The Babson Capital **Staff Letter**

First Quarter 2011

FIRM OVERVIEW

Babson Capital Management LLC and its subsidiaries manage $133.1 billion (as of December 31, 2010 assets include Babson Capital Management LLC and its subsidiaries Babson Capital Europe Limited and Cornerstone Real Estate Advisers) in assets for a broad range of global institutional investors and is the lead investment advisor to our parent, the Massachusetts Mutual Life Insurance Co. (MassMutual). Our goal is to build long-term relationships, based on transparency and trust, that provide value to our clients. Through proprietary research and analysis and a focus on investment fundamentals, we develop products and investment strategies that leverage our broad array of expertise in fixed income, equities, alternatives, structured product, and debt financing for corporations and commercial real estate.

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MACRO OVERVIEW

HIGHLIGHTS

- **Markets**: First quarter 2011 returns reflected investors move away from safer havens as riskier assets outperformed
- **Economic Review**: The U.S. economy has held up well considering the events that have transpired since the beginning of the year
- **Economic Outlook**: Several structural imbalances remain which serve to weigh on the outlook for sustained global growth

RISK ON, RISK OFF, RISK ON

Investors had some momentum going into 1Q11 as real GDP grew at a 3.1% Q/Q annualized rate in 4Q10 and there were abundant signs the economic recovery was taking hold. It was risk on to start the year until a confluence of natural and geopolitical events arose mid-quarter that caused investors to retreat, only long enough to digest current events and determine improving economic data should rule the day – risk on again. First quarter 2011 returns reflected changes in investor attitudes and the search for yield was rewarded as riskier assets outperformed. Equities and high yield corporate bonds and loans notably outperformed investment grade corporate bonds during the first quarter, while Treasuries followed up a poor 4Q10 performance by posting another negative return in 1Q11 (see Table 1).

TABLE 1: RETURNS

	TOTAL RETURN 2008 (%)	2009 (%)	2010 (%)	4Q2010 (%)	1Q2011 (%)	OAS (BPS)	YTW (%)
U.S. Aggregate*	5.24	5.93	6.54	-1.30	0.42	50	3.08
U.S. Treasury	13.74	-3.57	5.87	-2.64	-0.16	N/A	2.06
U.S. TIPS	-2.35	11.41	6.31	-0.65	2.08	N/A	2.90
U.S. Corporate Investment Grade	-4.94	18.68	9.00	-1.61	0.86	142	4.07
U.S. Corporate High Yield	-26.16	58.21	15.12	3.22	3.88	465	7.02
U.S. Leveraged Loans**	-28.76	44.87	9.97	3.30	2.65	503	6.29
Western European Leveraged Loans, Non-$U.S. Denom**	-30.32	48.53	8.75	3.35	4.69	565	8.10
U.S. Investment Grade CMBS	-22.72	28.14	20.81	1.09	2.39	230	4.08
U.S. ABS	-12.72	24.72	5.85	-1.48	0.64	64	2.05
U.S. MBS	8.34	5.89	5.37	0.24	0.58	34	3.75
U.S. Equity***	-37.00	26.46	15.06	10.76	5.92	N/A	N/A

Source: Factset, Barclays Capital, Credit Suisse, Standard & Poor's as of March 31, 2011
* U.S. Aggregate includes U.S. Treasuries, U.S. Agencies, U.S. Credit (includes Sovereign issues), U.S. Agency Mortgage-Backed Securities, U.S. CMBS and U.S. ABS.
** OAS=DM3 Spread. U.S. (European) Loan YTW=current yield+3 month LIBOR (EURIBOR) + U.S. (European) 3 year swap spread
*** U.S. Equity represented by S&P 500

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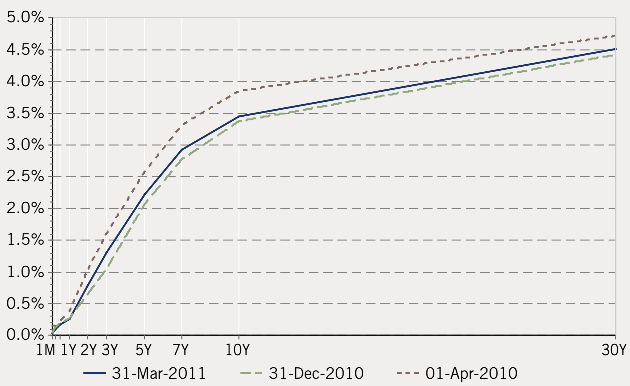
RATES

U.S. Treasury rates closed 1Q11 mixed compared to year-end 2010. T-Bill rates declined, but two-year Treasuries were up 23 bps, intermediates were higher by 18-31 bps and the long-end increased by 17 bps. Yield changes were driven by the risk-on, risk-off, risk-on see-saw that characterized first quarter events. Investor risk appetite appeared healthy at quarter end as intermediate yields backed up notably in the last week of the quarter. Inflation expectations also seem to be playing a part as TIPS significantly outperformed Treasuries during 1Q11.

