Pacific Income Advisers SECOND QUARTER 2010

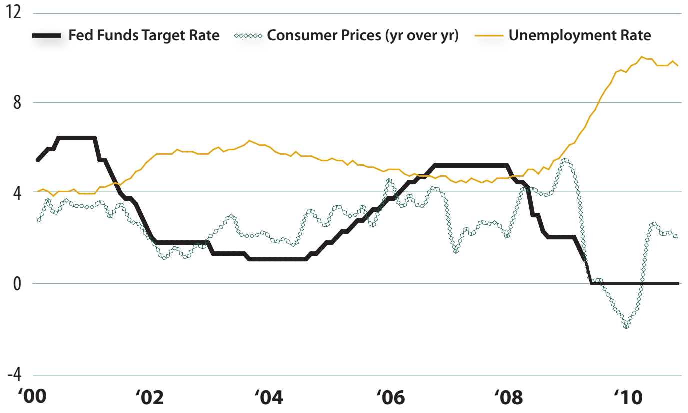
INVESTMENT COMMENTARY

IN REVIEW, the second quarter of 2010 provided investors with some brutal insights, as events throughout the quarter helped to elevate investor's awareness of risk. Prior to April 20th, few could envision that one mismanaged deep sea oil drilling rig could produce the horrific ecological and economic damage that the Gulf of Mexico will likely endure for generations. Decades of technological advancement, financial regulation and oversight separate today's stock exchanges from the market crash of 1987; however investors were blind-sided by the "flash crash" of 2:45PM on May 6th. In fact, if it weren't for an investigation involving Goldman Sachs, very few investors would have even heard of "high frequency trading"; which by some estimates may account for up to 70% of all NYSE trading volume. The unsustainable indebtedness of several Euro zone nations pejoratively referred to as PIIGS (Portugal, Italy, Ireland, Greece and Spain) has endangered the health of the global banking system and resulted in more than $1 trillion in financial support from the IMF and EU; in addition to the support of the ECB, which has become the buyer of last resort for the PIIGS public and private debt. The U.S. economy remains on fiscal and monetary life support; which has struggled to sustain consumer spending. May retail sales declined 1.2% and home sales plummeted 33% following the expiration of government appliance rebates and home purchase tax credits. The unemployment rate edged lower to 9.5% in June due to a drop in the work force; however 46% of all unemployed Americans have been out of work for more than six months. RealtyTrak Inc. calculated that roughly one out of every 78 housing units received at least one foreclosure filing in the first half of 2010. Coincidentally the Conference Board's Consumer Confidence Index dropped nearly 10 points from May (62.7) to June (52.9).

The FOMC convened twice during the quarter, each time leaving the fed funds target rate unchanged at 0-0.25%, while stating; "With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time". The yield curve flattened during the quarter, as the spread between 2- and 10-year treasuries narrowed by 48 bps to 2.33% - driven by the dramatic 90 bps decline in the 10-year treasury yield to 2.93%. Spreads widened across all credit sectors, however investment grade debt continued to produce positive returns; corporates (+3.42%), industrials (+4.21%), utilities (+4.75%) and BBB-rated corporates (+3.10%).

LOOKING FORWARD beyond the Euro zone sovereign debt crisis, the question on everyone's mind appears to be will the U.S. endure a double-dip recession? We believe that the probability of a double-dip recession, where GDP growth slides back to negative following a couple quarters of positive growth has increased to roughly 30%. However, we have maintained the unorthodox view that the modest GDP growth achieved over the past three quarters has not reflected an actual economic recovery, but rather an unsustainable shift in inventories and consumer spending driven by substantial fiscal and monetary stimulus. Furthermore, to sustain an economic recovery consumers need to clear a path toward unleveraged consumption by first unwinding the household leverage accumulated over the past few decades. The household sector debt increased to 96.4% of GDP by the start of 2008, up from 70.3% in 2001. The U.S. economy is now facing additional risks from a slowdown in global spending that will likely carry well into 2011. The surprisingly strong political will for stern austerity measures toward cutting the structural budget deficits in the Euro zone will most likely result in a Euroland recession in 2011. Interestingly, Euro austerity measures should help China's

