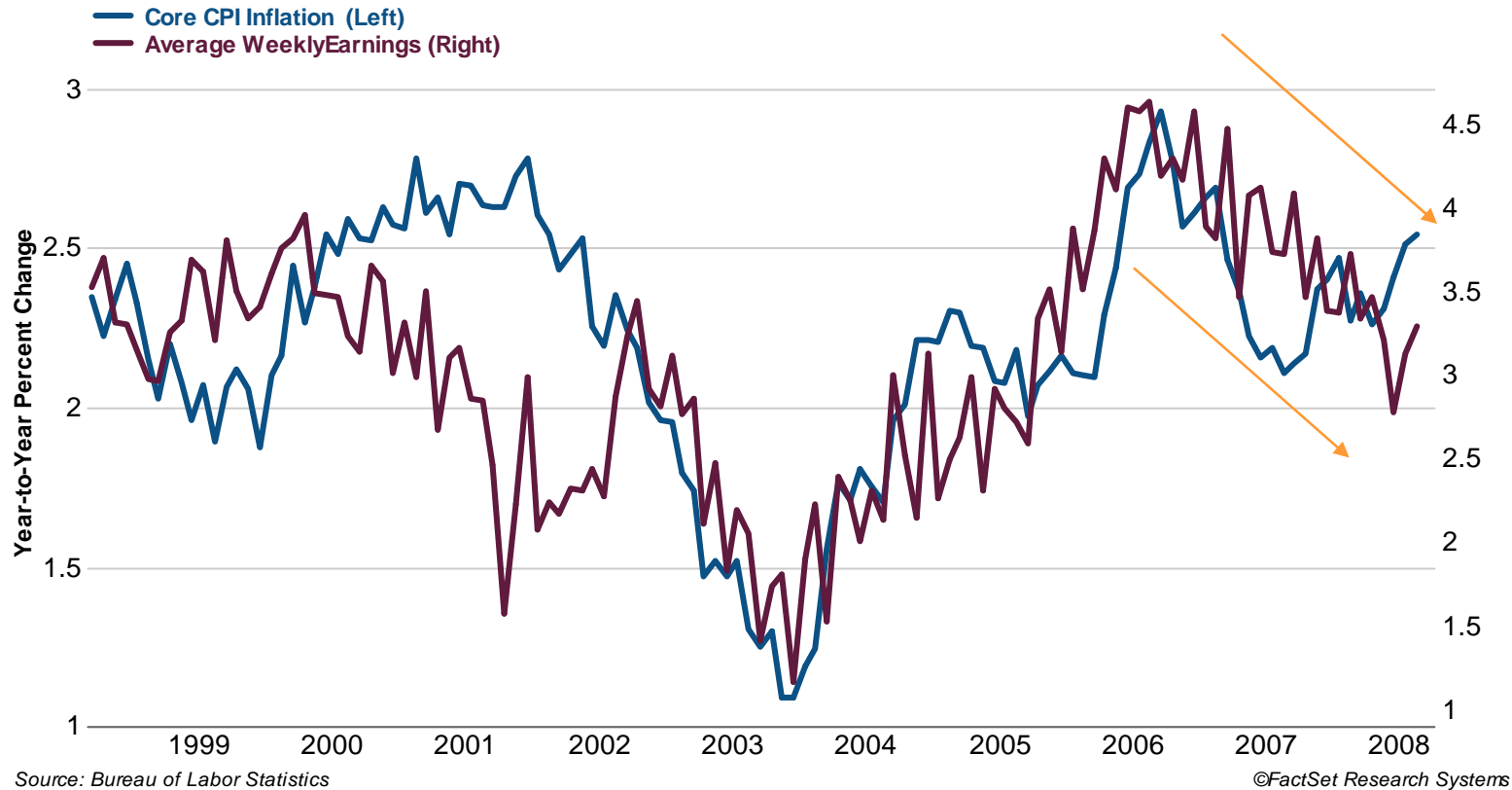
	Maturity			
	2 Year	5 Year	10 Year	30 Year
Nominal Treasury Yield	2.00%	3.00%	3.90%	4.45%
TIPS* Yield	1.80%	1.80%	2.00%	2.30%
Implied CPI	0.20%	1.20%	1.90%	2.15%