FIGURE 1: YIELD CURVE



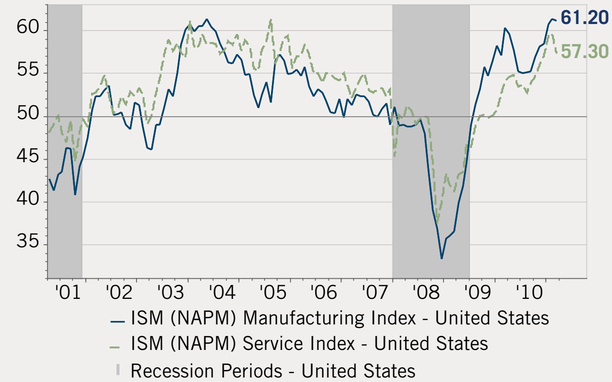
Source: Factset and Babson Capital as of March 31, 2011

ECONOMIC OVERVIEW

Resilient – this is the word that comes to mind when considering how the U.S. economy has reacted to the events that have transpired since the beginning of the year. During the past quarter, Japan, the 3rd largest economy in the world, was struck by a catastrophic 9.0 magnitude earthquake; democracy movements have sprouted up throughout North Africa and the Middle East and oil prices have risen 14%. Yet, through the end of 1Q11, the S&P 500 was up 5.9%, the 10 Yr Treasury bond widened 18 bps to 3.47% and the CRB index was up 8%. In the words of the FOMC, the economy certainly does appear to be on firmer footing!

Backing up the FOMC claim has been a run of generally good economic data that shows evidence the economy is moving from the recovery phase to an expansion phase. The index of leading economic indicators was up 0.8% in Feb, its 8th consecutive gain, the ISM reports on business (manufacturing and service) are firmly entrenched in expansion territory (Figure 2) and weekly unemployment claims remain on a downward trajectory. Further support can be found in the corporate sector where balance sheets remain in good shape and S&P 500 corporate profits are close to their prior peak level.

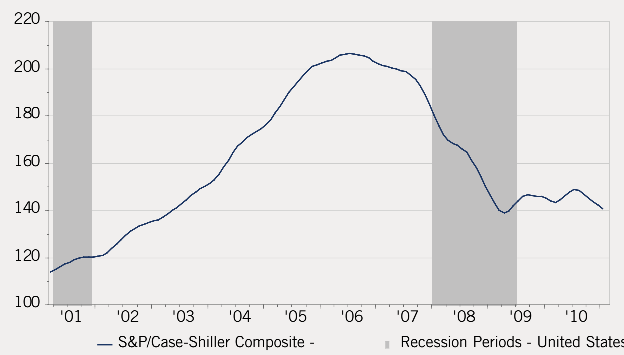
FIGURE 2: ISM REPORT ON BUSINESS



Source: FactSet and Babson Capital as of March 31, 2011

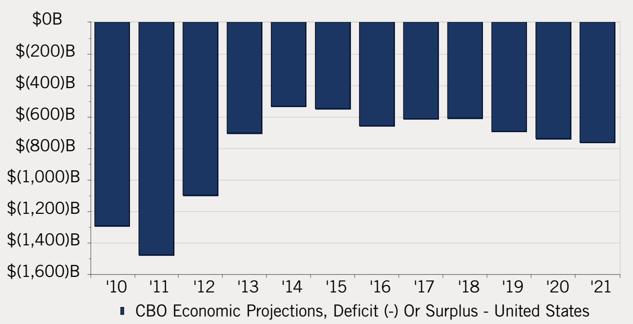
Despite evidence that investors are focusing on the improving economic data, it would be premature to pop the champagne corks. While the long term impact of recent geopolitical events is difficult to predict and the extent of disruption in the global supply chain due to the Japanese earthquake will have a short term negative impact, several structural imbalances remain which serve to weigh on the outlook for sustained global growth. The housing market in the U.S. continues to be stressed. Foreclosures continue to work their way through the system and have been putting downward pressure on prices (Figure 3). The new construction market shows no sign of a pulse as housing starts and building permits wallow at distressed levels. The construction sector lost over 1.8 million jobs between 2008 and 2009 and has lost another 133,000 jobs from January 2010 through 1Q11. The housing sector continues to be a drag on employment growth and, at over 40% of the CPI index, is holding overall inflation down with a 0.7% year-over-year increase in February 2011.

FIGURE 3: HOME PRICES



Source: FactSet and Babson Capital as of March 31, 2011

FIGURE 4: CBO DEFICIT PROJECTIONS



Source : FactSet, Congressional Budget Office and Babson Capital as of March 31, 2011

