

The Return of Spread Products

A White Paper from RidgeWorth Investments

May 2009



Market Environment

Over the past year, there has been extraordinary volatility in both the fixed income and equity markets. A crisis of confidence associated with the credit worthiness and solvency of financial system participants remains at the heart of this economic downturn which began in 2007.

A decade of artificially low interest rates led banks and broker dealers, governments, and individuals worldwide to embark on a debt financed consumption binge and assume mammoth amounts of leverage. The crisis of confidence sparked by the unwinding of sub-prime debt exploded the credit bubble in the second half of 2007. Risk averse investors fled to the safety of Treasury securities, eschewing non-government debt across all quality and maturity spectrums.

The financial crisis spilled over into the real economy affecting several key sectors such as employment, manufacturing and housing just to name a few. On the employment front, initial jobless claims soared to heights not seen since the early 1980s. At that time, there was a huge spike in claims that quickly reverted to pre-spike levels. In the recessions of 1990-91 and 2000-02, the decline in the rate of initial jobless claims after the initial spike was much more gradual. (See Exhibit 1)

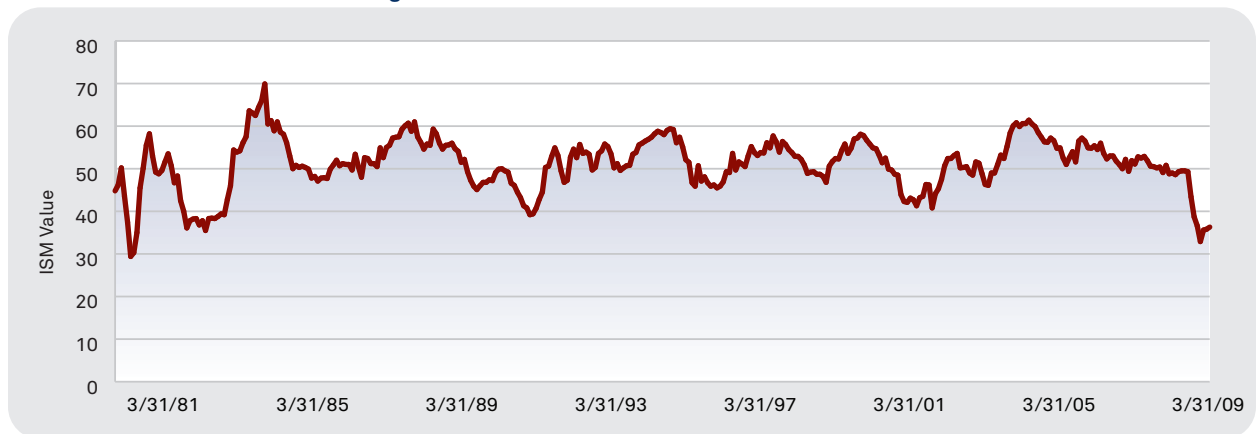
Exhibit 1: Trend of U.S. Initial Jobless Claims – 1980 - 2009



Source: Bloomberg

Data from the Institute of Supply Management's (ISM) Manufacturing Index shows a similar picture of a weak economy. The index, which peaked in early 2004 and started to gradually decline, dropped off dramatically in early 2008 and by the end of 2008 had fallen to the lowest levels in 28 years. Although the index had improved in early 2009, its March reading of 36.3 is below 41 which generally indicates a recession in the broader economy. (See Exhibit 2)

