Dresdner RCM Global Investors

Quarterly Investment Strategy Sheet

Second Quarter 2000

U.S. Core Fixed Income

► Market Environment

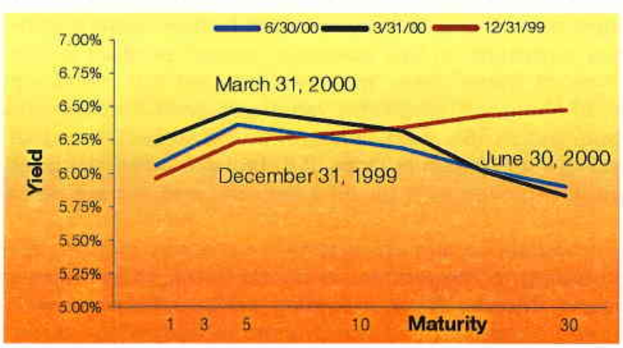
The second quarter could be characterized as having two distinct and extreme periods—the first half of the quarter saw extraordinary market volatility, while the second half was reasonably calm. Early in the quarter, economic indicators pointed to somewhat higher inflation and continued strong economic growth, as demonstrated by the reported first-quarter gross domestic product (GDP) of 5.4%. This was accompanied by the largest rise in consumer spending in 17 years, as well as rising energy prices. Heeding this threat of inflation, economic growth, and the supply/demand imbalance, the U.S. Federal Reserve Bank raised the federal funds rate by 50 basis points in May to 6.50%, the sixth such tightening during the last 11 months.

The possibility that the Fed might stomp too hard on the brakes and cause an economic full stop was, in part, the catalyst for extreme volatility in the stock markets. Also, lofty valuation levels and fears of a market plunge from dot-com fever created a flight to quality, pushing bond yields down as investors sought to temper portfolio risk. The confluence of these factors in April brought the yield on the 10-year Treasury down to 5.67%, its lowest level all year. However, as the quarter progressed, we saw a 180-degree reversal in sentiment and rates moved back up sharply. The increase in rates from the lows of 5.67% on the 10-year up to 6.50% in the span of six weeks was dramatic evidence of investors' trepidation of a hard-landing scenario in which the economy skidded to a halt. This marked the first half of the quarter—a period of extreme volatility with big highs and lows.

However, after the Fed tightening in mid-May, mounting evidence indicated that the Fed was starting to successfully slow the economy without adverse impacts. Housing starts were falling, consumer spending was down from record levels, and unemployment ticked up to 4.1% from a low of 3.9%. Consequently, investors cheered the potentially successful soft landing, and short rates fell. Long rates fell but to a lesser degree, causing the yield curve to become less inverted, with the current 10-year Treasury acting as the pivot point.

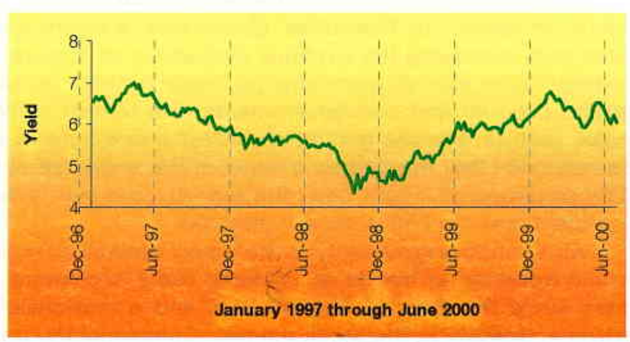
As the yield curve's behavior indicated, the market was again driven by fundamentals, rather than the supply/demand factors exaggerated by the unusual events that prevailed the previous quarter. It appears the market became comfortable with the technical conditions emanating from the Treasury buying back its debt, as well as with the issue surrounding the lack of an implicit guarantee of Government Sponsored Enterprises.

U.S. Treasury Yields Curves



Source: Dresdner RCM Global Investors

Ten-year U.S. Treasury Yield



Source: Datastream

► Portfolio Review

We were significantly underweighted in corporate bonds, primarily because of our concern that yield spreads would move wider, as well as concern for so-called event risk impacting quality of individual securities. This strategy benefited portfolios as corporate bonds underperformed substantially. Our decision to overweight U.S. agency securities helped performance, for that sector performed well, especially in June. We also overweighted mortgage-backed securities and structured asset product (asset-backeds and CMBS) which helped returns as investors' appetite for risk increased from previous months. Our decision to maintain durations shorter than benchmarks detracted from performance, as the Treasury market rallied on news of slower growth in the economy and the hope the Fed would remain on hold through the summer. Our portfolios had an overall emphasis in quality this past quarter with the average quality of portfolios at AA/Aa or better.