Data as of Sept. 23, 2008

** Treasury Inflation Protected Securities: Coupon adjusted based on U.S. consumer price index.*

Slowing Wage Growth Suggests Limited Risk of Wage-Price Spiral

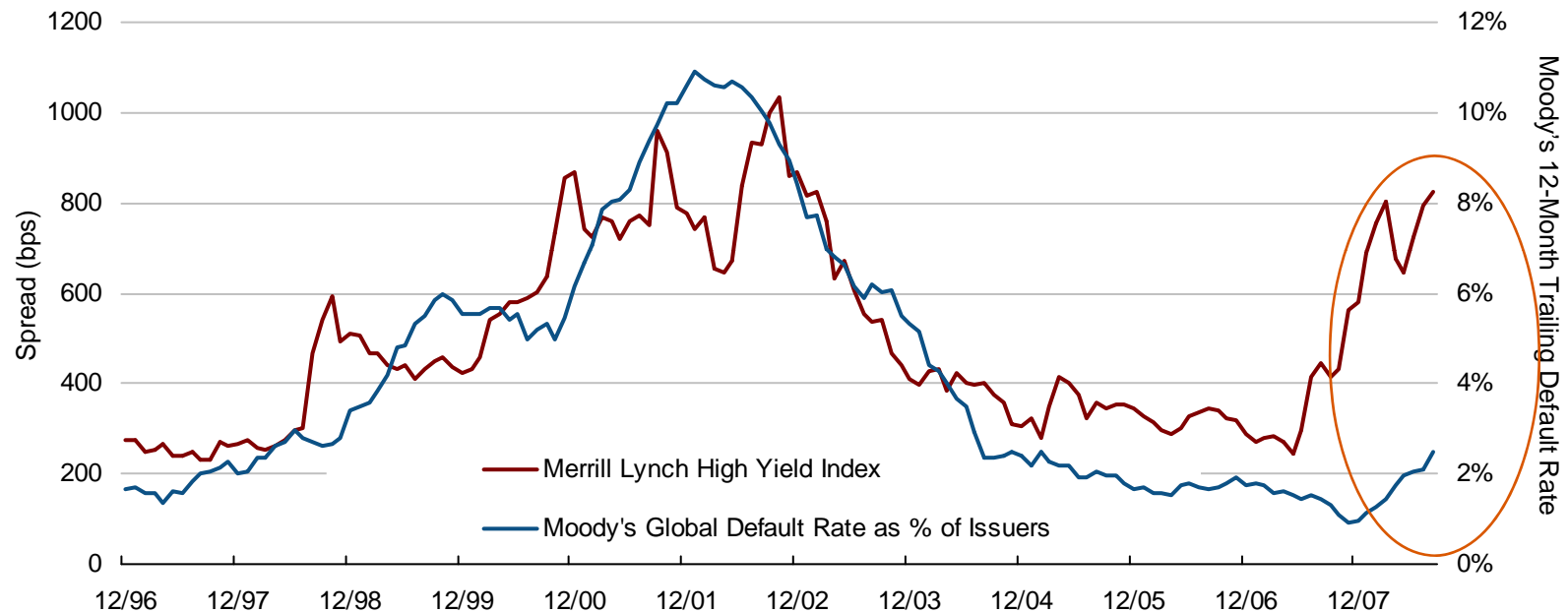
Core Consumer Price Index (CPI) and Average Weekly Earnings



The rise in the headline CPI has not translated into a more broad-based as evidenced by the relatively benign readings on the core CPI, which excludes food and energy prices. The reason for this is that the softening labor market has prevented workers from demanding pay raises to compensate them for higher energy prices. This is what occurred during the Great Inflation of the 1970s.

