

MARKET OVERVIEW

The deepening European sovereign crisis, political gridlock in the U.S., and weak economic growth combined to make financial markets extremely challenging, with increased volatility that at times resembled the financial crisis of 2008. With regard to Europe, investors were concerned with many issues including a Greek default, possible bank failures, talk about the break up of the Euro and the potential for a contagion spreading to other larger countries such as Italy. These concerns led to severe declines in stock prices and the widening of credit spreads for several European sovereigns. Although there has been much talk regarding another Greek bailout plan, nothing had been finalized as of the end of the quarter and this uncertainty roiled markets. In the U.S., economic growth stumbled forward with weak job growth, a continued anemic housing market, and a less robust manufacturing sector. Investors ran for the cover and safety of U.S. Treasuries despite the downgrade by S & P from AAA to AA+. The stock markets suffered serious declines, as did riskier fixed income asset classes such as high yield, emerging markets debt, and the financial sector of investment grade corporate bonds.

The Barclays Capital Aggregate Index returned +3.82% in the 3rd quarter of 2011, with the higher quality segments of the market posting stronger returns. Within the index, Treasuries was the best performing sector with an impressive return of +6.5%, while the Mortgage sector lagged with a return of +2.2%. The yield advantage of Investment Grade Corporate Bonds compensated for some of the widening to Treasuries that occurred in the flight to quality. The Mortgage sector was hurt by the CMBS sub-sector, which had a negative return. High Yield (-6.1% return) and Emerging Markets Debt (-2.1%) performed poorly, as would be expected in a flight-to-quality environment.

Sector	3rd Quarter Total Return
U.S. Treasuries	6.5%
Agencies	2.4%
MBS	2.2%
I.G. Corporates	2.9%
High Yield	-6.1%
Emerging Markets Debt	-2.1%

Credit Rating	3rd Quarter Total Return
AAA	4.2%
AA	3.3%
A	2.9%
BBB	2.2%
BB	-3.7%
B	-5.2%
CCC	-11.7%

Source: Barclays, as of 9/30/2011



Mark Foust
Senior Portfolio Advisor

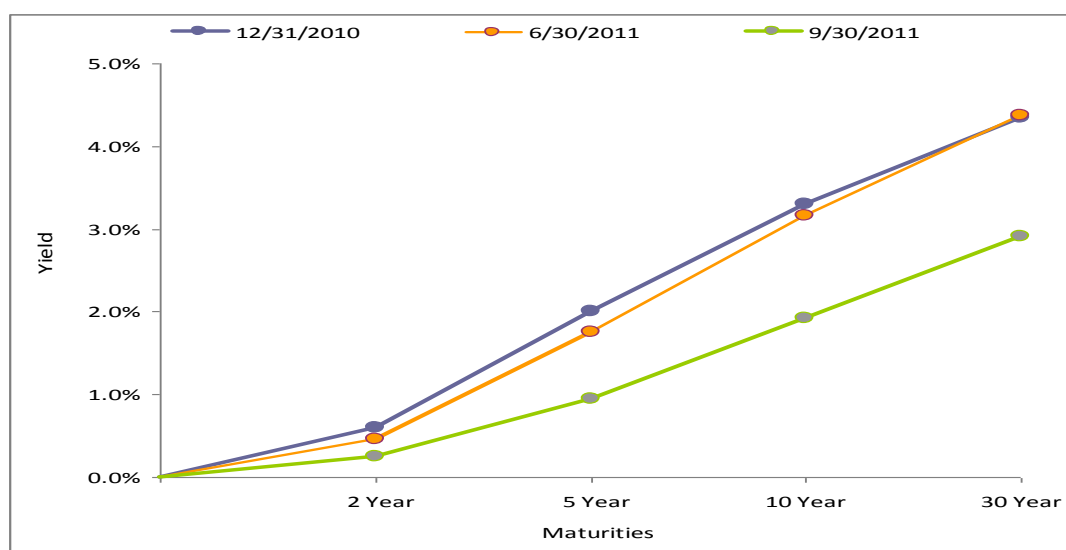
24 Years of investment experience
MBA—Pennsylvania State University
BS—Carnegie-Mellon University

DuPont Capital Management
One Righter Parkway, Suite 3200
Wilmington, DE 19803
Tel 302.477.6000
www.dupontcapital.com