The non-U.S. market performed well on an absolute basis, but because U.S. Treasuries outperformed non-U.S. markets, the tactical allocation of approximately 7% detracted slightly from performance, viewed on a relative basis. Where applicable, high yield (4% of portfolios) and emerging markets (2% of portfolios) both contributed positively to performance because of their facility to generate income and their spreads to Treasuries narrowing in June. The hedged non-U.S. sector experienced a great deal of intraperiod volatility. Our shifts in allocation and interesting repositionings within the quarter added value to the portfolios.

► Outlook

Early signs that the economy may be slowing have removed the specter of an aggressive tightening in policy by the Fed. However, signs that inflation may be picking up could prompt further tightening later this year. We believe it is still too early to conclude inflation is indeed on a cyclical upswing—therefore, our base expectation is for a 25-basis-point additional increase in the federal funds rate as further demonstration of resolve by the Fed to deal with inflationary pressures.

The economy does not appear to be headed for a hard landing. Though conditions are changing, private borrowing costs have risen only modestly, less than 100 basis points over the past year, and broad equity market indices have yet to suffer any sustained downturn. Additionally, though statistics vary widely depending on data collection and reporting techniques, conditions that precede a sharp downturn in U.S. growth (such as high levels of inventories, disruptions in credit markets, or a sharp slowdown abroad) are absent at this time.

The absence of concrete evidence on growth and inflation has led us to take the middle ground with respect to portfolio postures. We expect the market to remain in a trading range until more evidence emerges regarding the fate of the economy. At this point, we believe the market is overly optimistic regarding the prospects for a soft landing. We continue to feel the momentum favors a return to above-trend growth until rates move higher, at which time the slowdown may be harder and bumpier than what the market currently reflects.

Though the economy is slowing, inflation has become a significant risk. The favorable inflation statistics of the past few years were due to moderate energy prices, a strong U.S. dollar, and excess capacity in the global economy. The tide in these forces has turned, which will make it less probable that the United States can continue to enjoy low inflation in the face of rapid growth. The Fed has moved to intercept the rising inflation trajectory with six rate increases in the past 11 months, hoping to induce a slowdown in domestic consumption. Typically, a slowdown in growth does reduce price pressures, but the linkages are at times loose, as proven in the late 1970s. Should inflation fail to moderate immediately in the face of a slower growth, we expect the Fed to continue turning the monetary screws, so as to not let the hard-won gains of the past 10 years slip away.

If the economy does indeed achieve a soft landing, we would expect rates overall to decline and spread product to tighten in relation to Treasuries. Conversely, a return to stronger growth would likely result in further upward moves in rates and increasing the eventual probability of a more serious downturn. In this scenario, spread product is likely to underperform as risk premiums increase further. In recognition of these risks, we have reduced our overweight in spread product and non-governments, but remain convinced of the good long-term value and solid fundamentals of these sectors. We are adding a modest overweight in the long end of the yield curve, with the expectation that the dis-inversion that happed as a result of the expected soft landing might again reverse, if in fact the economy does not slow as expected. Right now, the market does not have enough premium in it for inflation risk, and we are not at all confident that the Fed is done tightening.

With continuing volatility in the equity market reflecting lofty valuations and an uncertain economic picture, interest in and appetite for bonds as an asset class is growing. Contributing to the interest in bonds is the sharp increase in rates since the lows of August 1998 and a responsible Federal Reserve Bank monetary policy combined with the extreme volatility in the stock market. Consequently, the discount on closed-end bond funds is narrowing—June saw positive cash flows into bond mutual funds after many months of serious outflows.

It remains to be seen whether a smooth landing awaits the U.S. economy, given the major macro and financial imbalances that have accumulated over the past half-decade, for the economy is reacting like an F-16 fighter that has been gaining speed and altitude during the past 9 years—but now it must land safely on the deck of a pitching aircraft carrier. The Fed has strung a cable over the deck, in hopes of hooking the tail and bringing it in safely. However, if for some reason it misses the cable, the aircraft either hits the throttle and takes off again or veers into the sea. Our best guess is a missed landing, followed by a return to full-throttle growth, then another attempt by the Fed to land the jet safely. For all concerned, let's hope the economy does not plunge into dark water.