High Yield Spreads have Decoupled from Market Fundamentals

Merrill Lynch High Yield Index Spread Over Treasuries vs. Moody's Default Rate

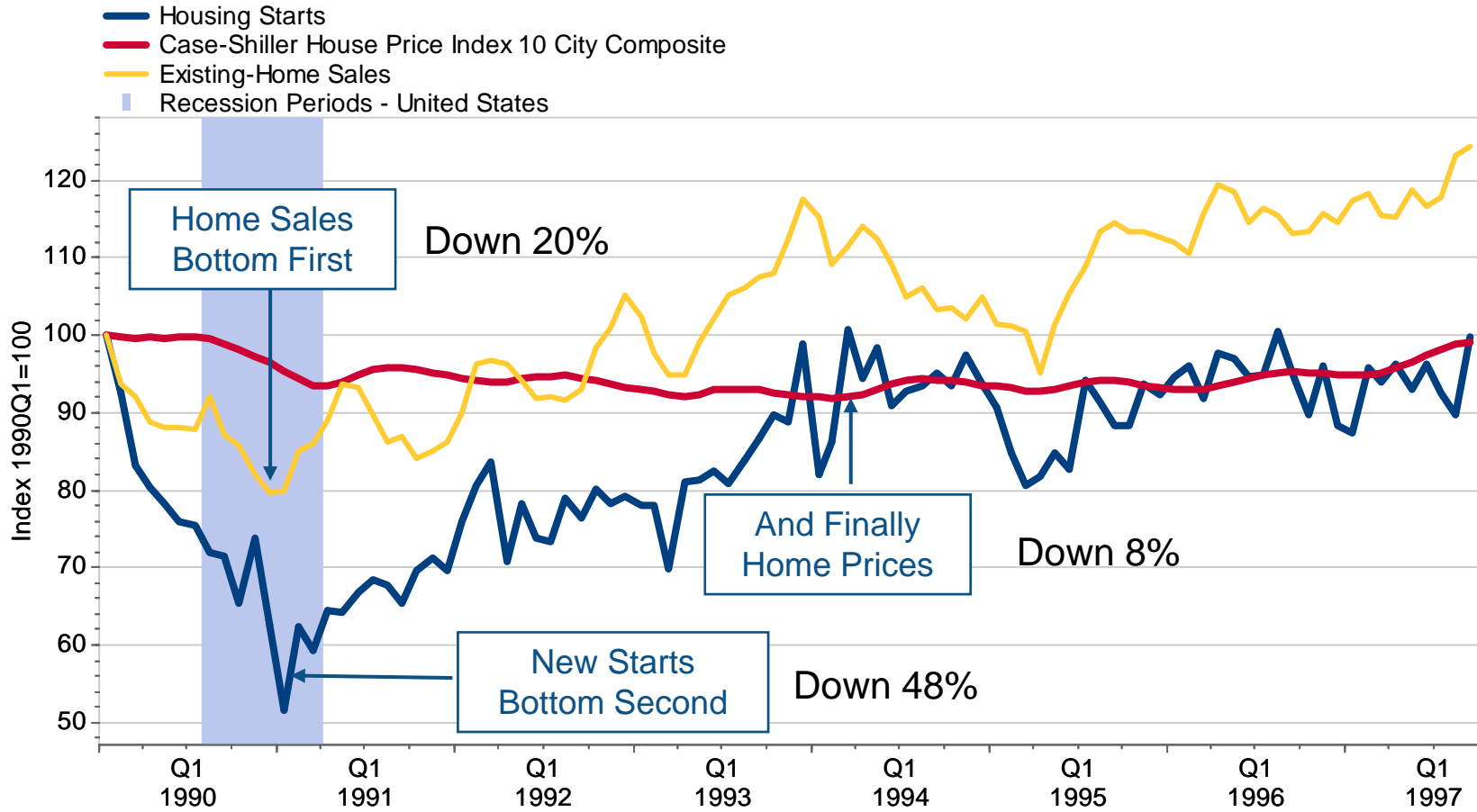


Source: Merrill Lynch, Moody's

High Yield spreads began to widen in June/July 2007 and trend continued into 2008 as growing dislike of risk and worries about the credit crunch and the US consumer drove spreads wider. The market began to rally post the hastily arranged takeover by JP Morgan of Bear Stearns in mid March 2008. Risk aversion increased over summer 2008 as worries about a global economic slowdown grew.

