

DoubleLine™

# Quarterly Commentary

June 2010

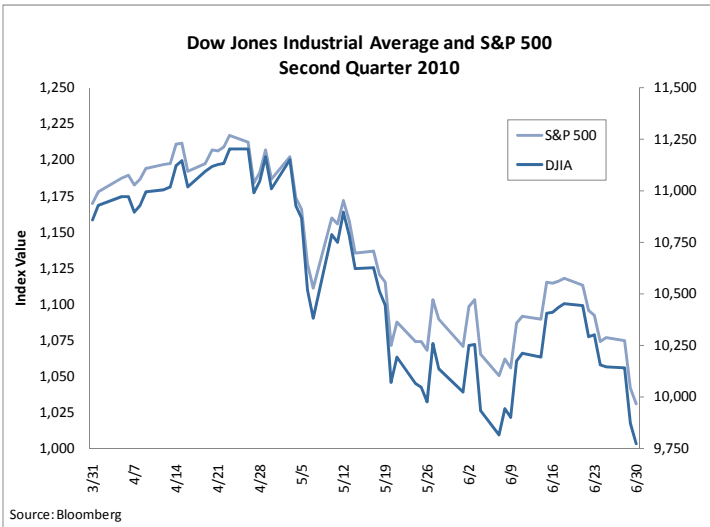


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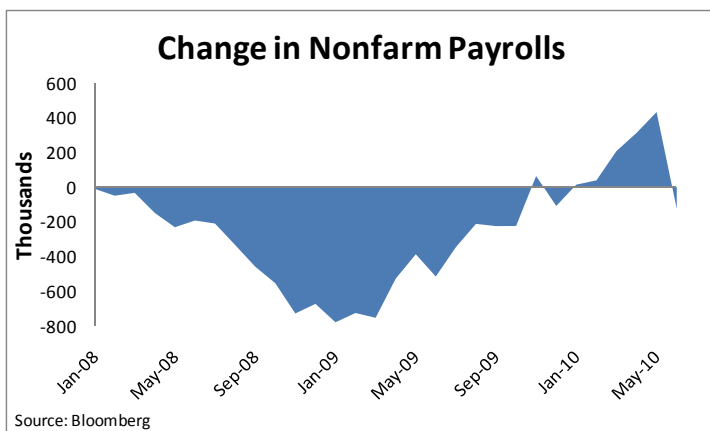


## Overview

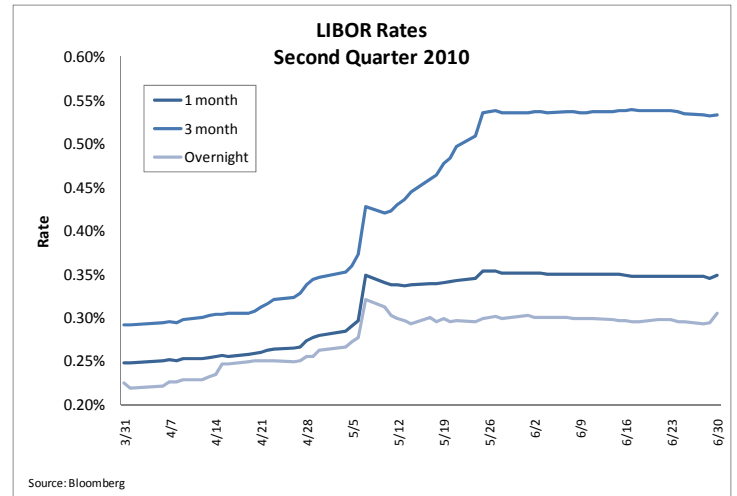
The major domestic equity indices posted massive losses in the second quarter of 2010, with the S&P 500 falling by 11.41%, and the Dow Jones Industrial Average down 9.34%.



The non-farm payroll report rose through the first two months of the quarter due to Federal Census hiring, but fell to a negative 125,000 in June.