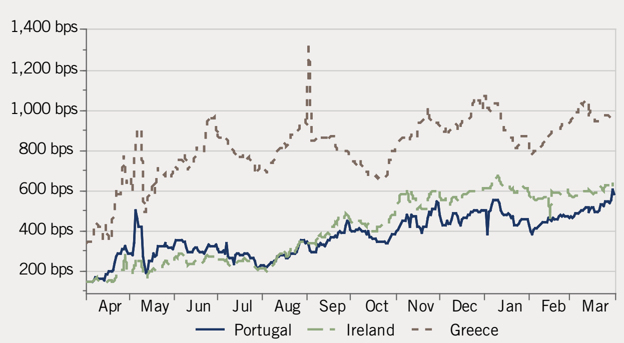
Fiscal problems on both the state and federal level continue to underscore the precarious financial position facing the government sector. Six months into the 2011 fiscal year and there is still no agreement on the federal budget. The chronic, huge deficits facing the U.S. (Figure 4) will require bold proposals that cut programs deemed sacrosanct by Congress in an effort to balance the budget or bring future deficits to a more manageable level, however, the bipartisan gridlock will likely lead to a watered down compromise which effectively "kicks the can down the road." Serious progress on this front may not occur until the next election cycle. Encouragingly, both parties appear to grasp the seriousness of the situation and discussion seems to revolve around the depth of spending cuts and not whether to cut spending.

On the global front, default worries for the Euro-zone peripheral economies seem to be increasing (Figure 5). Portugal and Greece were both recently downgraded after European policy makers agreed to new rules on bailout loans which may increase the probability these countries will be forced to restructure. The European Stability Mechanism (ESM), which will go into effect in 2013, replaces the temporary €750 billion European Financial Stability Facility (EFSF) with a permanent apparatus that essentially subordinates senior unsecured government debt to ESM loans. The priority given to ESM loans compromises the existing position of government bondholders and could lead to lower recovery values. At a minimum, the sovereign debt crisis highlights the disparity between the various economies of Europe and the challenges of administering a common monetary policy across a very diverse set of economic circumstances.

Fed watching has also moved to the forefront of investors' attention as the market tries to anticipate the next move and what happens when the QE2 program comes to an end in June. The underlying question is whether economic growth will be self-sustaining without massive government fiscal stimulus and an ultra-accommodative monetary policy. Currently, the market is not expecting an increase in the Fed Funds rate until 2012, so the immediate focus has been on inflation. While the current inflation rate remains low (Figure 6), inflation expectations have increased recently due to rising food and energy prices.

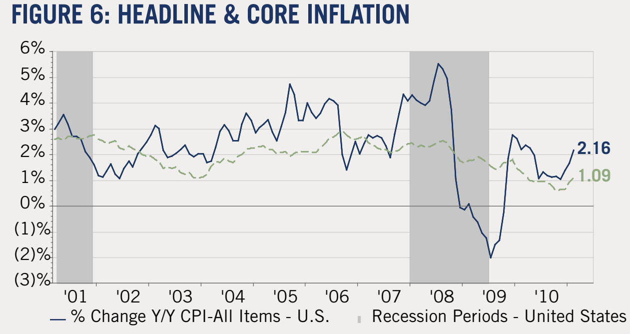
Two camps seem to be developing with respect to the direction of interest rates. On one side, there are those that see emerging market economies applying the brakes and the effects of the recent run up in oil and food prices being more transitory in nature. As a result, this group sees low to no inflation on the horizon and slowing economic growth, which leads them to forecast a 10 Yr Treasury yield of 2.5%. On the other side is a group that sees the economy moving from recovery to expansion mode, the end of the Fed's QE2 program (i.e. the primary bid in the Treasury markets) and higher inflation expectations. This camp forecasts the 10 Yr Treasury yield moving to 4.5%. The market seems to have split the difference with the 10 Yr Treasury yield currently hovering right in the middle. What does this mean for the economy going forward? Our expectation is that the aforementioned factors will result in slower growth in 2H11 with slightly more volatility than we have seen in the recent past.

FIGURE 5: FIVE YEAR CDS



Source: Bloomberg and Babson Capital as of March 31, 2011

FIGURE 6: HEADLINE & CORE INFLATION



Source: FactSet and Babson Capital as of March 31, 2011

Investment Grade Corporate Credit

INVESTMENT GRADE CORPORATE CREDIT HIGHLIGHTS

- Most of the spread compression took place in the first half of the quarter after which spreads remained steady around 130 bps through the macro shocks of the second half
- Lower quality and longer duration assets performed better contributing to excess returns of 0.5% for the quarter
- Two factors which could keep spreads from reaching the tights of the earlier cycle: an index comprised of lower credit quality and longer duration and a more uncertain macro environment now vs. the previous cycle

MARKET REVIEW

The prognosticators got it right – or at least half right. Back in November 2010, most of the sell-side corporate credit strategists predicted that spreads would rally to the 120-130 bps range by the time 2012 rolled around. Spreads have, in fact, rallied to those levels, but they did so much quicker than the prognosticators predicted. Credit spreads ended November 2010, when most of the 2011 strategy pieces started appearing, at 159 bps and rallied to 146 bps to end the year. In the current quarter, spreads have continued their rally to 128 bps by the ides of February. Since then, even with a 9.0 magnitude earthquake in Japan and historic revolutions sweeping the Middle East, spreads have remained relatively steady around 130 bps.