Defining the Bottom...Sales, Starts or Prices?

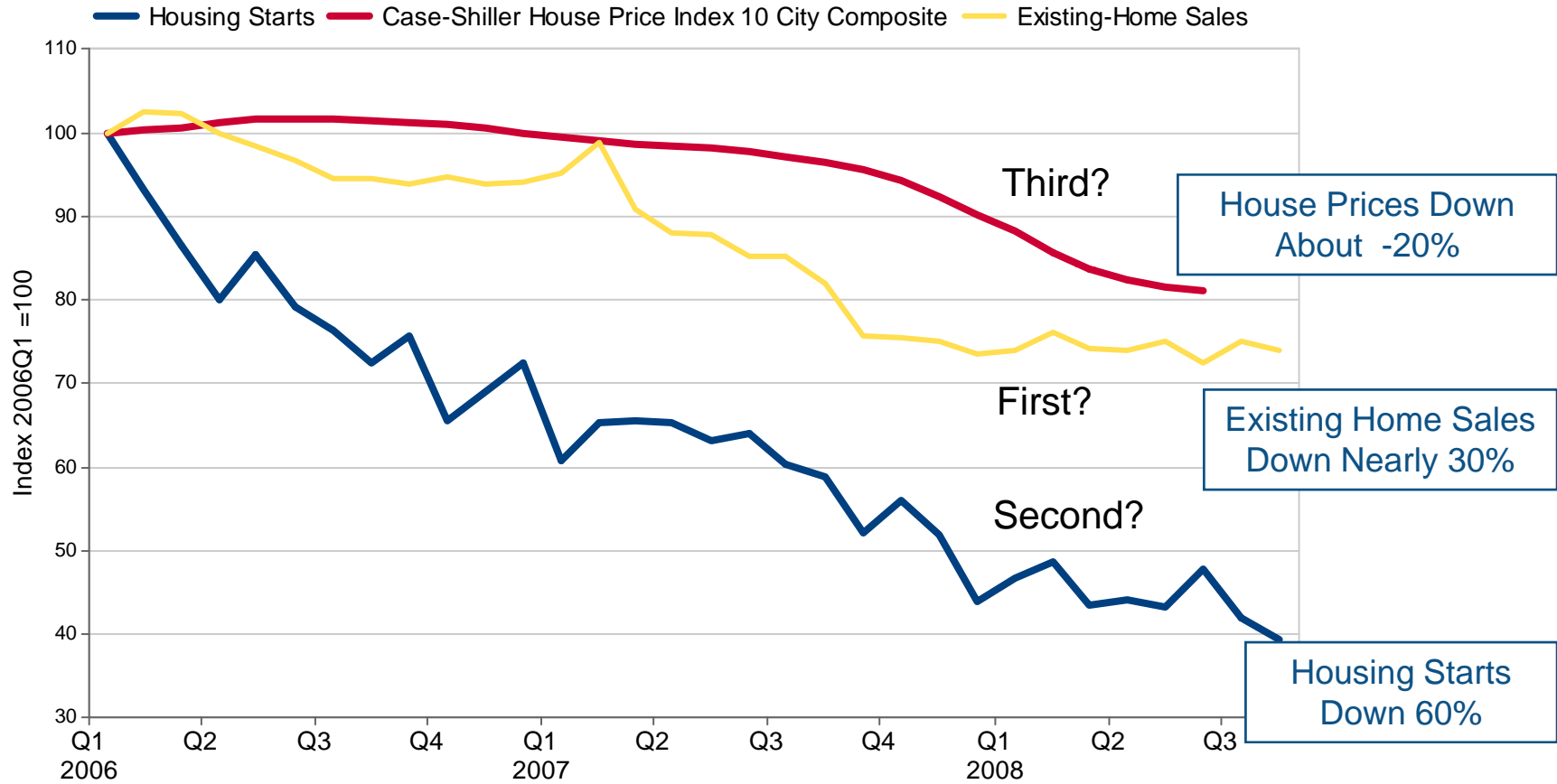
Housing Boom, Bust, and Recovery in the Early 1990s



Source: Census Bureau, S&P/Case-Shiller

Where Are We Today?