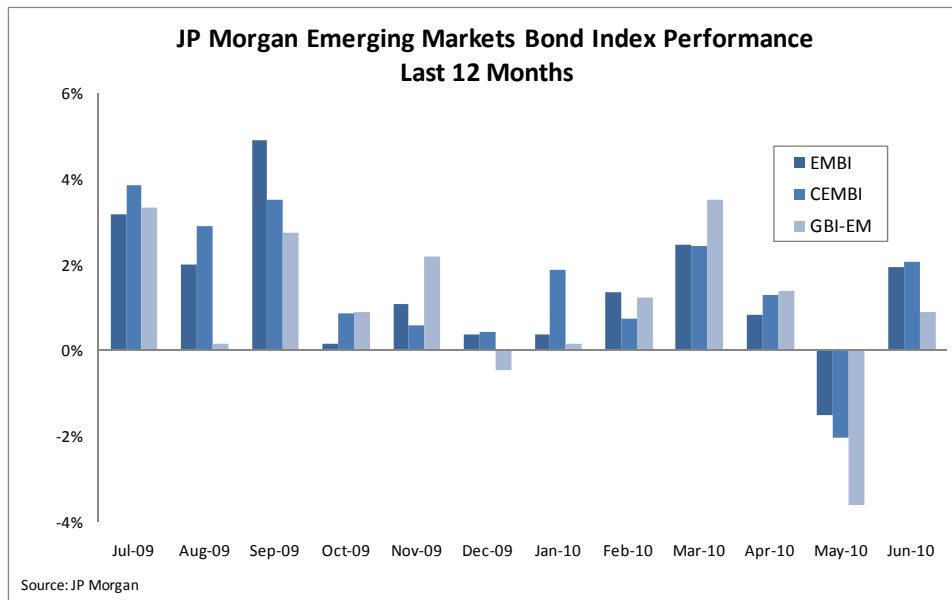


LIBOR rates continued to rise with relatively large increases during the first two months of the quarter but were flat in June with the 1-month LIBOR rate up 10 bps, closing the month at a yield of 0.35%. The 3-month LIBOR rate rose 24 bps to 0.53%, while overnight rates rose 8 bps to 0.31%.



## Emerging Markets

In Emerging Markets Fixed Income, the external sovereign and corporate debt indices represented by the JPMorgan Emerging Market Bond Index Global Diversified (EMBI) and the JPMorgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI) generated positive returns for second quarter 2010, of 1.24% and 1.26% respectively. The positive returns for the external sovereign and corporate indices were driven primarily by interest income and decrease in treasury yields; which more than offset the spread widening of 50-100 bps for both of these indices during the 2Q10. Local currency bonds, represented by the JPM Government Bond Index – Emerging Markets Broad Diversified (GBI-EM) was the weakest-performing sector during the quarter, returning negative 1.4%. The GBI-EM's negative returns for the quarter were primarily driven by bond and currency losses in Europe. This was partially offset by strong performance in Latin America and Asia.



	Tickers	Quarterly Return	YTD Return	YTM	Spread	S&P Ratings
EMBI	JPGCCOMP	1.24%	5.56%	6.42%	355	BB+
CEMBI	JBCDCOMP	1.26%	6.44%	6.43%	399	BBB
GBI-EM	JGENBDUU	-1.40%	3.45%	6.44%	NA	A-

During the 2Q10, continued negative news from the Greece/European sovereign and bank debt situation, weak U.S. employment numbers and financial sector reform challenged EM debt valuations. In addition, statements by the new Hungarian Ruling Party, which compared Hungary’s economic situation to that of Greece, also added to price weakness in Central and Eastern European credits. All of these concerns led to a near shutdown of new securities issuance within emerging markets for most of May and the first part of June.

