DELPHI FINANCIAL GROUP INC/DE
Form 10-Q
November 09, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended September 30, 2009

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission File Number 001-11462

DELPHI FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware (302)	478-5142	13-3427277
(State or other jurisdiction of incorporation or organization)	(Registrant s telephone number, including area code)	(I.R.S. Employer Identification Number)

1105 North Market Street, Suite 1230, P.O. Box 8985, Wilmington, Delaware	19899
(Address of principal executive offices)	(Zip Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to filing requirements for the past 90 days:

Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files):

Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

As of November 2, 2009, the Registrant had 48,161,591 shares of Class A Common Stock and 5,753,833 shares of Class B Common Stock outstanding.

DELPHI FINANCIAL GROUP, INC.
FORM 10-Q
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS
AND OTHER INFORMATION

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in Thousands, Except Per Share Data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenue:				
Premium and fee income	$ 342,610	$ 345,028	$ 1,052,776	$ 1,028,092
Net investment income	88,682	19,407	243,560	112,494
Net realized investment losses:				
Total other than temporary impairment losses	(73,771)	(28,173)	(137,007)	(52,479)
Less: Portion of other than temporary impairment losses recognized in other comprehensive income	21,748		42,467	
Net impairment losses recognized in earnings	(52,023)	(28,173)	(94,540)	(52,479)
Other net realized investment gains (losses)	1,564	(5,567)	(5,389)	(7,196)
	(50,459)	(33,740)	(99,929)	(59,675)
Loss on redemption of junior subordinated deferrable interest debentures underlying company-obligated mandatorily redeemable capital securities issued by unconsolidated subsidiaries		(598)		(598)
Total revenues	380,833	330,097	1,196,407	1,080,313
Benefits and expenses:				
Benefits, claims and interest credited to policyholders	240,956	244,042	748,361	730,709
Commissions	21,886	22,254	67,046	64,374
Amortization of cost of business acquired	26,740	21,814	76,217	58,459
Other operating expenses	61,054	55,756	181,813	161,567
	350,636	343,866	1,073,437	1,015,109
Operating income (loss)	30,197	(13,769)	122,970	65,204
Interest expense:				
Corporate debt	3,806	4,427	11,667	12,940
Junior subordinated debentures	3,247	3,240	9,728	9,726
Junior subordinated deferrable interest debentures underlying company-obligated redeemable capital securities issued by unconsolidated subsidiaries		177		934

	7,053	7,844	21,395	23,600
Income (loss) before income tax expense (benefit)	23,144	(21,613)	101,575	41,604
Income tax expense (benefit)	2,321	(11,803)	19,261	3,395
Net income (loss)	$ 20,823	$ (9,810)	$ 82,314	$ 38,209
Basic results per share of common stock:				
Net income (loss)	$ 0.39	$ (0.20)	$ 1.63	$ 0.79
Diluted results per share of common stock:				
Net income (loss)	$ 0.39	$ (0.20)	$ 1.63	$ 0.78
Dividends paid per share of common stock	$ 0.10	$ 0.10	$ 0.30	$ 0.29

See notes to consolidated financial statements.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands, Except Per Share Data)

	September 30, 2009	December 31, 2008
Assets:		
Investments:		
Fixed maturity securities, available for sale	$ 4,608,184	$ 3,773,382
Short-term investments	572,802	401,620
Other investments	542,047	479,921
	5,723,033	4,654,923
Cash	82,269	63,837
Cost of business acquired	244,930	264,777
Reinsurance receivables	378,277	376,731
Goodwill	93,929	93,929
Other assets	320,428	409,103
Assets held in separate account	109,016	90,573
Total assets	$ 6,951,882	$ 5,953,873
Liabilities and Equity:		
Future policy benefits:		
Life	$ 346,716	$ 300,567
Disability and accident	775,320	743,690
Unpaid claims and claim expenses:		
Life	64,110	70,076
Disability and accident	426,802	398,671
Casualty	1,158,937	1,061,046
Policyholder account balances	1,452,332	1,356,932
Corporate debt	365,750	350,750
Junior subordinated debentures	175,000	175,000
Other liabilities and policyholder funds	740,539	581,954
Liabilities related to separate account	109,016	90,573
Total liabilities	5,614,522	5,129,259
Equity:		
Preferred Stock, $.01 par; 50,000,000 shares authorized, none issued		
Class A Common Stock, $.01 par; 150,000,000 shares authorized; 55,922,807 and 48,946,432 shares issued, respectively	559	489
Class B Common Stock, $.01 par; 20,000,000 shares authorized; 5,981,049 shares issued	60	60
Additional paid-in capital	659,683	522,596