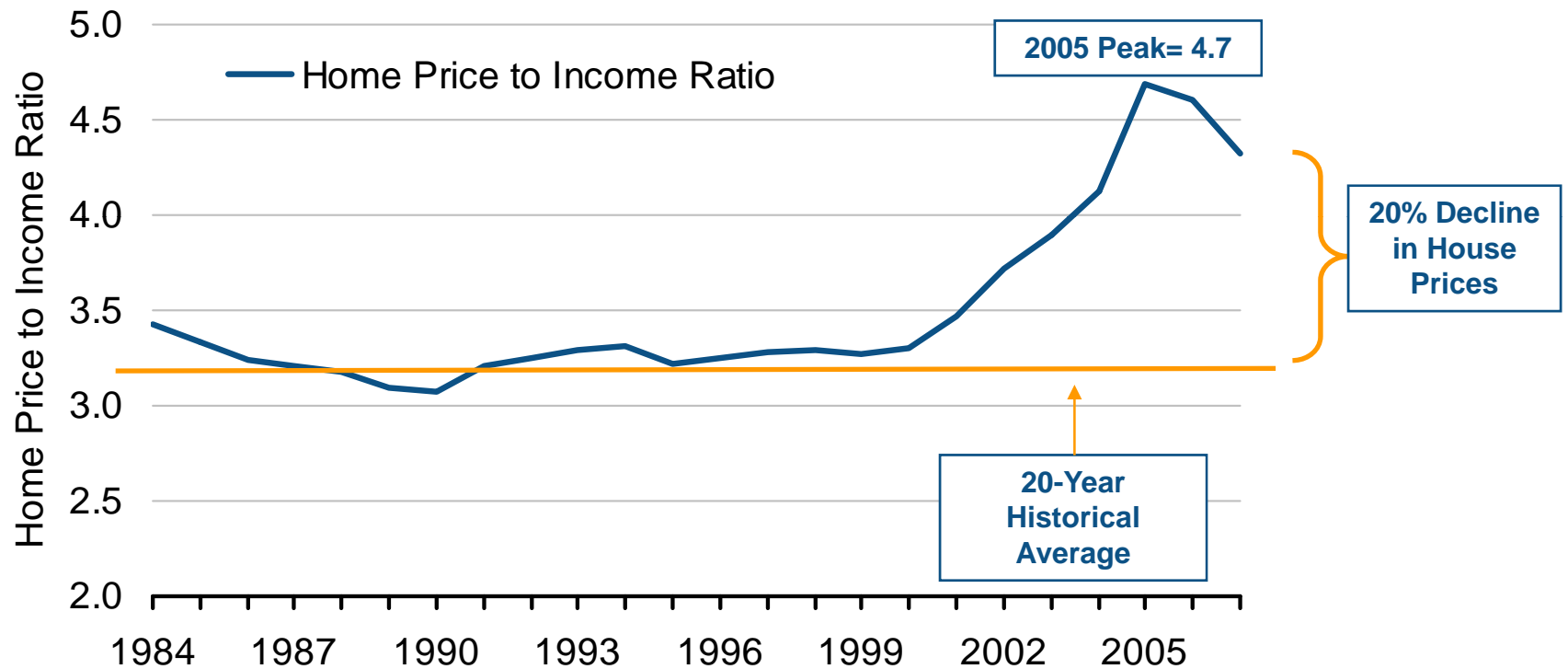
Housing Sales, Starts and Prices Indexed