While market sentiment has improved in part due to higher global growth estimates from the IMF and a stabilization of the euro, we expect that risk aversion will linger in 2H10 due to the following factors:

- European sovereign debt concerns;
- European bank stress test data;
- Declining global industrial output and downside risks to global GDP growth

- coming primarily from the world’s largest economies: U.S., Europe and Japan;
- Potential for a double dip recession in the U.S.

While we continue to believe that EM debt offers a persuasive investment case, EM spreads are expected to continue to be interconnected to the challenges being faced by the developed markets over the near-to medium-term.

Our investment strategy continues to focus on high quality investment grade credits. We maintain an underweight position in the Central and Eastern European region and also maintain an underweight position to the lower rated sovereign credits.

### Global Developed Credit

Although the U.S. credit markets delivered positive total returns during the second quarter, both the

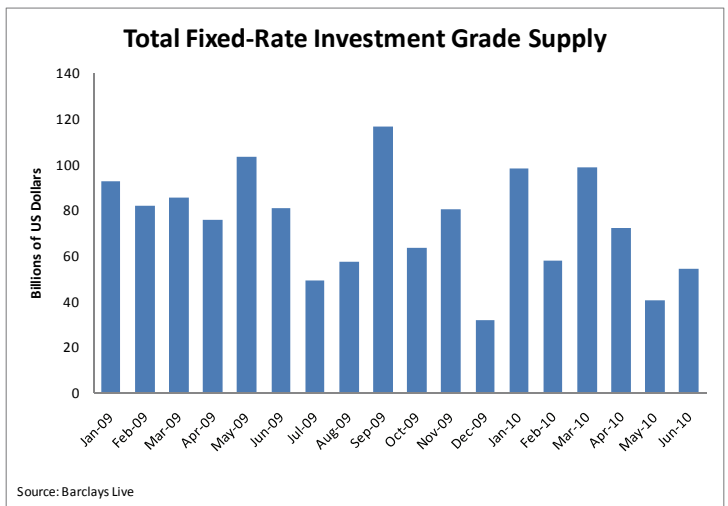
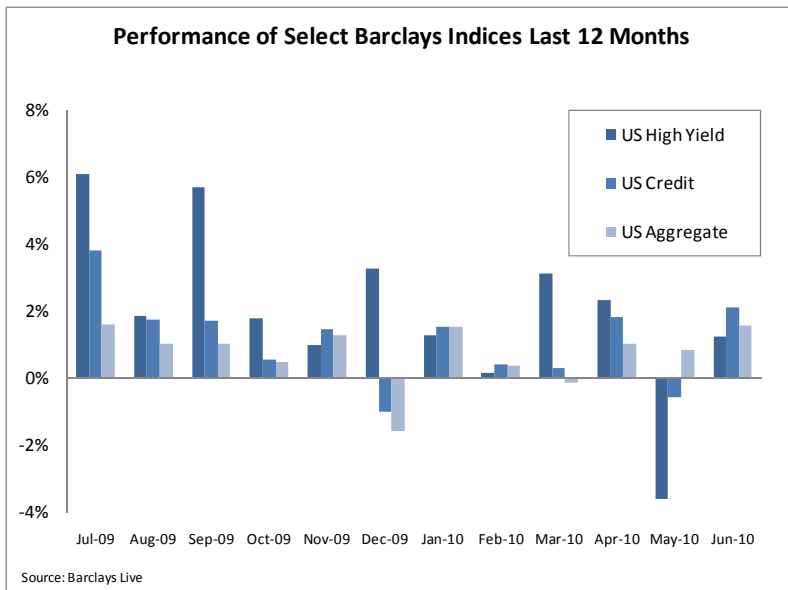
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investment grade and high yield sectors generated negative excess returns versus the broad market. Credit is now broadly wider on the year after having tightened for much of the first quarter, particularly in the US. Economic headlines continue to raise concerns of a double-dip recession. Although much of the recent negative news has been housing-related and can be ascribed to the end of the homebuyer tax credit, broader weakness has shown up in other measures such as consumer sentiment. Despite the increase in spreads, yields have fallen as interest rates benefited from a flight to quality, leading to positive total returns in investment grade and high yield. During the second quarter, the Barclay's US Credit Index returned 3.27%, generating an excess return of -2.23%. The Barclay's High Yield Index returned -0.11% with an excess return of -3.86%. By way of comparison, the total return of the Barclay's US Aggregate Index was 3.49% for the quarter.