Excess returns were a positive 0.5% (Barclays Capital US Aggregate Credit Corporate Index, as of March 31, 2011) during the quarter with lower quality and longer duration assets performing better than their less risky counterparts. That being said, the dispersion between the "risky" and "less risky" assets has been less pronounced than in past quarters. The difference between excess return in the long end and in the intermediate part of the curve was only 135 bps versus 89 bps. The difference between these numbers tended to be much larger when the "risk on" trade was in full swing. Financials, which still have a 45 bps OAS advantage over industrials, also performed better with excess returns of 145 bps versus 77 bps for industrials. Utilities, with spreads of 137 bps OAS, had excess returns of 88 bps.

OUTLOOK

The tights of the '04 to '07 spread cycle were in the low 70s. With corporate fundamentals exceedingly healthy and with the Federal Reserve inspired "reach for yield" trade still firmly intact, a question on many investment grade credit investors' minds is "can we get back to the lows of the previous cycle?" The short answer is likely "no."

We believe there are two issues that could keep spreads from reaching these levels. The first is that the composition of corporate credit has changed since then and mainly as a result of the 2008 crisis. The more obvious change in composition is that the overall credit quality of the index is lower. There has been a general downgrading of credit with few upgrades. The second change is that the average duration of the corporate universe has increased. During the 2008 crisis, money market funds, which large corporations viewed as riskless and used to pay operating expenses from, such as salary, seized up with the result that several large corporations were caught scrambling for cash. As a result, corporations termed out debt in the corporate market to reduce their money market holdings and increased their actual cash balances. Both these factors should serve to increase the "floor" on credit spreads for this cycle.

The second issue is that there are still a tremendous number of macro variables which were not present during the last cycle. "Boring" and "lackluster" were terms used to describe spreads in the middle part of the prior decade. It seems likely that we will not use those terms to describe spreads in the first half of this decade. There are many and significant moving parts in the macro environment today that will likely take years to play out.

With all that, spreads could still tighten if there are no significant macro disruptions, but they should not tighten to the levels they reached in the prior cycle.

FIGURE 7: IG CORPORATE CREDIT OAS

Source: Factset and Babson Capital as of March 31, 2011

High Yield Bonds and Loans

MARKET REVIEW

The high yield loan and bond markets returned 2.7% and 3.9%, respectively, for Q1 (Credit Suisse Leveraged Loan Index and Barclays Capital High Yield Index, as of March 31, 2011). This performance was driven by continued positive economic data and another strong corporate earnings season. High yield bond issuers reported full-year 2010 revenues and EBITDA that were up an average of 11% and 29%, respectively, and improved leverage by over a turn on average (JPM 2011 High Yield and Leverage Loan Outlook, February 2011). With economic improvement driving an increased risk appetite from investors, lower quality credits generally outperformed higher quality credits during the period. That said, unrest in the Middle East and the crisis in Japan resulted in increased market uncertainty in March.

HIGH YIELD CORPORATE CREDIT HIGHLIGHTS

- Strong corporate earnings and further corporate deleveraging resulted in loans returning 2.7% and bonds 3.9% for the quarter
- Although new issue terms are becoming more aggressive, the majority continues to be refinancing activity, as issuers take advantage of the low interest rate environment
- Loans should benefit from higher interest rates and bonds should be able to offset a modest increase in Treasuries with further spread tightening

The high yield default rate remains benign as corporate balance sheets improve with the ongoing economic recovery. The trailing 12-month high-yield bond default rate is 0.8% and stands at 1.1% for high yield loans on a par-weighted basis (JP Morgan High-Yield Market Monitor, April 1, 2011), which compares favorably to the historical averages of 3.9% and 4.0%, respectively.

In the primary market, the pace of new issuance remained strong as companies refinanced near-term maturities and took advantage of attractive market conditions. Loan issuance was particularly robust, marking the most active quarter since 2Q 2007.

Overall, investors appear content with their exposure to these risk assets. In fact, the overall positive fund flows into both loans and bonds in Q1 suggest that investors are still comfortable with the risk and opportunities in the high yield markets.

OUTLOOK

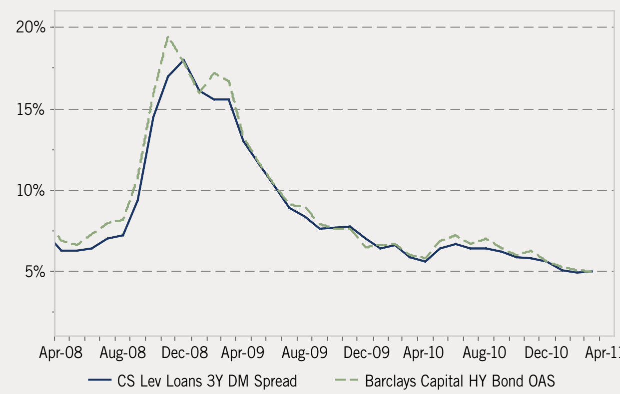
With the ongoing broad economic improvement, we expect the modest growth of revenue and EBITDA to continue for many credits. We anticipate that this will result in continued deleveraging of corporate balance sheets and a low default environment.