Source: Census Bureau, S&P/Case-Shiller

House Prices Need to Decline Further to Improve Affordability

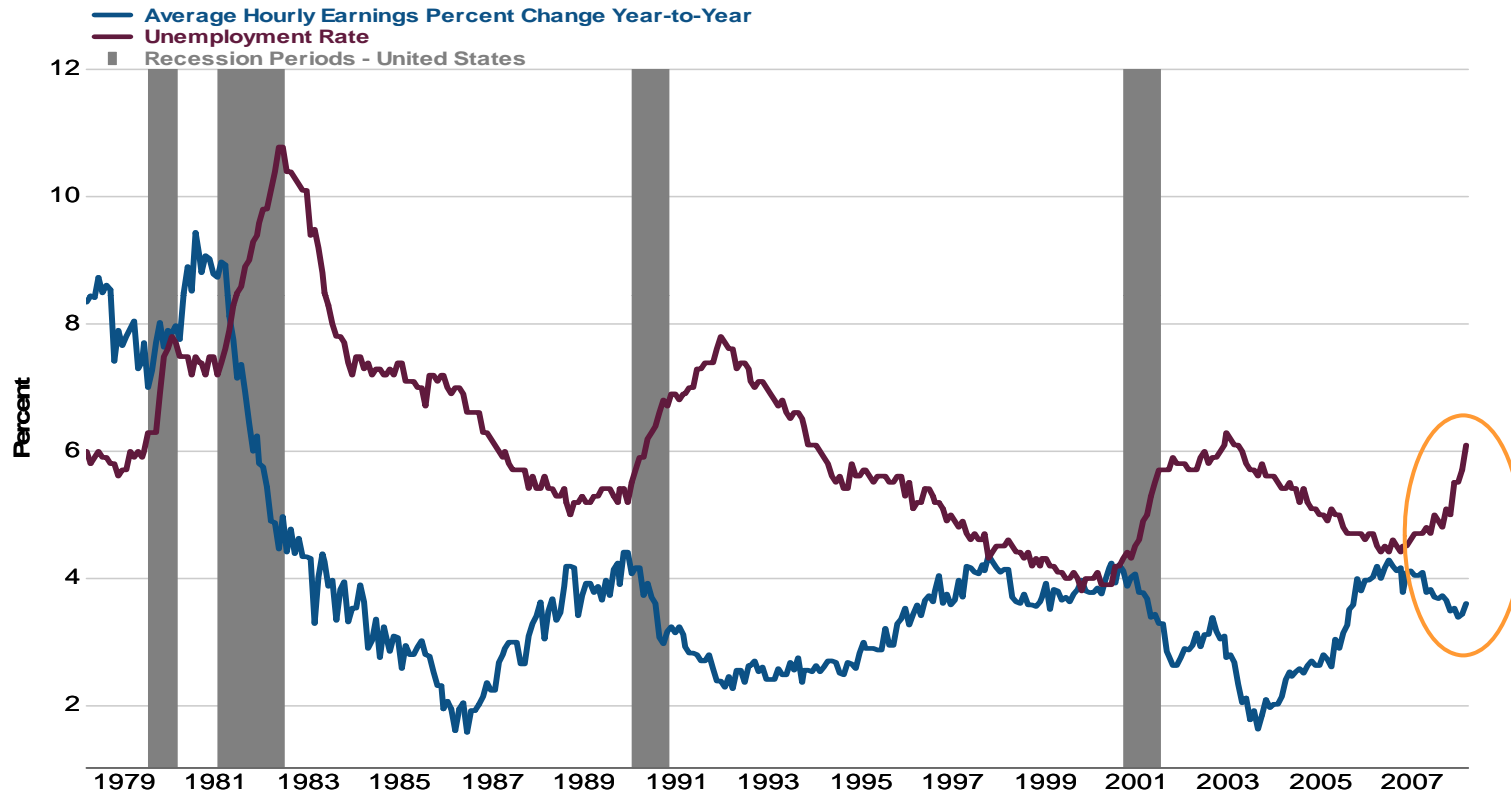
Home Prices to Median Household Incomes



Source: National Association of Realtors and the Census Bureau

Rising Unemployment and Slower Earnings Growth Pose Risks

Unemployment Rate and Average Hourly Earnings



Source: Department of Labor

Source: Department of Labor

The unemployment rate climbed to 6.1% in August and has risen 1.7 percentage points from the cyclical low of 4.4% it hit in March 2007. Increased slack in the labor market has caused growth in average hourly earnings to slow from a peak of 4.5% in May 2007 to 3.6% in August 2008.