Packaging (-0.27%), Oil Field Services (-3.06%) and Non-Captive Consumer Finance (-0.94%). Debt rated in the lower tier of investment grade (Baa) underperformed higher-rated debt (single-A or better). Pharmaceuticals were the top performers (+3.14%) in the high yield market followed by Environmental (+2.91%) and Airlines (+2.36%). The worst-performing sectors included Life Insurance (-7.78%), Property/Casualty Insurance (-4.29%), Brokerage (-3.94%) and Technology (-3.33%). In line with the investment grade market, lower-rated issues underperformed their higher-rated counterparts.

New investment grade supply totaled \$166.7 billion during the quarter, down from \$254.9 billion issued in the first quarter. High yield issuance totaled \$44.5 billion during the second quarter, down from the \$64.2 billion issued during the prior quarter.



Among investment grade corporate bonds, the best-performing sectors (as measured by total return) included Aerospace and Defense (+8.54%), Textiles (+8.54%), Restaurants (+6.76%) and Railroads (+6.97%). The worst-performing sectors were

The markets faced many challenges during the second quarter, ranging from natural disasters (a volcanic eruption in Iceland) to man-made disasters (the British Petroleum oil spill in the Gulf of Mexico). Added to those concerns was an attempted terrorist attack in Times Square and the threat of several potential sovereign defaults in the euro zone.

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Regulatory reform in the U.S. financial sector continued to work its way through Congress, and the uncertainty surrounding the final form of the legislation weighed heavily on the minds of investors.

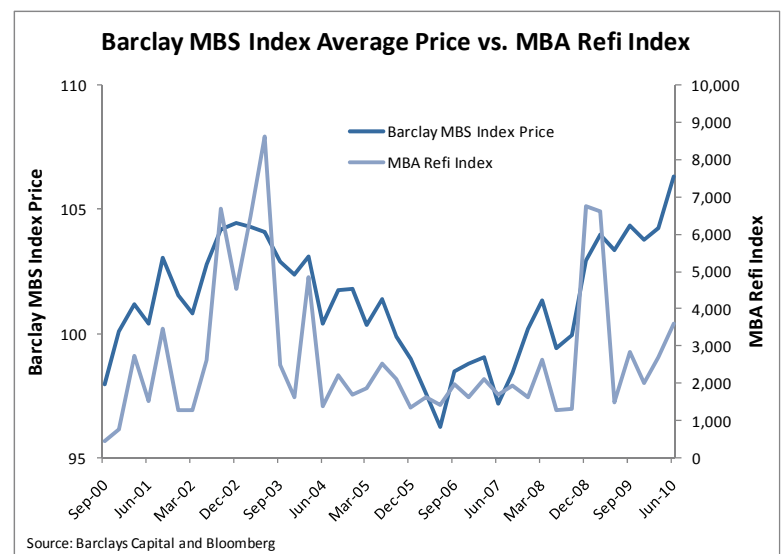
News on the U.S. economic front remained worrisome, with growing fears of a double-dip recession. The fading of various fiscal stimuli is manifesting itself in weak statistics in the employment and housing sectors, among others. At this point in a recovery, economists typically expect to see private payrolls consistently creating in excess of 150,000 new jobs per month. However, renewed weakening in labor market trends is posing a challenge to that orthodox outcome. The mortgage application data for purchases plunged 15% in June, and pending home sales declined 30% following the expiration of the homebuyer tax credits. This was more than twice the falloff predicted by the consensus. Even though the US Government has spent a material amount of resources on short-term “quick fixes,” including cash for clunkers, homebuyer tax credits and extensions in jobless claims, the underlying challenges remain. DoubleLine continues to maintain a conservative posture within the Global Developed Credit portion of its portfolios.