Exhibit 2: Trend of ISM Manufacturing Index – 1980 - 2009

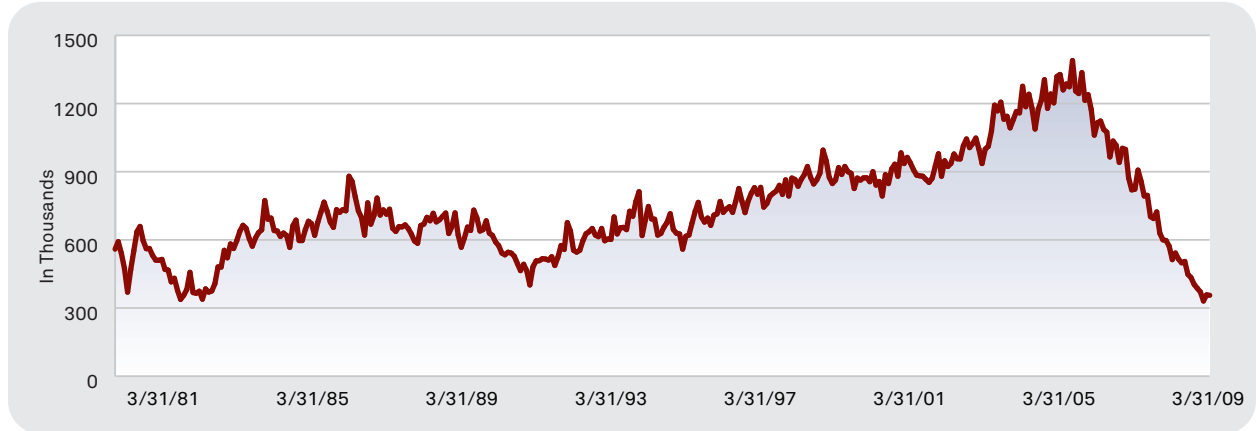


Source: Bloomberg. An ISM value greater than 50 means manufacturing is expanding. An ISM value less than 50 means manufacturing is contracting.



Finally, the housing picture continues to be bleak. New one-family home sales which peaked in late 2005 have been on a rapid decline, hitting their lowest level in more than 30 years in March 2009. (See Exhibit 3) This weak economic data has exacerbated problems associated with the great leverage unwind and produced significant dislocations in the market.

Exhibit 3: Trend of New One-Family Home Sales – 1980 - 2009



Source: Bloomberg

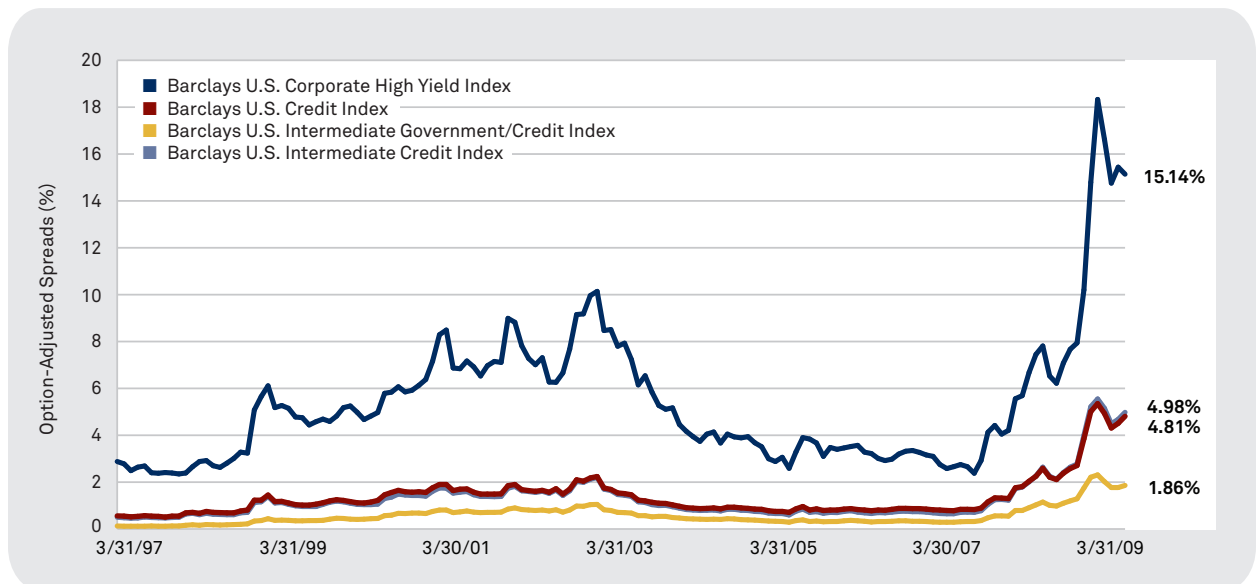
The Market Turmoil Presents Opportunity

The systemic deleveraging that occurred in the wake of what is now a 20-month-long credit crisis has created investment opportunities for long-term investors in several fixed income spread sectors. Three compelling reasons to invest in the fixed income markets are: (1) the dislocation of spread sectors relative to the risk-free asset, (2) high credit risk premiums and (3) historically low prices with extreme default rates already priced in.

