

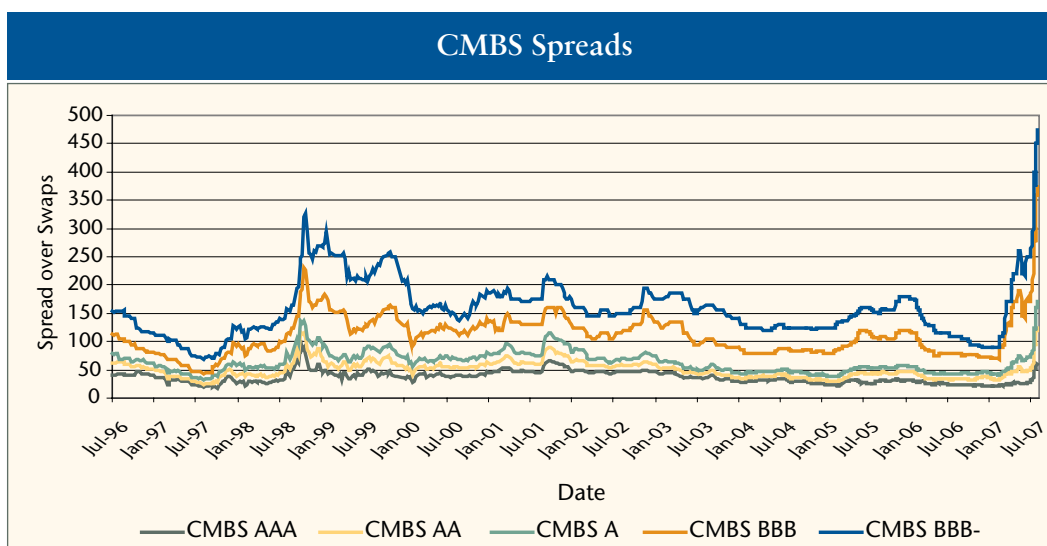
## Opportunities in a Volatile Market

# Commercial Mortgage-Backed Securities

It has become almost cliché to talk about how challenging the last few weeks have been for fixed income, particularly structured products. This piece is designed to stare down those challenges and to look for opportunities in the midst of all of this turmoil. One area of opportunity is commercial mortgage-backed securities (CMBS). While most fixed income products are struggling due to some deterioration in fundamentals, the negative moves in the CMBS space continue to be driven primarily by technical factors. Our analysis of the current state of the CMBS market leads us to see long term opportunities instead of challenges.

### Where Are We Now?

Because the CMBS markets have existed only since 1993, there have been few major market movements over its lifetime. Prior to the past two weeks, the biggest spread movement occurred in 1998 with the Russian debt crisis. The following graph shows that the spread widening over the past two weeks has been greater than that event.



Source: Lehman Brothers

## How Did We Get Here?

The CMBS market has never been a market that has led the fixed income markets. Instead, it has taken its cues from other fixed income asset classes and this round of spread widening has been no exception. This time, however, CMBS definitely helped to fan the flames. The following table compares the factors driving spread widening in CMBS and in the larger fixed-income markets.

Fixed Income Drivers	CMBS Drivers
Sub-Prime Meltdown	Deterioration in Loan Underwriting
Volatility in the Corporate Bond Market	Huge Issuance Calendar in Volatile Market
“Shorts” Moved from ABX onto CMBX	Increased Number of “Fast Money” Accounts
Lack of Liquidity	Lack of Liquidity

Source: Principal Global Investors

## Where Do We Go from Here?

Given the technical factors currently affecting the CMBS market and the expectations that the fixed income market will remain volatile for the foreseeable future, we do not expect spreads to snap back anytime soon. The direction of swap spreads over the short term will also have a direct impact on the relative performance of CMBS. In short, the near-term outlook is that the CMBS market will move in step with corporates and asset-backed securities (ABS), and that there will be continued price discovery in the market as the \$20 billion of August supply hits the market.