FED's **MANDATE**



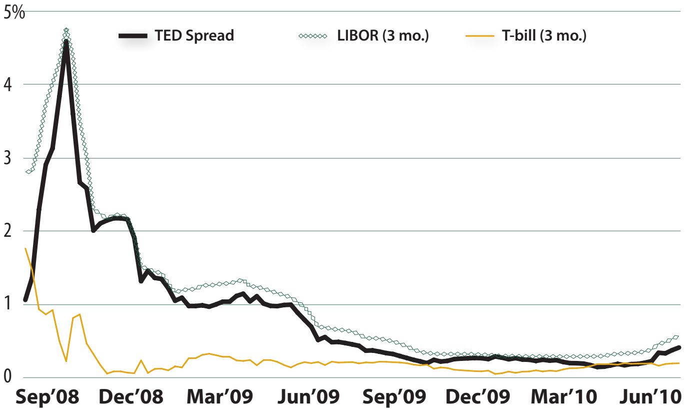
The federal funds rate target compared to measures of unemployment and inflation

Source: Labor Department and Federal Reserve efforts to slow their growth and help to reduce inflation. China's annual trade surplus recently reached 0.6% of global GDP, which is a world record and why China's tightening policies can also exacerbate U.S. economic weakness.

We believe interest rates should remain range bound over the next several quarters. However, we adjusted our 10-year treasury yield target range downward to 2.75% – 3.5% to reflect the increased global economic risk. We continue to believe there is no meaningful inflation risk for the foreseeable future; other than a modest decline in purchasing power as a result from continued strength in the U.S. dollar due to a global flight to quality. Consequently, we envision real rates of returns to remain at the low end of the 2-3% historical range; while we believe that global deflationary pressures could drive U.S. inflation below the 1% level by mid-2011. Short-term interest rates should also remain low into 2011, driven by an anemic real estate market and anchored by accommodative monetary policy. When the time comes for a shift in monetary policy it will most likely reflect stabilization in the real estate market and consumer spending, rather than a need to get in front of runaway inflation.

PIA PORTFOLIO structure is modestly bulleted, and we lengthened our duration to neutral relative to the benchmark. We continue believe the efforts of our fiscal policy makers to reflate our economy to health will increase our deficits, and long term portends higher interest rates and the potential for a steeper yield curve. However, in the near term, the fear of a double-dip recession coupled with the Euro sovereign debt crisis has led to a strong flight to quality, driving interest rates lower. We exited the TIPS sector early in the quarter, as they appreciated throughout last year to levels that more than fully priced inflation expectations associated with an economic recovery. Credit spreads widened commensurately with increased economic risks, and as such we continue to believe the corporate sector hovers near fair valuation levels on a risk adjusted basis. We maintain our credit overweight and continue to favor the more liquid, higher quality credits as we expect on-going spread volatility throughout 2010. We believe BBB-rated credits offer attractive return potential; however only with sufficient diversification to manage the idiosyncratic credit risk. We continue to underweight the securitized debt sectors, maintaining a modest overweight in high-quality Agency Mortgage pass-throughs where we can benefit from the attractiveness of the TBA dollar roll market. We favor seasoned premium coupon MBS, that should exhibit a favorable prepayment activity as tighter underwriting standards will prevent homeowners, except those with excellent credit, to take advantage of the current record low mortgage rates.

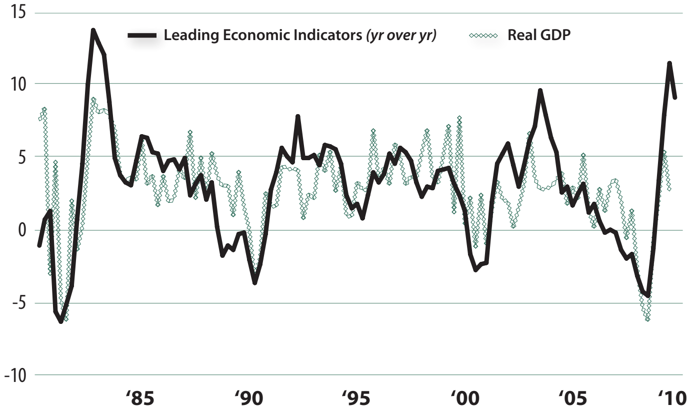
TED **SPREAD**



The TED spread is the difference between the three-month T-bill interest rate and the three-month Eurodollar contract as represented by the London Interbank Offered Rate (LIBOR). The TED spread is an indicator of perceived credit risk in the general economy. This is because T-bills are considered risk-free while LIBOR reflects the credit risk of lending to commercial banks.
Source: Bloomberg