Dislocation Relative to the Risk-Free Asset

A lingering flight to quality has pushed spreads of every non-government bond relative to the risk-free asset to historic levels. (See Exhibit 4) Because these dislocations in historical credit spreads have been driven as much by technical factors as fundamentals, we are cautiously optimistic that investors who are positioned properly in the following fixed income sectors will be the beneficiaries of long-term return potential.

Exhibit 4: Option-Adjusted Bond Spreads



Source: Barclays



- **Corporate Bonds.** The Barclays U.S. Corporate Bond Index started 2008 with a spread of 198 basis points, which is near its average over the past 10 years; it ended the year at 555 basis points, narrowing slightly by the end of first quarter 2009 to 543 basis points. Typically analyzed in this yield spread context, the current index yield of 7.71% as of first quarter 2009 has not gone unnoticed by many non-traditional corporate bond investors. We believe this represents a unique buying opportunity for investors; but given the uncertainty that persists in certain areas of the corporate bond market (Financials in particular), the market is likely to reward skilled bond pickers who have a proven track record at assessing risk.
- **High Yield Bonds.** As of June 2007, prior to the onset of the financial market crisis, the Barclays U.S. Corporate High Yield Index spread was on the low end of its historical spreads at 292 basis points; by the end of first quarter 2009, this had increased to its largest spread in history of 1514 basis points. Similar to the other spread sectors, this deterioration represented the expectation of a brutal economic environment and a rise in defaults to depression-like levels of 15% or more. While attractive on the surface, such valuations can still be challenged by the ultimate depth/duration of this recession as well as the sheer amount of leverage many high yield companies currently carry. Given such uncertainty, initial allocations to this sector should focus on the healthiest segment of the high yield market – the BB/B rated credits.
- **Bank Loans.** Despite the seniority of banks loans in the capital structure, the sector found itself under as much pressure in 2008 as the other spread sectors. Bank loan spreads have narrowed from a 2008 high of 2373 basis points to Libor, yet remain uncharacteristically high at 1617 basis points as of the end of March 2009. The average spread to Libor between 1997 through 2007 was 346 basis points.
- **Municipal Bonds.** Despite a rally in early January, yields remain unusually high relative to Treasury bonds of comparable maturities. Municipal bonds have historically traded at 70-100% of Treasury Bonds¹. As of March 2009, however, a 10-year AAA-rated municipal bond yield was trading at 118% of the 10-year Treasury; a 30-year AAA municipal bond was trading at 136% of a comparable Treasury. Given the backdrop of tremendous economic weakness and the government’s unprecedented response through a multitude of initiatives and the need to pay for those emergency actions, it is unlikely that tax rates over the long-term will decline. In fact, it is more likely that tax rates will rise which will make the favorable tax treatment of municipals even more valuable.

Credit Risk Premiums at Historic Highs

In recent years, investors were not adequately compensated for assuming risk. Investors offered credit to corporations and countries at a very low cost and with few strings attached. Now credit spreads more realistically reflect the economic uncertainty, abnormal liquidity situation, and investor risk aversion. (See Exhibit 5) The spreads do not always reflect just the fundamental valuations. In theory, spreads should compensate the investor for expected default rates and recovery values, plus a risk premium for relative illiquidity of the asset class. Premiums would be higher during periods of economic uncertainty and lower when the economy is more stable.

Exhibit 5: Comparison of Option-Adjusted Spreads by Credit Quality

	3/31/2007	3/31/2009	Difference
Investment Grade			
AAA	56bp	218bp	162bp
AA	68	386	318
A	86	500	414
BBB	117	683	566
High Yield			
BB	194	1016	822
B	269	1358	1089
CCC	431	2318	1887
Spread between AAA & BB	138	798	660

Source: Barclays Live. The high grade yield spread (OAS) is between the Barclays Corporate Quality Indexes and comparable duration Treasuries. The high yield spread (OAS) is between the Barclays High Yield Quality Indexes and comparable duration Treasuries.