Although higher commodity and raw material costs are beginning to have an impact on corporate results and guidance, we believe companies will be able to cope with these given the overall health of their balance sheets. Although the majority of new issuances continue to be refinancings, new issue terms have clearly become more aggressive. Notably, several new loan issuances have lacked maintenance covenants and a few PIK toggle bonds have come to market.

We are mindful of the potential impact that higher interest rates may have on the high yield market. Due to their floating rate nature, loans will benefit from an increase in interest rates. That said, the impact will be partially offset in those issuers with LIBOR floors. Moreover, we believe high yield bonds should be able to offset a modest increase in Treasuries (approx. 50 bps) with further credit spread tightening. While bond yields are near all-time lows, we believe the spread premium to Treasuries remains attractive.

Overall, high yield markets will likely favor credit pickers, with the majority of non-distressed loans trading at or near par and more than 60% of high yield bond issuers trading above their respective call prices. Although event risk remains a concern (Middle East, Japan, sovereign debt), the momentum of the economy is better now than last year. With loan spreads above historical averages and continued credit improvement expected, we believe both loans and bonds remain well positioned to provide attractive risk-adjusted returns.

FIGURE 8: U.S. LOAN AND BOND SPREADS



Source: Factset, Credit Suisse and Babson Capital as of March 31, 2011

European Loans

MARKET REVIEW

The European leveraged loan market continued to have a positive tone during the first quarter of 2011. Geopolitical unrest across North Africa and parts of the Middle East coupled with increasing inflationary concerns brought volatility to many traditional asset classes. However, the stability of the loan market was once again demonstrated by year-to-date index returns of 4.7% (Credit Suisse Western European Leveraged Loan Index, as of March 31, 2011). The encouraging momentum of 11 straight positive weeks from the start of the year was brought to a halt by the tragic events in Japan.

Overall, the strength of bids for loans remained technically driven, mainly due to CLO funds with repayments far outweighing any new issuance. According to the S&P LCD European Leveraged Loan Review (Q1 2011), institutional loan repayments totaling €9.7 billion in Q1 resulted in the doubling of new issuance brought to the market. In parallel, we have also seen the repricing of many 2010 trans-Atlantic deals, with margins and attractive LIBOR floors being gradually reduced. This on the whole has been accepted by investors, who would rather remain invested than being repaid.

In the new issue market, a total of six new deals have been priced this quarter, with margins ranging from 425-525 bps over LIBOR. A large portion of Q1 repayments were driven by the continued trend of senior secured bonds refinancing loans. In fact, 21% of bond deals in Q1 were used to refinance outstanding bank debt. Whilst many of the traditional loan investors are unable to invest in fixed-rate bonds, following much reverse enquiry, arranging banks are now starting to tap the growing institutional demand for floating-rate product by facilitating split-, fixed-, and floating-rate senior secured bonds. The last three senior secured deals launched in Europe have offered this flexibility with FRNs totaling €1.2 billion. We remain supportive of this burgeoning trend. However, the quantum of floating-rate notes expected to come to market is highly unlikely to be sufficient enough to replace the volume of loans currently being repaid.

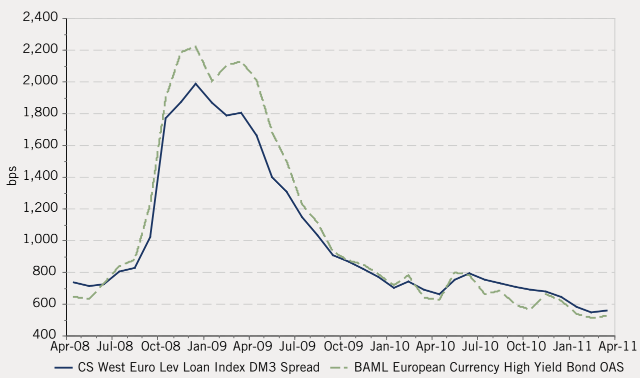
EUROPEAN LOAN HIGHLIGHTS

- The European loan market held steady to return 4.7% for the quarter with market strength underpinned by CLO repayments outweighing new issuance
- A new trend surfaced: arranging banks are facilitating split-, fixed-, and floating-rate senior-secured bonds to tap growing demand for floating rate product
- Further material tightening in the short term is unlikely given the strength of the rally so far

OUTLOOK

Secondary market spreads have continued to tighten throughout Q1 with seemingly insatiable investor appetite for sub-par assets. Given the strength of this rally thus far, further material tightening in the short term is unlikely. The technical bid should remain strong, however, and should further underpin the market's stability. New-issue spreads appear to have found a level with single-B-rated assets pricing in the 425-450 bps over LIBOR range for both fixed and floating issues. With rising inflation an increasing concern throughout much of the Euro region and fixed bond yields already close to historic lows, we expect this level to hold with deal pressure transferring to structural issues and increasing leverage. Despite the recent tightening, loan spreads are still significantly wide of their historical averages and remain attractive on a risk-adjusted basis.

