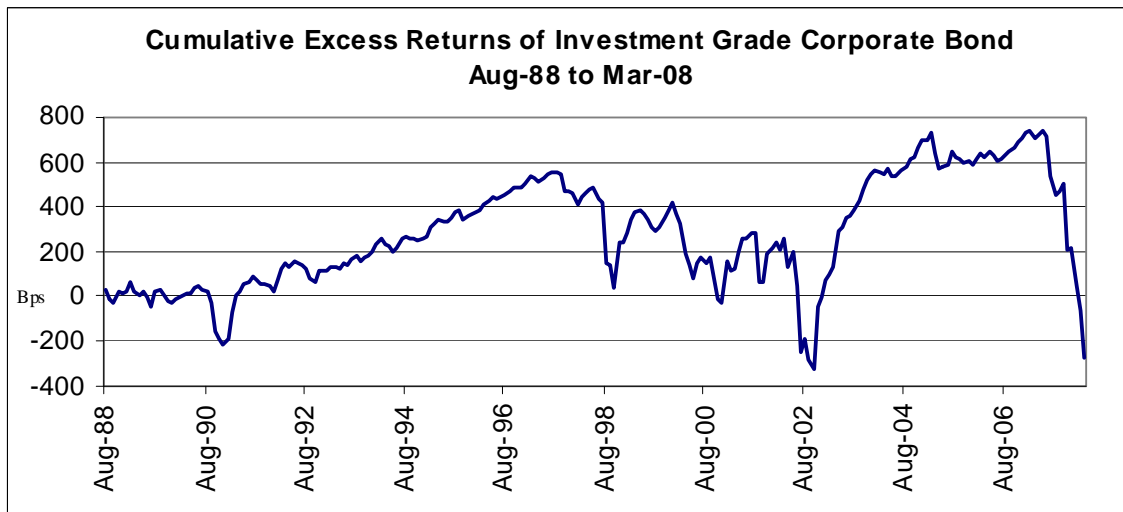


“It’s Time To Play Offense”

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May 2008*

Recent challenges in the fixed income markets demonstrate that bonds can exhibit volatile and asymmetric returns. These peaks and valleys require an investment approach that emphasizes strategic positioning over tactical execution. As a sector’s cycle stumbles and meanders to its opposite extreme, positioning will be the predominant factor in determining returns for bond managers for several quarters.

Volatility is seen over periods across fixed income sectors and the graph below exhibits actual cycles for investment grade corporate bonds. It is evident that cumulative excess returns can grow for many years and then be virtually erased in a brief period of time. At the peaks in the cycles, risk premiums (i.e., credit spreads) are very low. The opposite is true in the valleys; risk premiums are very high, or priced to a worst-case scenario such as a very deep and prolonged recession.



Source: Lehman Brothers

Given our perennial goal of positioning our clients’ portfolios in an optimal risk/reward profile, it is most valuable to identify points where non-Treasury bonds over- or under-compensate for their inherent risks. In other words, at what point are you getting paid more than enough to take incremental risk?

We believe the most recent fixed income investment cycle began to recover in mid-March 2008. (I think the actual date is important, as it was the bailout of Bear Stearns that prompted it). This is diametrically opposed to our stated strategy contained in our March 2007 Investment Highlight article, “When a Good Defense Equals a Good Offense”. In fact, we are now at the point where we believe that non-Treasury bonds, with few exceptions, are priced attractively and poised to deliver positive excess returns for the next several quarters.

Since the beginning of 2008, our strategy has been to steadily diminish our holdings in Treasuries and replace them with corporate bonds and the highest quality structured securities. Since we began doing this, our portfolios have exhibited volatile returns relative to the benchmark on a month-to-month basis. However, we believe this strategy will provide positive excess returns over the long run.

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“It’s Time To Play Offense”

Our commitment to this strategy is based on the following:

- Currently, relative valuations on corporate bonds and high-quality structured securities are priced for a near-Armageddon scenario or economic malaise for a decade or more.
- Given the valuations, we expect these bonds to produce large excess income for several years that will overcompensate for volatile environments.
- New Federal Reserve financing vehicles such as the Term Securities Lending Facilities and the Term Auction Facilities are working, as evidenced by the return of liquidity and functionality to the financial markets. Furthermore, the Fed and the U.S. Treasury Department are fully focused on stabilizing the housing market and its debilitating effects on the capital markets.

This strategic initiative is in process and we will continue to add valuable non-Treasury bonds to our clients’ portfolios when the bonds are available. Highlights of our strategy are:

- Large structured financials, such as hybrids and preferreds when permissible
- In core-plus mandates, high-quality High Yield bonds with lower leverage; small exposure to CCC-rated bonds
- Agency MBS
- High-quality ABS with strong structure and large sponsors. (i.e., Chase Credit Cards)

Allegiant’s fixed income team believes that by playing offense to execute this strategy, we are positioning our clients’ portfolios in an optimal risk/reward profile and enabling the portfolios to perform well relative to benchmarks and peers. We expect a rocky road given the environment, but the tremendous opportunities given the current valuations justify the potential volatility. As exhibited in the chart on the first page, these opportunities are uncommon and fleeting and must be taken advantage of at the right time in order to deliver successful returns to our clients in the future.