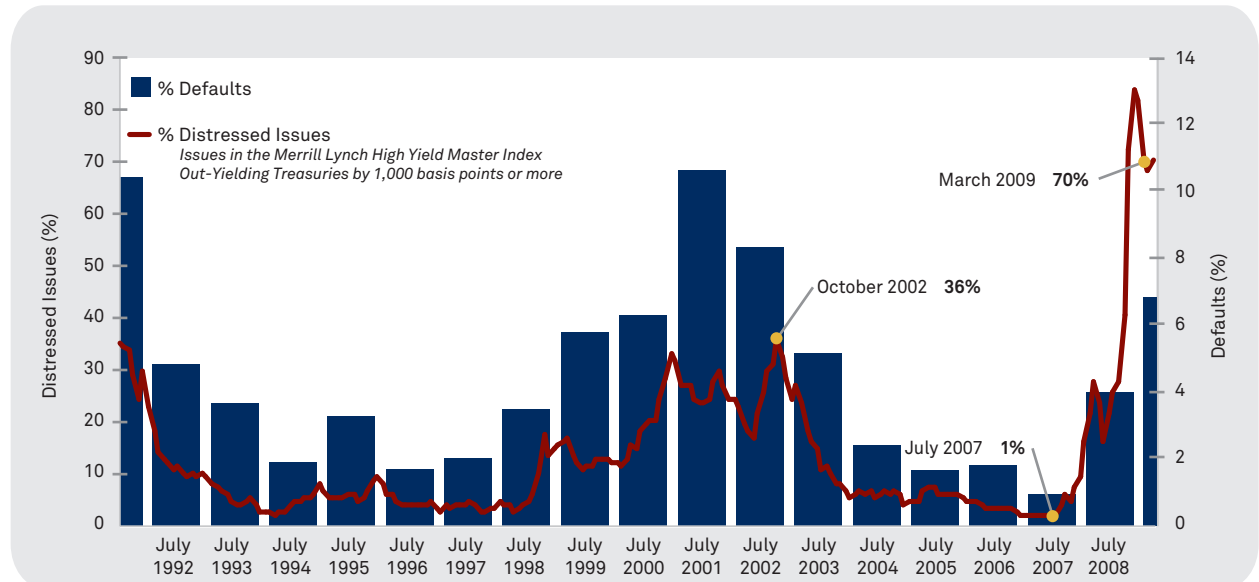
¹ Crisis Upends Muni-Treasury Relationship, by Dan Seymour, 12/02/08, The Bond Buyer, located at: www.bondbuyer.com/article.html?id=2008120150NW1WWY



Extreme Defaults Priced In

Investors appear to have already priced in the probability of record-high defaults. Exhibit 6 illustrates that the distressed ratio exaggerates defaults. As of March 2009, approximately 70% of the high yield market was priced as distressed credits (bonds trading with spreads of 1000 basis points or more), while only 6.8% actually defaulted. In comparison, the distressed ratio hovered around just 1% in July 2007.

Exhibit 6: Percentage of Distressed Issues Relative to Default Rates Since 1991



Source: Merrill Lynch & Company, Moody's

Although spreads reflect default rates that may be too extreme, there is no doubt the U.S. is entering a period of expected higher corporate debt defaults. The three leading rating agencies have tripled their projections for defaults on high yield bonds to 14% or higher this year from around 4.5% in 2008. In 2007, when credit was at its richest level, default rates were less than 1%. Now various estimates point to \$450 billion to \$500 billion of corporate bond and bank loan defaults over the next two years. The rating agencies expect defaults to peak in the second half of 2009, based on forecasts of when the economy will bottom out².

Given that a high level of economic uncertainty surrounding GDP growth, unemployment, final demand, and corporate earnings abounds, high default rates should be expected. We believe that this uncertainty argues against a purely index approach, requiring an actively managed strategy to fixed income investing.

Issue Selection is Critical

The yield spread disconnect may represent a rare opportunity for managers who can successfully separate healthy from distressed issuers. It's our view that security selection is more important than duration or sector/quality allocation decisions in adding excess return. Solid credit research will become even more important as rating downgrades increase and pressure on recovery rates intensifies.