FIGURE 9: EUROPEAN LOAN AND BOND SPREADS



Source: Factset, Credit Suisse and Babson Capital as of March 31, 2011

Structured Credit Highlights

MARKET REVIEW

CLO liability prices climbed during the first half of the quarter before retreating in late February and early March. While macro events undoubtedly played a role in market softness, we believe the CLO market selloff was unwarrantedly severe in the mezzanine part of the capital stack where prices fell nearly 10 points from the highs. In fact, we believe that a good portion of the price decline was due to the liquidation of several hundred million dollars of CLO paper early in March by a hedge fund, which exacerbated an already nervous and tired—from the BWIC barrage that occurred earlier in the year—investor base.

Price movement through the quarter was mixed: typical original issue AAA-rated CLO tranches traded tighter by 20 bps to a discount margin of approximately 180 bps (low to mid 90's price) while original-issue AA-rated paper ended unchanged. The mezzanine part of the capital stack was mixed with original-issue A paper widening by 15 bps (1 pt) but original-issue BBB and BB paper trading tighter by 25 bps (1-2 pts) and 100 bps (6-7 pts), respectively. There was also much volatility during the quarter: original-issue BBB CLOs traded between 500 bps and 750 bps before closing the quarter at 625 bps; original-issue BB paper traded from 700 bps to 950 bps. In price terms, the peak-to-trough swing for both of these tranches amounts to approximately 10 pts.

Over $9 billion of secondary CLO paper was visibly offered during the first quarter (Citigroup, March 18, 2011) including nearly $4.5 billion in February alone, largely due to an increase in mezzanine offerings. The deluge of trading, however, left dealer desks and many investor accounts exhausted.

The primary market seemed slow during the quarter with only three new deals pricing, half the number priced in the quarter before. Bank of America priced Ares XVI, a $410 million deal for Ares Capital and Morgan Stanley priced OHA Intrepid, a $413 million deal for Oak Hill. Meanwhile, Citigroup priced a $400 million deal for Fraser Sullivan named Fraser Sullivan V. In all cases, the manager retained or pre-placed all of the CLO equity. New-issue AAA spreads cleared in the 155–165 bps context and generally had 32-36% original subordination. In a sign that senior investors are beginning to exert more influence, all three new transactions contained a two-year non-call period, which contrasts with several 2010 deals that had only a one-year non-call period.

STRUCTURED CREDIT HIGHLIGHTS

- CLO liability prices were volatile in Q1 due in part to the liquidation of several hundred million dollars of CLO paper in early March when the selloff in mezzanine paper was unwarrantedly severe
- The number of new deals fell 50% from the previous quarter as only three were priced where the managers retained or pre-placed all of the CLO equity
- With an improving economy and improving default rates for speculative grade issuers, we believe CLO spreads should tighten across the capital stack during Q2

CLO ratings continued to improve during the quarter, with more than 860 CLO rating upgrades YTD – the highest number of upgrades in years (JP Morgan, March 11, 2011). Most of the upgrades were by S&P, but we believe that will change as Moody's recently announced changes to their CLO rating methodology (removing certain stress factors and increasing loan recovery estimates) that may also lead to rating improvement for most CLOs.

OUTLOOK

We expect CLO spreads to tighten across the capital stack during Q2, eventually surpassing Q1 tights. While events in Libya and Japan are certainly significant and should give investors pause, we believe that CLO price drops experienced in recent weeks were excessive. The economic recovery in the US appears to be accelerating, new issue leveraged loan credit metrics (e.g., debt/EBITDA) are in line with historic averages, and the speculative grade default rate is projected to go lower. Consequently, we continue to see value in well selected secondary CLO tranches and expect to take advantage of these shorter term volatile trading periods.

TABLE 2: CLO SPREADS

	AAA		AA		A		BBB		BB		EQUITY
	CURRENT	Δ	CURRENT	Δ	CURRENT	Δ	CURRENT	Δ	CURRENT	Δ	Δ
CLOs	180	-20	350	0	475	+15	625	-25	850	-100	4.0 yrs of pmts

Source: Babson Capital as of March 31, 2011

Mortgage and Asset Backed Securities

MARKET REVIEW

The economic recovery won't be complete until there is a meaningful turnaround in the housing sector, and its performance during the first quarter of 2011 underlined just how far away that is. Both new and existing home sales remained at or near their trough levels through February. After climbing for the last three quarters of 2009 and the first half of 2010, home prices began a slow drift downward through year-end. This is expected to continue at least through the second quarter of this year, and could bring the overall market back near its 2009 lows. Borrower performance in the legacy mortgage universe deteriorated modestly during the first quarter of 2011 as delinquent loan pipelines continued to grow, albeit quite slowly. Foreclosure timelines have lengthened, especially for some of the larger servicers subject to headline risk around foreclosure practices. This has resulted in a slowing of realized default rates and some reduction in cash flows to mortgage note holders. It has also caused an increase in severities on liquidated loans, as servicers recover principal and interest, taxes, and legal fees that have been advanced during the foreclosure process. A proposed settlement between states' attorneys general and the major servicers around the "robo signing" issue and other abuses seems likely to lengthen foreclosure timelines and increase severities further, as dual track foreclosure/modification would be prohibited under the proposed settlement. The adoption of the settlement has been cast in doubt, however, as some AG's object due to the likelihood that borrowers would have an incentive to pursue strategic default under its terms.

