Overview

In light of the recent volatility in the credit markets, we would like to update you on current market conditions and provide you with our thoughts on the impact of these developments on CDO portfolios. In this commentary, we offer our views on the U.S. and European bank loan markets, as well as on U.S. corporate and high yield bonds.

The current state of the market represents a significant challenge for CDO investors, underwriters and managers alike. The well-publicized U.S. subprime mortgage implosion and the credit liquidity crisis that ensued have resulted in a major repricing of risk in the credit markets. CDOs backed by corporate debt have experienced significant mark-to-market declines, albeit as a result of technical pressures rather than credit fundamentals. On the plus side, the correction has resulted in a more attractive supply of assets – in the form of wider spreads on newly issued debt and secondary paper that is more appropriately priced – as well as tighter structures and covenants.

We believe our vast experience and resources in credit, portfolio management and structuring position us well to deal with the increased volatility in the current marketplace. We believe that our investment approach, based on solid credit research and a conservative portfolio management style, has traditionally fared well during times of market dislocation. In our opinion, it is times like these when experienced and well-resourced managers are able to differentiate themselves and outperform the market.

We note that the Dryden portfolios do not have any direct exposure to subprime mortgage securitizations. As always, we continue to emphasize individual credit selection, focusing on companies with sound business models, market positions and appropriate capital structures. While current credit fundamentals remain fairly strong, it is our view that they are probably peaking for the current credit cycle. We will also continue to apply our structuring expertise to managing and issuing CDOs in line with market conditions and, as always, strive to provide timely communications to investors.

U.S. Bank Loans

The bank loan market continues to be challenged by weak market technicals. The forward calendar remains substantial, with well over $230 billion of new supply that is expected to be launched over the next six months. Many of these transactions are expected to be lower-rated, with aggressive structures that include weak covenant packages. From a supply standpoint, hedge funds, CLO warehouses and bank loan prime rate funds have been net sellers of bank loan assets since the end of June. On the demand side, new CLO issuance is waning, as investors in these structures are requiring higher returns that are difficult to meet given the current spread environment. Consequently, we believe that conditions in the bank loan market will continue to be tested until supply and demand are better aligned.

Generally speaking, the U.S. economic backdrop has been positive and credit fundamentals continue to be fairly strong, with the exception of homebuilding and auto-related businesses. GDP improved from its sluggish annual growth of 0.4% in the first quarter of this year to 4.0% growth in the second quarter. Consensus views on GDP for the balance of the year are mixed but are generally in the 2-2.5% range. However, these estimates could be adversely impacted by a continuation of the stricter lending standards that are being imposed broadly by lenders, as well as further deterioration in the residential real estate markets. We note that Moody's speculative default rate, which is currently less than 1%, remains at its lowest level in a decade. While Moody's forecasting model projects defaults to increase over the next year, they still are expected to remain below long-term averages.

The S&P/LSTA Leveraged Bank Loan Index has returned 0.19% through August 10, 2007, versus 3.81% over the same period in 2006. Since the end of the second quarter of 2007, the index return has been -3.30%, as a result of declines in secondary prices during July. Year-to-date primary institutional loan issuance totals approximately $300 billion, or about $107 billion net of loan refinancings and repayments. Primary issuance volume is about 50% above levels in the comparable 2006 period. Finally, bank loans have accounted for 75% of all leveraged finance issuance so far in 2007. This represents a 3% increase over their share of the leveraged finance market in 2006.[1]

While the new issue calendar has been limited over the past six weeks, we believe that the clearing price for B-rated credits is in the range of LIBOR + 350-425 bps. These spreads are about 100-175 bps. wider than levels we saw in early June. For BB-rated loans, we believe that the clearing price for new issuance would be in the LIBOR + 250-275 bps. range, at least 75-100 bps wider than early-June levels. On a positive note, because of the overall softness in the primary market, new issues are coming with one to two years of call protection and traditional covenant packages. However, given the uncertainty in the current market environment, we expect the range of any pricing and structural adjustments to be highly variable in the near term.

In the secondary market, S&P's Loan Commentary & Data (LCD) flow name composite was at 95.87% of par as of August 23, 2007, which is 74 bps. above the all-time low of 95.13% established on July 31, 2007.[2] Although S&P's index contains only 15 names, it is representative of the secondary price levels we are seeing across the market.

On the demand side, until very recently, 2007 CLO issuance was tracking at a record pace. Interest from non-traditional lenders, including high yield and hedge fund investors, was quite strong. However, the problems in the subprime mortgage asset class have reduced demand and increased return requirements for the debt tranches of structured products, including CLOs. Consequently, it has become very challenging to raise capital for new CLOs. Nevertheless, there is evidence of new buyers stepping into the void left by the slowdown of CLO issuance. These buyers include alternative investment managers such as newer hedge funds and private equity firms, as well as a variety of traditional accounts like money managers and insurance companies.