U.S. Treasuries

Treasuries had a very strong quarter with yields declining across the curve as economic growth slowed and concerns about a double-dip recession intensified, both in the U.S. and globally. Investors shifted their attention away from equities and riskier assets and moved toward Treasuries and other safer fixed income investments. The yield curve flattened significantly, partly due to the weak economy and partly due to the expectation and announcement of “Operation Twist” by the Federal Reserve. This tactic will have the Fed selling shorter maturity Treasuries and purchasing longer maturity Treasuries. To illustrate the degree to which long Treasuries outperformed, the Barclay’s Long Treasury Index returned 24.7% for the quarter while the Intermediate Treasury Index returned only 3.5%. The Federal Reserve also stated “that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.” For the 3rd quarter, yields declined for the two, five, ten, and thirty-year Treasuries by 21, 81, 124, and 146 basis points, respectively. The yield of the two-year note fell to 0.25% while the ten-year Treasury declined significantly to 1.92%.

U.S. Treasuries Yield Curve



Source: Bloomberg, as of 9/30/2011

Spread Products

Spreads widened for all non-Treasury products during the quarter, particularly in some of the sectors with the widest spreads, including High Yield, Investment Grade Financials, Emerging Markets Debt, and CMBS. Investment grade credit widened 87 basis points during the quarter to 241 basis points over Treasuries, with Financials performing much worse than Industrials and Utilities. Financials continue to be the widest sector by far with spreads averaging 334 basis points over Treasuries. Spreads in Investment Grade Corporate Bonds are well above long-term averages and appear attractive, particularly given expectations of slow-to-moderate economic growth and good underlying fundamentals. High Yield widened by a staggering 275 basis points to 845 basis points over Treasuries and average prices moved lower by over \$8 to \$93.7. The current spread for High Yield is much wider than the long-term average and is getting closer to levels typically only experienced during a recession. We believe this sector has value compared to current and projected default levels. CMBS and sub-prime mortgage spreads also widened as investors became more concerned that the recent slowdown in economic activity could hurt the fundamentals in these sectors. On the issuance side, supply was light in the 3rd quarter with only \$193 billion in new issue corporate bond supply, which was down from \$314 billion in the 2nd quarter. High Yield issuance was particularly low with \$25 billion of issuance as compared to \$89 billion and \$92 billion in the first and second quarters, respectively.

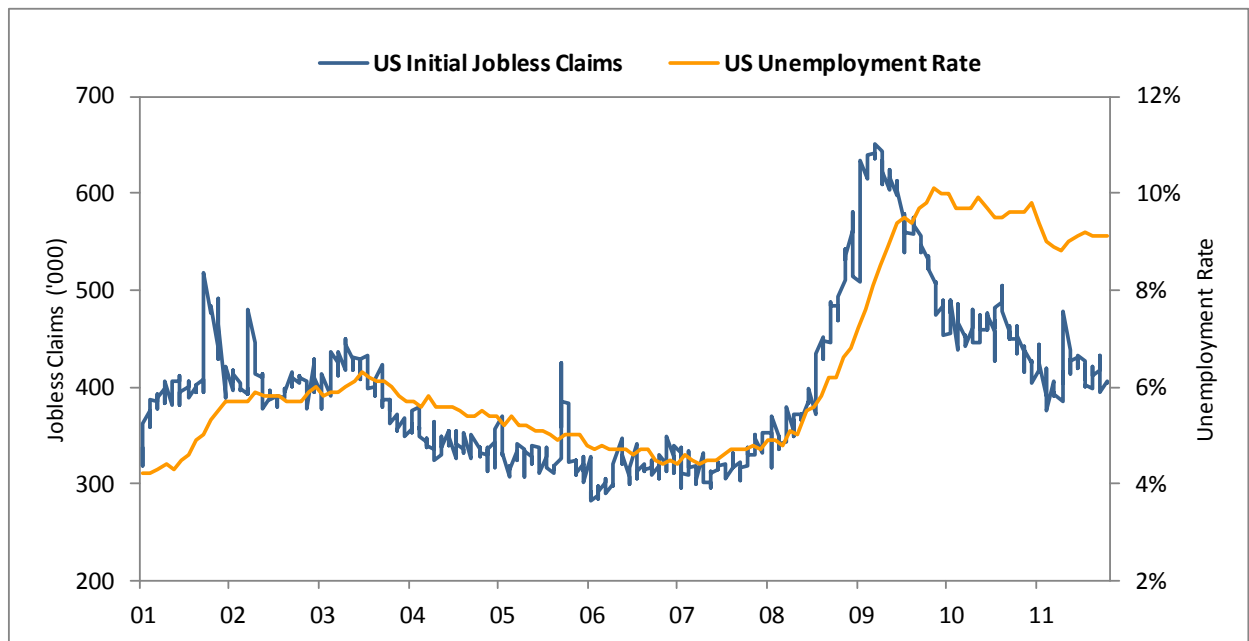
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The Economy