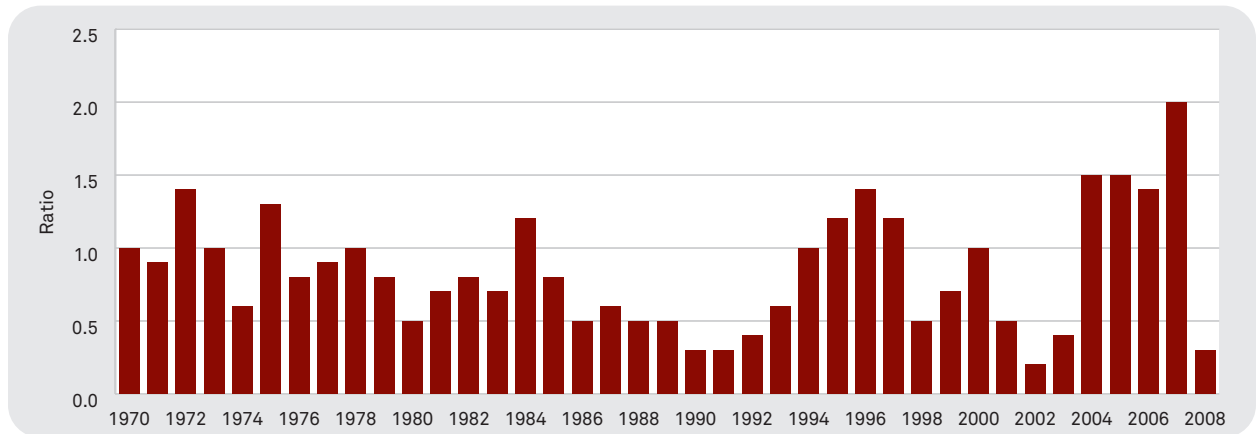
Rating Downgrades Expected to Increase

After several years of improving credit quality, an increasing number of investment grade borrowers are at risk of losing their investment grade ratings. The ratio of upgrades to downgrades decreased sharply in 2008 in the face of economic uncertainty. Exhibit 7 shows the annual upgrade-to-downgrade ratio for Moody's-rated corporate issuers between 1970 and 2008, illustrating that the 2008 decline in the ratio was the largest in the past 39 years. After being called to account for their too rosy evaluation of debt which led to the structured finance mortgage debacle, rating agencies have stepped up efforts to avoid a repeat of past mistakes. No corporate balance sheet is exempt from this increased scrutiny.

² Wall Street Journal Online, "Wave of Bad Debt Swamps Companies"; by Jeffrey McCracken and Vishesh Kumar, February 13, 2009, located at: www.online.wsj.com/article/SB1234462online.wsj.com/article/SB123446235205578373.html



Exhibit 7: Annual Corporate Bond Upgrade/Downgrade Ratio Since 1970



Source: Moody's

Companies who stand to lose their investment grade ratings face several headwinds. Borrowing costs have increased dramatically as investors demand higher yields to compensate for risk. Compared to the 2002 downturn, banks are not necessarily in a position to provide alternative financing for companies which are forced out of the debt markets. And raising cash through issuing new equity may not be as easy as before the start of bear market³.

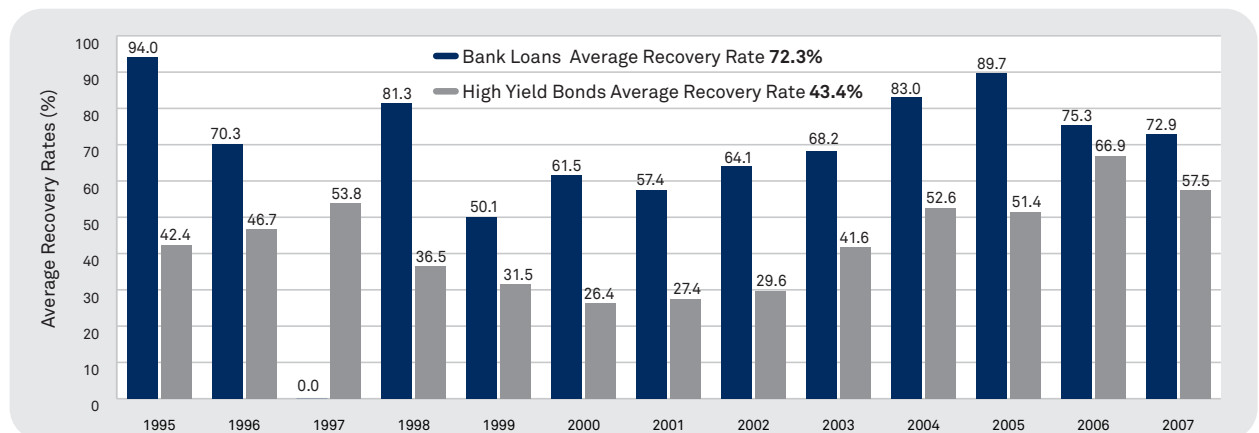
In the face of rising downgrades, investors need to determine if a bond's current price accurately reflects a rating downgrade that might occur. Or does the price perhaps reflect a downgrade that is unlikely to occur. In either situation, bottom-up fundamental research is key.