European Bank Loans

Since the start of the year, credit metrics in the European leveraged loan market have been deteriorating and returns were on the decline due to the excessive demand for collateral from new CLO managers and hedge funds. By the end of the first half of 2007, average total leverage in the market had reached 6x from 5.4x in 2006, according to S&P LCD, while the weighted average institutional spread had fallen by almost 25 bps. to 254 bps. The majority of incremental debt was through the first-lien as multiples increased by more than half a turn to 5.2x senior. With cheaper second lien replacing mezzanine, average funding costs were less than 295 bps. from 315 bps. in 2006.

The insatiable demand in the market led to a number of borrower-friendly features appearing in Europe. Mark-to-market repricings, covenant-lite structures and PIK toggle notes appeared first in cross-border transactions with U.S. borrowers. As investor demand remained unabated thanks to record low CLO liability spreads and significant hedge fund interest, pure European deals soon included many of these features.

The market began to overheat in June as deal volume reached record levels in Europe (€116 billion for the first six months of 2007 vs. €68.5 billion over the same period in 2006). Volumes in the secondary market began to drop off and leveraged loan indices started to trade below par as U.S. subprime mortgage contagion spread to the European leveraged loan market.

Recent price declines for loans have been unprecedented, with all paper in the market currently trading below par. This is despite a strong corporate and economic backdrop in Europe and high yield default rates of less than 1%. Consequently, our view of the value in the market has improved, as this correction has come at a time when the loan market was clearly overheating, rather than being due to weaker credit fundamentals.

1. *Source: Standard & Poor's Leveraged Commentary & Data (as of August 16, 2007)*
2. *Source: Standard & Poor's Leveraged Commentary & Data (as of August 23, 2007)*

For now, liquidity remains thin and the primary deal pipeline is on hold. The reduced appetite for leveraged loans will test underwriting banks that are currently sitting on commitments of more than €150 billion in Europe. Many deals will have to be re-cut and amended as lenders become more risk averse, which should lead to an improvement in the quality and return profile of loans going forward. However, with the excess of paper in the secondary market still coming out of hedge funds and a growing number of liquidating CLO warehouses, we expect market technicals to remain weak for the remainder of the year.

U.S. Corporate Bonds

Corporate bonds returned -0.8% in the second quarter of 2007, with an excess return of +4 bps. to U.S. Treasuries. Corporates delivered +0.7% in the first half of 2007.[3] Overall, corporate bonds continue to benefit from strong underlying fundamentals. Corporate earnings, cash flows and debt coverage ratios remain strong, supported by positive economic growth. Weighing negatively on the market is growing supply, which is increasing as the credit cycle matures. Management confidence also led to more shareholder-friendly activities, such as share buybacks and LBOs. Though the supply calendar remains healthy for now, LBO activity has trailed off significantly in the third quarter. M&A activity will be driven more by strategic (corporate) buyers. Finally, concerns over the subprime market and hedge fund activity may increase risk aversion.

Within the credit sectors, we expect favorable economic growth to provide solid underlying support. Nevertheless, our outlook is neutral, given a potential increase in investor risk aversion in response to the subprime market's woes, which could temper spread tightening in the near term. We look for stronger performance in these sectors later in the quarter, when the LBO supply calendar is expected to decline.

U.S. High Yield Bonds

High yield bonds returned +0.3% in the second quarter, with an excess return to U.S. Treasuries of +43 bps. In the first half of 2007, high yield bonds delivered +3.0%. High yield spreads tightened to an all-time low of +265 bps. over U.S. Treasuries in early June, then gave back those gains as a wave of highly leveraged new deals hit the market.[4]

Overall, high yield continues to benefit from solid credit fundamentals, with the default rate at cyclical lows. The greatest concern now is the large volume of lower quality LBO deals in the pipeline that have excessive leverage multiples and weak covenants. These deals will have to clear the market at very wide spreads, putting pressure on the secondary market. Another significant concern is the possibility of a recession sparked by problems in the housing sector and the related credit squeeze. We expect the economy to merely slow down, but fear of a recession may still pressure spreads in the near term.

3. Source: Lehman Brothers (as of June 30, 2007)
4. Source: Merrill Lynch (as of June 30, 2007)

Conclusion

While secondary market prices have fallen and new CDO issuance will slow in the near term, we believe that the existing Dryden portfolios can benefit from current market conditions. Thus far, weakness in the credit sectors is largely technical in nature; credit fundamentals have not shown any signs of deteriorating in the near term. We view the repricing of risk as a healthy development and look to take advantage of better loan structures, wider new issue spreads and attractive secondary market opportunities.

We would also like to take this opportunity to make you aware of our new CDO website, **www.drydencdo.com**. When first landing on the site, you will be asked to select the region where the investor entity you represent is based. You will then be directed to our home page. Portions of the site are still under construction; however, specific CDO-related information, such as organizational documents, Trustee reports, newsletters and marked-to-market holding files, can continue to be accessed via the Client Login process, which has not changed. If you experience any problems with logging in, or if you have not previously been assigned a user-ID and password, please let us know.

We encourage you to contact us with any questions or feedback related to this communication, the new website or any other matter, and we pledge to respond to you in a timely manner. Thank you for your investment and continued confidence in our platform.

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