Economic growth continued to be very poor, due to lack of confidence of both consumers and corporations, anemic job growth, political gridlock, a weak housing market, and the worsening European financial crisis. Second quarter GDP came in at 1.3%, and investors' expectations are for continued weak growth for the balance of the year with an increased probability of another recession. Retail sales remained stagnant during the 3rd quarter with no change in August and a small gain of 0.3% in July. Personal income actually declined by 0.1% in August after increasing 0.1% in July, and consumption gains were 0.7% and 0.2% in July and August, respectively.

The Housing market showed continued poor results in the 3rd quarter. New home sales and housing starts were weak again over the last few months and distressed sales are still having an impact on the market. The S&P Case-Shiller Home Price index has shown very small gains over the quarter, but year-over-year prices fell by 4.1% for the 20-City Composite as of July 2011.

The labor market remained sluggish with non-farm payroll showing only small gains. Both weekly jobless claims and the unemployment rate moved slightly lower. Non-farm payroll had monthly increases of 127,000; 57,000; and 103,000 over the 3rd quarter, an average gain of less than 92,000 per month. This was in-line with average gains of 87,000 in the 2nd quarter and much weaker than the average gain of 188,000 in the 1st quarter. The unemployment rate ticked down by only 0.1% over the past three months to 9.1%. Government employment, particularly in local and state government, has shown further weakness in recent months and experienced declines of 65,000 over the quarter. Of note, local government employment declined by 35,000 in September and has fallen by 535,000 over the past two years. Many state and local governments have been facing significant budget deficits and we expect that some will be forced to cut additional workers or, at a minimum, leave job openings unfilled. Weekly jobless claims have moved lower over the last few months to a four-week moving average of 414,000 as of late September, down from 426,750 in June. Most economists believe that weekly jobless claims need to be below 400,000 on a consistent basis for meaningful job growth to take place.



Source: U.S. Department of Labor, as of 9/30/2011

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Inflation

Inflation, as measured by The Consumer Price Index (CPI) and Producer Price Index (PPI), has remained high, mostly driven by both energy and food prices. The CPI increased 3.9% year-over-year (September 30, 2010, to September 30, 2011), with Core CPI showing a more modest 2.0% increase over the same time period. The PPI increased by a still-high 7.0% year-over-year, but Core PPI increased by only 2.5%. Expectations are for inflation to moderate due to the slower economic growth in recent months along with much lower oil prices. Commodity prices, in general, have come down over the past three months with oil moving from \$95 to \$79 a barrel and the Dow Jones-UBS Commodity Index 11.3% below the closing level at the end of the 2nd quarter.

THE LOOK FORWARD

Before looking forward, it is interesting to glance back to the end of 2010, only nine months ago, and remind ourselves how different the environment was with most forecasters looking for growth above 3% in 2011. Investors were concerned with inflation and trying to determine when the Federal Reserve would begin increasing interest rates. Fast forward to the present and growth is sluggish and fragile, and investors are running for safety with fears of a recession or a repeat of 2008. To say that 2011 has been challenging is a huge understatement. In our commentary at the end of 2010, we said “We expect to see “waves” of economic news in the coming year with positive news followed again by disappointing or slower data. It is important not to get caught by surprise in the waves, but instead to ride the waves and maintain a longer-term investment outlook.” We certainly were not looking for anything as bad as what we have experienced in 2011. That said, we were not convinced that 2011 was going to be as smooth of a ride as was projected by the markets.

As negative as everything seems to be at this time, we expect the global economic environment to marginally improve over the next year. In our view, job growth should pick up slightly in the private sector, with companies adding to the workforce as some sectors continue to show growth. The consumer could begin spending again if oil prices remain at current levels and the job picture improves slightly. Businesses have the potential to increase spending and investment as companies are holding record levels of cash. We believe emerging economies will continue to grow (although at a slower pace than in 2010), which could help support exports from the U.S. We also expect the Federal Reserve to keep interest rates very low, as they have stated, until at least mid-2013.