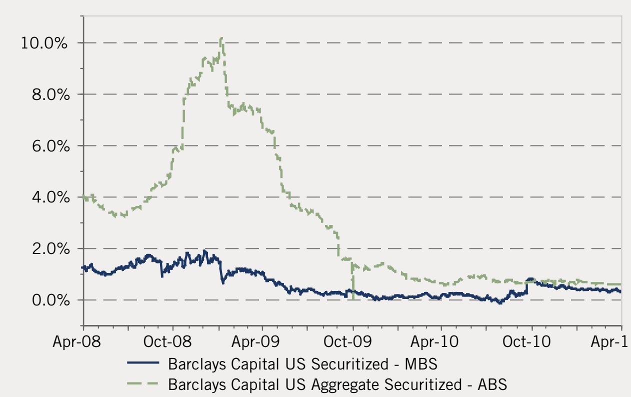
MORTGAGE AND ASSET BACKED SECURITIES HIGHLIGHTS

- Fundamentals have not really improved: borrower performance in the legacy mortgage universe deteriorated modestly as delinquent loan pipelines grew slowly
- We believe seasoned mezzanine paper to be one of the best ways to take advantage of the volatility due to its stronger collateral credit profile and better appreciation potential in rallies compared to later vintage, last cash flow and next-to-last cash flow AAAs
- Going forward, we expect supply to come primarily from sales by the U.S. Treasury and pay downs from the Fed/GSE portfolios; traditional net supply will be much lower due to the still weak housing market

For most of the first quarter, performance in the non-agency mortgage market remained strong. Prices in most sub-sectors rose by a point or more in January, and stabilized in February. Option ARM's formed a notable exception, rising by 3 to 4 points in January and giving back about half of that in February. Performance was also strong in the first part of March, but the sector has generally followed the equity market during the later part of the month, first falling sharply and then recovering part of the losses. The recent volatility has created trading opportunities, first on the short side and later in the month on the long side, as prices on some sub-prime paper dropped by 4 points or more on an intra-month basis. Those short-term pricing differences translate to 200 bps differences in yield in some cases, and are more than enough to provoke a shift in perspective: we view much of this paper as unattractive, at least for longer cash flows, at 6% yields, but would be interested at 8%.

Agency MBS spreads traded in a narrow range during the first quarter. Supply continued to be light and demand steady. Late in the quarter there was a surprise announcement from the Treasury on their Agency MBS portfolio sales. The initial reaction was concern over the additional supply but spreads proved resilient and were just slightly wider. Banks and foreign investors have been more active since the beginning of the year. REITS have recently emerged as a strong buying presence as they continue to raise equity and need to invest. There has been no sign of higher prepayments in spite of mortgage rates going lower.

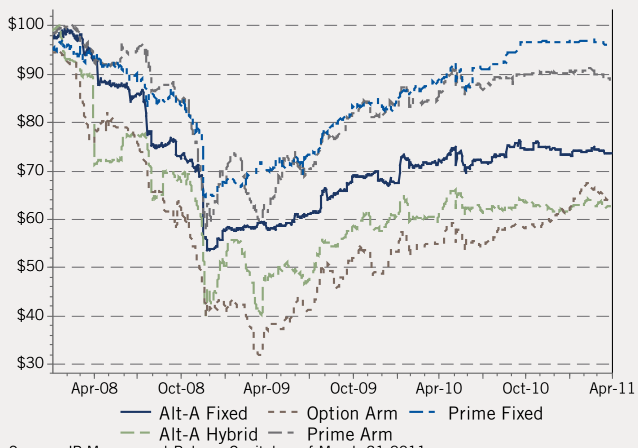
FIGURE 10: MBS AND ABS OAS



Source: Factset and Babson Capital as of March 31, 2011

The ABS market, as expected, has continued on a robust note through the first quarter. Deal flow remains strong and spreads remain tight. Activity for more esoteric issuers (jet engines, cell towers, timberland, timeshares) underlines the strength of this market and the ongoing search for yield in structures that can be viewed as "corporate substitutes."

FIGURE 11: MBS PRICES



Source: JP Morgan and Babson Capital as of March 31 2011

OUTLOOK

While the fundamental picture in this sector has never really improved - in fact, "stabilized" is being charitable - pricing generally reflects a sober assessment of the headwinds the sector faces, as it has all along over the past couple of years. We believe the recent performance of this market will likely form a reasonably good template for activity going forward, as yields for longer paper push through to the 6% or richer level on the low side where they would meet plenty of sellers at those levels, but also find support from opportunistic buyers in the 8% range. This range of levels should provide trading opportunities, with seasoned mezzanine paper one of the best ways to take advantage of the volatility. This paper tends to offer an attractive combination of a stronger collateral credit profile and better appreciation potential in rallies, compared to later vintage, last cash flow and next-to-last cash flow AAA's. Shorter duration cashflows have been and remain attractive, trading on a spread basis anywhere from +175 bps to +300 bps.