## Agency Mortgage-Backed Securities

The U.S. Agency mortgage market returned 2.87% for the second quarter, underperforming the Barclay’s Capital U.S. Aggregate Bond Index return of 3.49% and the U.S. Treasury Index return of 4.68%. During the quarter, Treasury rates dropped across the curve. Two-year rates dropped 41 bps, 5-year rates dropped 77 bps and 10-year rates dropped 88 bps. In this Treasury market context, the mortgage market underperformance for 2Q10 conforms with orthodox expectations.

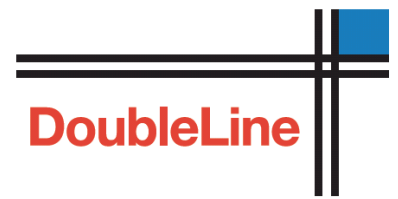
The quarter started with the Barclay’s Capital MBS Index at an average dollar price of 104.25. As rates fell, the price of the mortgage index rose to 106.3 by quarter-end. At these premiums, the Agency mortgage market likely will underperform if Treasury yields fall in the future.

Higher mortgage prices are typically correlated with faster prepayment speeds. With the mortgage index at an all-time high in dollar price, a fall in yields should accelerate prepayments to very fast speeds. Those fast speeds have not materialized so far.



Given the changing economic landscape, borrower credit worthiness has supplanted the differential between borrower legacy rates and prevailing mortgage rates as the primary determinant of prepayment speeds. Mortgage rates are close to all-time lows. So by historical norms, most mortgage borrowers should be able to reduce their borrowing costs by refinancing. The problem for many borrowers is that lenders have tightened up their underwriting standards at the same time that many borrowers’ economic circumstances have

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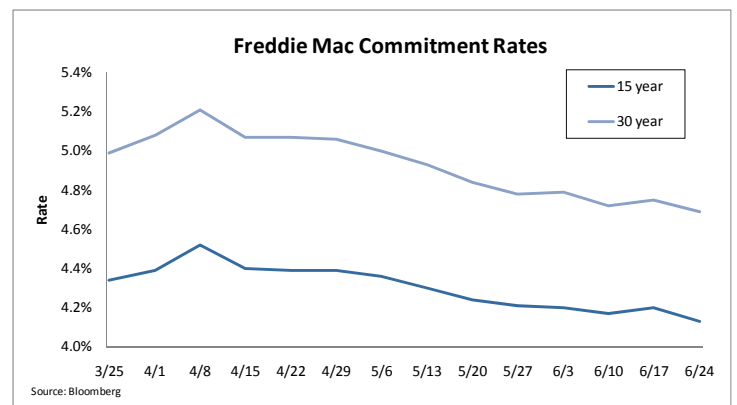
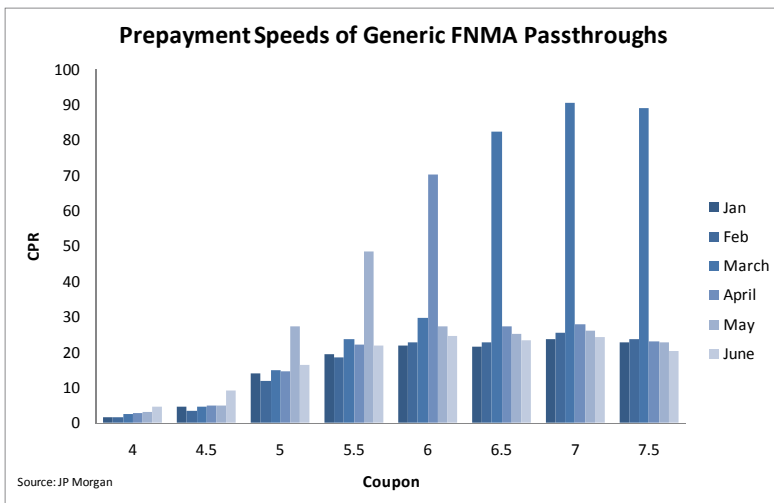