Longer term, the story for CMBS improves. It is our opinion that current spreads, both relative to swaps and to Treasuries, offer tremendous value due to our current outlook on commercial real estate fundamentals and due to the expected shifts that will take hold in the CMBS market going into 2008. While most of the underlying assets in other fixed income products are facing major headwinds, the outlook for commercial real estate remains positive over the next two to three years for several reasons:

- Real estate markets across the United States are currently close to equilibrium
- Rental growth is still being seen in the top 15 to 25 markets
- Job growth has slowed but remains stable with most companies still retaining strong balance sheets
- The high cost of building is helping to moderate new supply

The CMBS community prides itself on being proactive at dealing with problems before they arise. When the market sensed that underwriting had deteriorated past the point of rationality, the B-piece buyers, the investment grade buyers, and the rating agencies began to push back. We expect the results of this push-back to be:

- Higher subordination levels from the rating agencies
- Significantly more conservative loan underwriting
- Lower supply in the fourth quarter

## Where are the Best Opportunities in CMBS?

We think there is value from both an overall yield and total return perspective in investing "down in credit" in CMBS. The following chart demonstrates the recent changes in the CMBS credit curve, and gives a sense of the massive widening that has taken place in the mezzanine CMBS classes.

Credit Curve	08/02/07	07/23/07	01/01/07	2006 Average	2005 Average
Jr AAA to AA	+35	+12	+5	+5	+7
Jr AAA to A	+75	+37	+13	+14	+17
Jr AAA to A-	+100	+47	+17	+22	+27
AA to A	+40	+15	+9	+9	+10
A to A-	+25	+10	+4	+8	+10

Source: Principal Global Investors

Given that our positive outlook for real estate fundamentals has not materially changed through this volatility, we continue to look for opportunities in AA and A tranches backed by pools that we feel are appropriately rated and underwritten. Investors are not differentiating among CMBS issues in the market in terms of overall quality, so significant value can be generated by being able to sift through the market to find those issues which exhibit superior-quality loan pools. The key to finding these pools is the same as it has always been: conducting fundamental real estate analysis and having the ability to quantitatively model each transaction.

We expect that the problems in the residential markets and in select corporate credits will continue into next year, so the risk to our outlook is that volatility continues to pressure the market beyond 2008. We believe, however, that the strong near-term outlook for commercial real estate fundamentals eventually will allow the CMBS market to outperform over the longer term.

CMBS Cash Spreads		
Ratings*	Spread over Swaps	Spread to Treasuries
AAA	60	133
AA	105	178
AA-	115	188
A	150	223
A-	175	248
BBB+	290	368
BBB	325	398
BBB-	400	473

\*10 yr. Average Life

Source: Principal Global Investors

As always, we welcome your questions and comments.

**Marc Peterson**, CFA, Portfolio Manager, CMBS

**Jason Haigh**, Assistant Portfolio Manager, CMBS

## Disclosures

The information in this document has been derived from sources believed to be accurate as of August 2007. It contains general information only on investment matters and should not be considered as a comprehensive statement on any matter and should not be relied upon as such. The information it contains does not take account of any investor's investment objectives, particular needs or financial situation. You should consider whether an investment fits your investment objectives, particular needs and financial situation before making any investment decision.

Subject to any contrary provisions of applicable law, no company in the Principal Financial Group nor any of their employees or directors gives any warranty of reliability or accuracy nor accepts any responsibility arising in any other way (including by reason of negligence) for errors or omissions in this document.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This document is issued in

- The United Kingdom by Principal Global Investors (Europe) Limited, 16 St Martins Le Grand, London, EC1A 4EN, registered in England, No. 03819986, which has approved its contents, and which is authorised and regulated by the Financial Services Authority.
- Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore.
- Hong Kong by Principal Global Investors (Asia) Limited, which is regulated by the Securities and Futures Commission.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385) which is regulated by the Australian Securities and Investment Commission.

In the United Kingdom this document is directed exclusively at persons who are market counterparties or intermediate customers (as defined by the rules of the Financial Services Authority). In connection with its management of client portfolios, Principal Global Investors (Europe) Limited may delegate management authority to affiliates that are not authorised and regulated by the Financial Services Authority. In any such case, the client may not benefit from all protections afforded by rules and regulations enacted under the Financial Services and Markets Act 2000.



PRINCIPAL GLOBAL INVESTORS | 801 GRAND AVENUE | DES MOINES, IA 50392-0490 | 800-533-1390