Recovery Rates Pressured

Bond holders purchase debt securities primarily for the income stream, but they receive the added benefit of having priority claim relative to stock holders on a company's remaining assets in the case of default. In this continued economic downturn, where the erosion of capital has the potential for rising defaults, bond holders may not be afforded the level of recovery on troubled assets that they received during previous recessions.

Exhibit 8 illustrates the historical recovery rates for bank loans and high yield bonds. Because distressed companies are carrying higher levels of debt and more senior secured bank loans, recovery rates may be less than they were in the past. Historically, bond holders have recovered 43 cents on the dollar for defaulted high yield bonds but Fitch Ratings recently indicated in a Wall Street Journal interview that the recovery rate could fall to 20 cents on the dollar or lower given the severity of the current economic downturn.

Exhibit 8: Average Recovery Rates for Bank Loans and High Yield Bonds Since 1995



Source: Credit Suisse

³ Jeffrey McCracken and Vishesh Kumar



Market Outlook

Despite the heightened market volatility and lingering supply/demand imbalance, our outlook is cautiously optimistic. We recognize that we are witnessing opportunities that are unparalleled in the history of fixed income markets. Attractive valuations in defensive corporates, opportunistic buyers and government initiatives warrant increasing exposure to credit assets.

Attractive Valuations in Defensive Corporates. Amid our view on corporate bonds, we are wary of Financials. Rather, we favor defensively oriented corporates. The more defensive areas including consumer staples, health care, pharmaceutical, and food and beverage have attractive yields coupled with better fundamentals. We also like regulated businesses like utilities and pipelines.

New Entrants. Distressed sellers are starting to be replaced with opportunistic buyers. New entrants are entering the market and this will be favorable for the supply/demand equation. As volatility abates and the economy stabilizes, we expect more investors to capitalize on the unsustainably low prices and high yields in the fixed income market.

Government Initiatives. Though it's uncertain what impact government initiatives will have on the lingering recession, it is expected to improve investor confidence in the capital markets. Investor confidence will play an integral role in determining how and when the economy will return to normal.

Summary

The value opportunity we see in fixed income spread products is derived from the market's extraordinary deviation from historical patterns. Most of the selling pressure thus far has been technical in nature as forced selling due to deleveraging prompted investors, regardless of the price, to sell securities that they were able to sell.

This environment has created an unprecedented opportunity for fixed income investors to improve their risk-adjusted returns by moving up the capital structure. Bonds are attractive in this kind of environment, particularly in the investment grade corporate, high quality high yield, bank loan and municipal bond markets where valuations reflect Great Depression-like levels. Security selection is very important, however, and we believe the market will favor discriminating investment managers who employ rigorous fundamental credit research that emphasizes bottom-up security selection and sector specialization. At some point, fixed income markets in general will return to more normal spread relationships and discriminating bond investors stand to benefit from the reversal as well.



About RidgeWorth Investments

RidgeWorth serves as a money management holding company with eight style-specific institutional investment management boutiques, each with a well-defined, proven approach and all with unwavering commitments to exceptional performance. Through our multiple, style-specific boutiques, we offer a wide range of equity, alternative, fixed income and liquidity management investment disciplines.

RidgeWorth Investments, an investment adviser registered with the SEC since 1985, is headquartered in Atlanta, Georgia.

Investment Considerations

Mutual fund investing involves risk, including possible loss of principal. Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates. Investments in lower rated bonds are subject to greater credit risk and may experience greater volatility than higher rated securities. Bank loans are typically senior and secured, in contrast to other below-investment grade securities. However, there is no guarantee that the value of the collateral will not decline, causing a loan to be substantially unsecured. Loans generally are subject to restrictions on resale. Certain types of loans may limit the ability of a Fund to enforce its rights and may involve assuming additional credit risks. Intermediate-term, higher-quality bonds generally offer less risk than longer-term bonds and a lower rate of return. Municipal bond fund income may be subject to certain state and local taxes and, depending on your tax status, the federal alternative minimum tax.

Important Information

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