worsened. This one-two punch makes it much tougher for borrowers to qualify for refinancing. As a result, current prepayment speeds are in the 10, 20 and 30 CPR range as opposed to the 40, 50 and 60 CPR range historically experienced at times of premium mortgage prices amid falling interest rates.

Further analysis of Agency mortgage prepayments requires dissecting prepayments into voluntary and involuntary prepayments. With approximately 25% of mortgage borrowers underwater on their mortgages, the possibility of these borrowers defaulting has to be considered. In the case of an Agency mortgage, the default or involuntary prepayment gets passed through to the bond holder at par as a prepayment. Involuntary prepayments were observed during the second quarter as FNMA and FHLMC both announced they would henceforth buy out all loans that were delinquent for over 120 days. During the quarter, all the FNMA and FHLMC coupons experienced a fast month as there was a backlog of very delinquent loans that were bought out all at once. We expect the effect of the buyout of delinquent loans will increase the prepayments by 5-10 CPR above the voluntary prepayments.

The Agency mortgage sector should perform well going forward if rates remain at current levels or move higher. If rates fall, the Agency mortgage market will have a tough time keeping pace with the Aggregate or Treasury market, given the high prevailing Agency dollar prices. Other than changes in interest rates, we would single out three other risks face mortgage performance in the near future.

The first deals with the Fed's position of \$1.25 trillion of Agency mortgages. These purchases, made in 2009-2010, were part of an emergency quantitative-easing initiative to suppress the primary mortgage rate in the U.S. If the Fed were to liquidate these positions, substantial downward pricing pressure would weigh on the mortgage market as well as weaken a vulnerable housing market and fragile economy. Thus we doubt the Fed will take this action. It seems to us, the Fed is more likely to buy more mortgages than sell from its existing holdings.



The second area of risk deals with concerns of potential for a refinancing wave as mortgage rates are at historic low levels. As mentioned above, underwriting standards have tightened to where they were in the early 1990s. These tighter standards make it very difficult for many borrowers to qualify for refinancing.

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The third area of risk would be a big pickup in home sales and big home price appreciation. We do not see this happening in the near future given the combination of tighter underwriting standards and current economic conditions.

## Non-Agency Mortgage-Backed Securities

We return to our previous month's conversation regarding "strategic defaults" in this month's commentary. Fannie Mae announced plans to begin pursuit of deficiency judgments in instances of strategic default. Whether or not Fannie Mae actually carries through on that threat remains to be seen. We are pleased, however, that the moral issue regarding repayment of personal debt, and more to the point, repayment of mortgage debt, has become a major issue for the Government Sponsored Enterprises (GSEs).

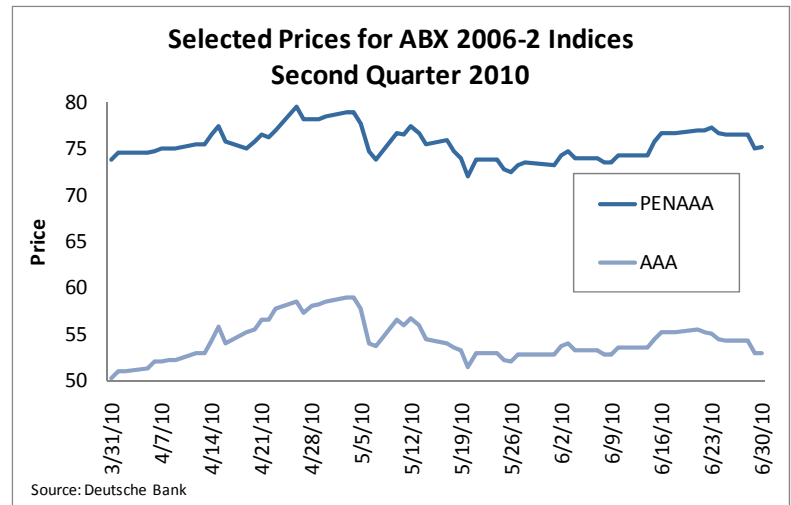
The non-Agency market continued to grind slowly tighter as investors reached for yield. On average, the non-Agency market is up anywhere between 0.5% to 2.5% during the month of June. The sector's higher prices continued to be based on market technicals (lack of new supply and consistent amortization).