The legacy market is of course underpinned by the inexorable slide in principal balances as bonds pay off or are written off, but this raises the question of what will happen to the non-agency world going forward. The first quarter did see the sale of one new deal backed by jumbo mortgages, but this exception serves more to highlight the fact that the securitized mortgage market is far from recovery. We don't expect meaningful issuance until what have basically become political issues around servicing and underwriting are fully settled.

In ABS, we expect to see continued strong issuance in credit cards and autos, together with ongoing new issuance and interest in esoterics. Refinancing of certain FFELP auction rate student loan deals should allow spreads in this sector to move tighter as well. Finally, we expect that some European RMBS or ABS issuers will find their way to dollar denominated issuance over the next few months in order to take advantage of favorable demand conditions in these markets.

Going forward, supply will come primarily from sales by the U.S. Treasury and pay downs from the Fed/GSE portfolios. Traditional net supply will be much lower due to the weak housing market. Refinancing risk should remain low due to tighter underwriting standards and higher originations costs. Spreads are still at relatively attractive levels for a high quality liquid asset and are likely to continue to trade in a narrow range.

Commercial Real Estate

MARKET REVIEW

For the CMBS market, the start of 2011 was positive as the bullishness that characterized the market at the end of 2010 carried over into the New Year. With little new-issue supply, at least initially, and the uncertain prospect of forced selling by insurance companies due to the new National Association of Insurance Commissioners (NAIC) process for determining capital requirements never materializing, spreads in the secondary market moved steadily tighter through late February.

COMMERCIAL REAL ESTATE HIGHLIGHTS

- Q1 saw the return of CMBS issuance, with one single borrower and five multi-borrower transactions totaling $8.2 billion for the quarter
- Compared to 2005-7 vintage CMBS, the new issues have fewer loans, higher loan concentration, and simpler structures; underwriting standards have also become more conservative
- We believe 2011 CMBS issuance will be in the $35 billion - $45 billion range; demand should remain strong for “legacy” transactions given their wider spread levels

As concerns over events in the Middle East and North Africa and the tragedy in Japan began to spill over into the CMBS market, spreads started to widen as BWIC volumes increased. Much of this selling pressure was felt most severely by the AM (AAA at issuance with 20% credit enhancement) and AJ (junior AAA) tranches which had seen strong performance given the significant “grab-for-yield” momentum from investors over the last nine months or so. As volatility in the broader markets declined over the past few weeks and the steady stream of BWICs tapered off, CMBS spreads have slowly tightened again as buyers have come back to the market. For the first quarter of 2011, the Barclays Capital CMBS Investment Grade Index delivered total returns of 2.39% (March 31, 2011).

FIGURE 12: CMBS INVESTMENT GRADE OAS

Source: Factset and Babson Capital as of March 31, 2011

The most significant headline to come out of the first quarter of 2011 would be the return of CMBS issuance. February saw the pricing of the first new issue deal of 2011, the DBUBS 2011-LC1 transaction, into strong demand with broad investor participation and at levels higher than initial price guidance – a trend that would generally characterize most new issue transactions in the first quarter. This relationship was particularly evident in the mezzanine classes [AA-rated and below] where demand outweighed supply and led to classes being multiple times oversubscribed. In total, five multi-borrower and one single-borrower new issue CMBS transactions priced during the quarter totaling $8.2 billion.

To date, all new issue CMBS transactions have been privately-issued through Rule 144A. These “new” new-issue CMBS, dubbed “CMBS 2.0” in the market lexicon, could be generally characterized as having a fewer number of loans, although higher loan concentration, and simpler structures, i.e. fewer tranches, compared to the 2005-2007 vintage year transactions. Additionally, underwriting standards have been more conservative with amortizing loans underwritten to in-place cash flows and weighted-average loan-to-value ratios, for the pool as a whole, in the low 60% points. Finally, the inclusion of a “trust” or “operating” advisor in a few of the transactions to review the practices of the special servicer has addressed some of the concerns of the investment-grade bondholders regarding the loan workout process.

OUTLOOK

Demand for new issue bonds should continue to be strong, especially in the mezzanine classes. In total, we expect 2011 CMBS issuance to fall in the range of $35 billion - $45 billion with a large percentage of that volume coming from the refinancing of existing CMBS loans. However, the increased competition among loan originators raises the specter that underwriting standards will start to decline at some point.

Given the strong demand for new issue CMBS, demand should remain strong for bonds from existing, or "legacy," CMBS transactions given their wider spread levels compared to recent new issues. Moving down the capital structure presents a mixed bag as prices on mezzanine classes could come under pressure from high severity loan liquidations and continued interest shortfalls. However, selective purchases in mezzanine classes that stand to benefit in a recovery scenario have the potential to realize outsized returns over the course of the year. Finally, we expect to see volatility in both the delinquency rate and percentage of specially-serviced loans going forward as new loans become "troubled" and from elevated loan modification and liquidation activity on the part of the special servicers. Also, with CMBS loan maturities totaling ~$40 billion due in 2011, we expect to see more maturity defaults on the horizon as many of these loans are highly levered and may require a cash equity infusion from the borrower to meet current underwriting standards.

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