LEADING **ECONOMIC INDICATORS**

& Real GDP *(yearly percent change)*



Source: Bloomberg

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KEY RATES

	6/30/10	3/31/10	12/31/09
Fed Funds Target Rate	0-0.25%	0-0.25%	0-0.25%
3 Month LIBOR	0.53	0.29	0.25
On-the-run Treasuries:			
3 Months	0.17	0.15	0.05
6 Months	0.22	0.23	0.19
2 Years	0.60	1.02	1.14
5 Years	1.77	2.54	2.68
10 Years	2.93	3.83	3.84
30 Years	3.89	4.71	4.64

Source: Bloomberg

KEY ECONOMIC INDICATORS

as of	6/30/10	6/30/09
DXY	86.02	80.13
Oil	75.63	69.89
Gold	1242.25	926.60
CRB	258.52	249.96
GDP	2.7	-0.7
CPI	2.0	-1.4
Core PCE Deflator	1.3	1.5
Unemployment Rate	9.7	9.5
Consumer Confidence	52.90	49.30
S&P/Case-Shiller – Comp-20	3.81	-15.38

Source: Bloomberg

INDEX RETURNS

	2Q'10	YTD	1-Year
Barclays Capital –			
Universal	3.14%	5.25%	10.60%
Aggregate	3.49	5.33	9.50
Aggregate ex-credit	3.55	5.25	7.99
Gov-Credit	3.88	5.49	9.65
Int. Gov-Credit	2.97	4.56	8.29
Corporate	3.42	5.79	15.92
Treasury only	4.69	5.86	6.67
1-3 year Gov	1.17	1.89	2.85
BofA Merrill – 1-yr T-Note	0.26	0.51	0.99
Int. High Yield	-0.18	4.22	25.41
International Debt	-2.43	-4.04	1.89
Emerging Markets Debt	0.97	5.65	20.44
S&P 500	-11.43	-6.65	14.43
DJIA	-9.36	-5.00	18.94
NASDAQ	-11.01	-6.17	18.53
EAFE AWI	-13.69	-12.84	6.56

Source: Bloomberg & Barclays Capital

SECTOR RETURNS

2Q'10	Total Return	Excess Return
U.S. Treasuries	4.69%	0.00%
Government-related U.S. Agency	2.62	-0.62
Government-related Credit	2.69	-2.12
Corporate	3.42	-2.25
Corporate Financials	1.82	-2.97
Corporate Industrials	4.21	-1.80
Corporate Utilities	4.75	-2.08
Corporate AAA-rated	6.27	-0.21
Corporate AA-rated	3.09	-1.80
Corporate A-rated	3.78	-1.98
Corporate BBB-rated	3.10	-2.80
Corporate High-Yield	-0.11	-3.86
Mortgage-backed Securities-FR	2.93	-0.01
Mortgage-backed Securities-Hybrid	1.39	0.39
CMBS	2.78	-0.67
ABS	2.54	-0.08

Source: Barclays Capital

Pacific Income Advisers, Inc. (PIA) is an autonomous investment management firm registered under the Investment Advisers Act of 1940. PIA manages a variety of fixed income, equity, and balanced assets for primarily United States clients.

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BENCHMARK DESCRIPTION

Barclays Capital U.S. Universal Index represents the union of the U.S. Aggregate Index, U.S. Corporate High-Yield Index, Investment-Grade 144A Index, Eurodollar Index, U.S. Emerging Markets Index, and the non-ERISA eligible portion of the CMBS Index. The index covers USD-denominated, taxable bonds that are rated either investment-grade or below investment-grade. Some U.S. Universal Index constituents may be eligible for one or more of its contributing subcomponents that are not mutually exclusive. These securities are not double-counted in the index. You can not invest directly in an index.

Barclays Capital U.S. Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The issues must be rated investment grade, be publicly traded, and meet certain maturity and issue size requirements. You can not invest directly in an index.