The non-Agency market continued to offer the best loss-adjusted yields, in the 7-8% range, as compared to other fixed income sectors. The non-Agency market, however, faces uncertainty surrounding potential shadow supply: both the amount of supply waiting in the wings, and the timing of its hitting the marketplace. In our opinion, the supply does exist; however, it will take a significant event to create mass unwinding from current bondholders. Such catalytic events could include a scenario in which prices move even higher and accounts begin taking the profits from the upward moves, a significant increase in

defaults, or another massive price decline in this sector, similar to that seen in March 2009.

Barring any the aforementioned events, we expect the market to continue its gradual progress toward higher prices and lower yields until the spread between the non-Agency market and other investment alternatives meaningfully contracts.

The indices (ABX/CMBS and PrimeX) behaved in muted fashion in June with PrimeX.FRM1 starting the month at 107 and closing at 107½. CMBX and ABX on average were up approximately 1%.



The other important event of the month is the work being done in Washington on financial reform legislation. Although President Obama had hoped for a pre-July 4 signing, that day came and went without passage in the Senate. Ultimately, we expect some form of financial reform legislation will be enacted before the November mid-term elections, although the measures to be included and excluded remain to be seen.

With a 2000-page document and so many different

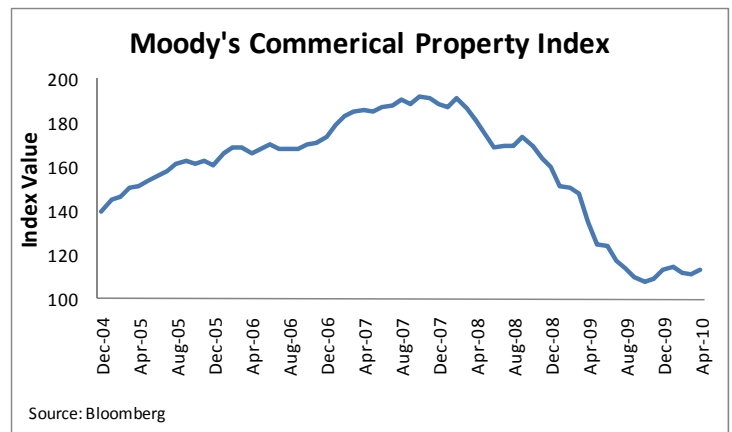
factions competing for their piece, it will probably take until at least mid-July before we get clarity and passage. Much of the bill has to do with how the securitization market will look going forward. We have seen that quality product (notably the Redwood deal) brings out the buyers, and the market needs that type of product to restart. By putting in place more standardized rules and setting the bar higher, we believe that a new securitization market can emerge. We intend to continue to follow the events in Washington closely.

## Commercial Mortgage-Backed and Asset-Backed Securities

With the first half of 2010 behind us, performance of commercial mortgage-backed securities (CMBS) has been anything but lackluster as the sector continued to outperform the Barclays Aggregate U.S. Bond Index, closing out the month of June with a 1.94% return vs. the index return of 1.57%. A quick recap on the second quarter brings us back to an April/May barrage of headline news from the Euro Zone that halted a four-month-long rally and spurred the flight-to-quality trade. During this time, market volatility spiked, and CMBS periodically traded in strong positive correlation to broader equity market movements. Subsequently, as market-perceived clarity improved, price volatility abated as investors and dealers regained confidence to restore two-way market flows. The sector is up 2.78% for the quarter and 12.14% year to date, outperforming ABS sector by 24 bps and 733 bps respectively.