One of the key wildcards is the uncertainty caused by government leaders in both the United States and Europe. In the U.S., our politicians’ inability to take decisive actions to attempt to improve the economy, spur job growth, and to cut deficits is paralyzing both consumers and businesses. No one has any idea what, if any, action will be taken to: 1) change personal or corporate tax rates, 2) improve hiring conditions, or 3) cut deficits. This uncertainty has led to temporary paralyses that will linger until the future becomes somewhat clearer. The unfortunate news is that we are more than one year away from the next presidential election and the Republican Party may have an incentive to delay changes until after that election.

With regard to Europe, there are articles and headlines daily about the worsening problems in Greece and the increased potential for contagion to other larger countries such as Spain and Italy. Although there have been numerous meetings and much talk, the European nations are having difficulty agreeing on the terms of another bailout. Similar to the U.S., this lack of an agreement has led to some negative sentiment and a resolution is needed to at least partially remove the uncertainty. We believe Europe will continue to support Greece to avoid a potentially ugly default. An organized restructuring looks to be inevitable, the key word being “organized.” A final agreement demonstrating support for Greece could help the overall tone of financial markets.

While some of our comments have been negative, most fixed income sectors’ current prices appear to factor in the significant negative market sentiment. Any positive surprises could lead to strong performance in the various spread products, particularly in investment grade corporate bonds, high yield and emerging markets debt.

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To summarize our outlook:

- 1) Continued accommodative monetary policies – Federal reserve has stated that they expect to keep the Funds Rate exceptionally low until at least mid-2013
- 2) Slow-to-moderate economic growth – we expect U.S. economic growth of between 1.5% and 3.0% over the next 12 to 18 months
- 3) The European crisis will continue to make headlines and impact global confidence
- 4) Persistent high unemployment
- 5) Core inflation should moderate over the next year
- 6) Supportive corporate earnings
- 7) Strong corporate balance sheets and low default rates
- 8) Political and economic uncertainty continues to paralyze the economy in the short-to-medium term

Portfolio Positioning

In the **Government** sector, we moved the portfolios to a shorter duration than the benchmark late in the quarter. (On average, we were between 0.20 and 0.30 years shorter than the benchmark in Core Fixed Income and more in some other products.) We continue to have a small position in inflation indexed U.S. Treasuries (TIPS) and have a large underweight to Treasuries as we find better value in the Corporate and Mortgage sectors.

Our portfolios are positioned with an overweight exposure to the **Mortgage** sector including modest overweights in the 30-year 3.5% and 6% coupons. We continue to have an overweight exposure to higher quality non-agency subprime, Alt-A, and Prime MBS and are growing our CMBS exposure opportunistically with 50% of our CMBS exposure in higher quality securities with average lives of less than 1 year.

Our **Credit** holdings are focused on issues with potential to outperform the benchmark on a risk-controlled basis. We believe that corporate bonds represent one of the best opportunities in the fixed income markets and hold an overweight of over 6% to this sector. Spreads of approximately 240 basis points over Treasuries are far wider than historical averages and the combination of wide spreads, the significant yield advantage over Treasuries, and supportive fundamentals lead us to believe that this sector will outperform Treasuries, possibly by a wide margin. As far as industries, we are overweight specific insurance companies where we see good value and we also have overweights to the banking, energy, REITs, and communication sectors. Security selection will be important over the next year as some companies will likely experience negative events or have difficulties despite the supportive overall credit environment. With improved balance sheets and large cash balances, we expect there could be a higher level of merger and acquisition activity as well as increased dividend payouts. We believe deep, cautious research is needed to benefit from the positive credit trends and avoid the potential pitfalls.

We believe **High Yield** will outperform investment grade securities over the next twelve-to-eighteen months. Slow-to-moderate economic growth and defaults at-or-below historical averages should lead to better returns for this asset class despite the current uncertainty. Similar to investment grade credit, we believe security selection will be very important and we are seeing good value in some lower priced and distressed securities.

We are also positive on **Emerging Markets Debt** as we believe growth will remain higher in emerging countries than in the U.S., Japan, and developed countries in Europe. In addition, we expect capital to continue to flow into the asset class over the next few years. We believe there are opportunities for strong returns in countries such as Argentina and Venezuela, and with local currency bonds in Brazil. The recent widening in spreads gives this sector even more value than earlier in the year.

So, much like at the end of last quarter, we will continue to see waves on the horizon and some may be difficult to ride, but we believe investors can step back in and approach the next six-to-twelve months with a little more optimism.

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