Barclays Capital U.S. Aggregate Ex-Credit Index (LB Agg (Ex-Credit)) The index covers the U.S. investment grade fixed rate bond market, with index components for government, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. You can not invest directly in an index.

Barclays Capital U.S. Government/Credit Bond Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. You can not invest directly in an index.

Barclays Capital U.S. Intermediate Government/Credit Bond Index is the Intermediate component of the U.S. Government/Credit index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. You can not invest directly in an index.

Barclays Capital U.S. 1-3 Year Government Bond Index consist of securities in the U.S. Government Index with a maturity from 1 up to (but not including) 3 years. Securities issued by the U.S. Government (i.e., securities in the Treasury and Agency Indices). Inclusions: Public obligations of the U.S. Treasury with a remaining maturity of one year or more. Publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government. You can not invest directly in an index.

Barclays Capital U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. You can not invest directly in an index.

Barclays Capital U.S. Corporate Bond Index covers USD-denominated, investment-grade, fixed-rate, taxable securities sold by industrial, utility, and financial issuers. It includes publicly issued U.S. corporate debentures and secured notes that meet specific maturity, liquidity, and quality requirements. Securities in the index roll up to the U.S. Credit and U.S. Aggregate indices. The U.S. Corporate Index was launched on January 1, 1973. You can not invest directly in an index.

BofA Merrill Lynch 1-Year US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue. The issue selected at each month-end rebalancing is the outstanding Treasury note that matures closest to, but not beyond, one year from the rebalancing date. To qualify for selection, an issue must have settled on or before the month-end rebalancing date. You can not invest directly in an index.

Barclays Capital Corporate Intermediate U.S. High Yield Index - is the Intermediate component of the U.S. Corporate High Yield index. The Barclays Capital U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, and 144-As are also included. You can not invest directly in an index.

Barclays Capital Global Aggregate Index provides a broad-based measure of the global investment-grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the U.S. Aggregate Index (USD 300 million), the Pan-European Aggregate Index (EUR 300 million), and the Asian-Pacific Aggregate Index (JPY 35 billion). In addition to securities from these three benchmarks (94.4% of the overall Global Aggregate market value), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300 million), Euro-Yen (JPY 35 billion), Canadian (CAD 300 million), and Investment-Grade 144A (USD 300 million) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized subindices by liquidity constraint, sector, quality, and maturity. The Global Aggregate Index is a component of the Multiverse Index. You can not invest directly in an index.

Barclays Capital Global Emerging Markets Index consists of the fixed and floating-rate USD-denominated U.S. Emerging Markets Index and the primarily EUR and GBP-denominated fixed-rate Pan-European Emerging Markets Index and includes emerging markets debt from the following regions: Americas, Europe, Asia, Middle East, and Africa. For the index, an emerging market is defined as any country that has a long term foreign currency debt sovereign rating of Baa1/BBB+/BBB+ or below using the middle rating of Moody's, S&P, and Fitch. The index does not overlap with the U.S. Corporate High-Yield Index or the Pan Euro Corporate High-Yield Index, but may overlap with other investment-grade Aggregate Indices if the securities meet their index eligibility rules. You can not invest directly in an index.

S&P 500 Index – The S&P 500 index includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. You can not invest directly in an index.

The NASDAQ-100 Index is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international issues listed on the NASDAQ. No security can have more than a 24% weighting. The index was developed with a base value of 125 as of February1, 1985. Prior to December 21, 1998 the Nasdaq 100 was a cap-weighted index. You can not invest directly in an index.

The Dow Jones Industrial Average (DJIA) is an index used to measure the performance of the U.S. financial markets. Introduced on May 26, 1896 by Charles H. Dow, it is the oldest stock price measure in continuous use. Over the past century "the Dow" has become the most widely recognized stock market indication in the U.S. and probably in the entire world. Most of the stocks included in the index are listed on the New York Stock Exchange, and are all large blue-chip companies that reflect the health of the U.S. economy. All but a handful of these have major business operations throughout the world, thus providing some insight into the economic well-being of the global economy. You can not invest directly in an index.

MSCI EAFE Index is a capitalization weighted index that monitors the performance of stocks from Europe, Australiasia, and the Far East. You can not invest directly in an index.