As we have mentioned previously, the outperformance of CMBS versus the index does not necessarily reflect an underlying improvement in

credit performance. In fact, CMBS fundamentals have remained weak with the 30+ day delinquency rate increasing by 24 bps in June to 8.26% and 60+ day delinquencies increasing by 14 bps to 7.15%. In addition, despite limited volume on servicer default liquidations, the average six-month loss severities have been in the 60% range. One bright spot in the CMBS fundamental outlook front may be in commercial property prices: the latest Moody's Commercial Property Price Index data showed a 1.7% increase in April, although, even with that gain, the overall CPPI has experienced a 41.1% decrease in value from its October 2007 peak level. We would note, however, that the CPPI data have been rather choppy in the past few months as the index tracks repeat sales, and transaction volumes have been very low. It is hard to develop much confidence in these readings as indicative of an actual market stabilization.



With broader economic indicators showing signs of slowing and uncertainty with regard to the sustainability of the supposed "recovery," we continue to tread cautiously in this sector. In the meantime, our focus remains at the top of the capital structure where added credit support and seniority in the debt stack provide ample basis and relative value versus other spread products as credit fundamentals

## U.S. Government Securities

Two trends characterized the U.S. Government market in the second quarter: lower yields and a flatter yield curve. These trends were animated by economic challenges around the globe. The fiscal crisis in Greece engulfed the euro zone and brought to the forefront awareness of budgetary problems and high debt burdens in a number of European economies. The bailout spearheaded by the European Community failed to calm the markets. The domestic economy suffered setbacks as well, as broadly disappointing economic data heightened double dip concerns and revived deflation fears. The 10-year Treasury yield opened the quarter at 3.83%, reached a high of 3.99% on April 4 and then declined steadily to 2.93% at quarter-end. The yield curve, as measured by the spread between the two-year and 30-year Treasuries, began the quarter at 369 bps, peaked just 2 bps steeper in mid-April and then fell to 327 bps on June 30.

**Yield Curve (%)**

	3/31/2010	6/30/2010	Change
3 month	0.15	0.17	0.02
6 month	0.23	0.22	-0.01
1 year	0.38	0.31	-0.07
2 year	1.02	0.60	-0.42
3 year	1.57	0.96	-0.61
5 year	2.54	1.77	-0.77
10 year	3.83	2.93	-0.90
30 year	4.71	3.89	-0.82

Source: Bloomberg

The Barclays Capital U.S. Government index returned 1.71% in June and 4.24% for the full quarter. Returns were correlated with maturity, with one- to three-year issues posting a return of 1.17% for the quarter while issues longer than 20 years returned 14.31%. Treasuries returned 1.86% in June and 4.68% for the

quarter, while Agency issues returned 1.11% in June and 2.60% for the quarter. On a duration-adjusted basis, Agency issues outperformed Treasuries by 19 basis points for the quarter. Inflation-adjusted Treasuries returned 1.43% in June and 3.82% for the quarter, underperforming conventional Treasuries and highlighting the decline in inflation expectations.

The posture of the government portfolio shifted during the quarter. Portfolio duration was, as matter of policy, neutral to the Government index, but the portfolio was repositioned to benefit from a flatter yield curve. We expect a bias toward a flatter yield curve regardless of the direction of the overall level of interest rates. Looking forward, we expect to reduce our exposure to risk in the agency sector in coming months. We anticipate stable Agency spreads in the near term. However, the deteriorating fiscal situation in the U.S. increases the uncertainty surrounding the future status of the Government Sponsored Enterprises and risk of a GSE reform plan that is detrimental to bondholders.

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