Accumulated other comprehensive loss	(46,303)	(351,710)
Retained earnings	916,309	846,390
Treasury stock, at cost; 7,761,216 shares of Class A Common Stock and 227,216 shares of Class B Common Stock	(197,246)	(197,246)
Total shareholders equity	1,333,062	820,579
Noncontrolling interest	4,298	4,035
Total equity	1,337,360	824,614
Total liabilities and equity	$ 6,951,882	$ 5,953,873

See notes to consolidated financial statements.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY
(Dollars in Thousands)
(Unaudited)

	Class A Common Stock	Class B Common Stock	Additional Paid in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Shareholders Equity	Non-controlling Interest	Total Equity
Balance, January 1, 2008	$ 487	$ 59	$ 509,742	$ (42,497)	$ 828,116	$ (154,517)	$ 1,141,390	$ 30,181	$ 1,171,571
Net income					38,209		38,209	1,697	39,906
Other comprehensive loss:									
Increase in net unrealized depreciation on investments				(246,781)			(246,781)	(1,032)	(247,813)
Decrease in net loss on cash flow hedge				589			589		589
Change in net periodic pension cost				35			35		35
Comprehensive loss							(207,948)	665	(207,283)
Change in noncontrolling interest ownership								(491)	(491)
Exercise of stock options	2	1	7,197				7,200		7,200
Stock-based compensation			4,880				4,880		4,880
Acquisition of treasury stock						(42,729)	(42,729)		(42,729)
Cash dividends					(13,716)		(13,716)		(13,716)
Balance, September 30, 2008	$ 489	$ 60	$ 521,819	$ (288,654)	$ 852,609	$ (197,246)	$ 889,077`	$ 30,355	$ 919,432
Balance, January 1, 2009	$ 489	$ 60	$ 522,596	$ (351,710)	$ 846,390	$ (197,246)	$ 820,579	$ 4,035	$ 824,614
Cumulative effect adjustment, April 1, 2009				(2,372)	2,372				
Net income					82,314		82,314	226	82,540
Other comprehensive income:									
Decrease in net unrealized depreciation on investments				325,660			325,660		325,660
Increase in other than temporary impairment losses recognized in other				(19,343)			(19,343)		(19,343)

comprehensive income									
Decrease in net loss on cash flow hedge				589			589		589
Change in net periodic pension cost				873			873		873
Comprehensive income							390,093	226	390,319
Net contribution from noncontrolling interest								37	37
Issuance of common stock	65		121,056				121,121		121,121
Exercise of stock options	5		9,189				9,194		9,194
Stock-based compensation			6,842				6,842		6,842
Cash dividends					(14,767)		(14,767)		(14,767)
Balance, September 30, 2009	$ 559	$ 60	$ 659,683	$ (46,303)	$ 916,309	$ (197,246)	$ 1,333,062	$ 4,298	$ 1,337,360

See notes to consolidated financial statements.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(Unaudited)

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Operating activities:		
Net income	$ 82,314	$ 38,209
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in policy liabilities and policyholder accounts	225,538	194,967
Net change in reinsurance receivables and payables	(4,613)	18,901
Amortization, principally the cost of business acquired and investments	38,295	46,601
Deferred costs of business acquired	(97,936)	(94,043)
Net realized losses on investments	99,929	59,675
Net change in federal income tax liability	6,632	(53,654)
Other	(14,101)	(56,828)
Net cash provided by operating activities	336,058	267,484
Investing activities:		
Purchases of investments and loans made	(1,206,214)	(1,012,307)
Sales of investments and receipts from repayment of loans	177,957	348,569
Maturities of investments	637,166	311,840
Net change in short-term investments	(171,162)	(158,961)
Change in deposit in separate account	4,845	10,547
Net cash used by investing activities	(557,408)	(500,312)
Financing activities:		
Deposits to policyholder accounts	242,614	335,082
Withdrawals from policyholder accounts	(131,337)	(83,382)
Borrowings under revolving credit facility	17,000	79,000
Principal payments under revolving credit facility	(2,000)	(6,000)
Redemption of junior subordinated deferrable interest debentures		(20,619)
Proceeds from the issuance of common stock	121,121	
Acquisition of treasury stock		(42,729)
Cash dividends paid on common stock	(14,767)	(13,715)
Other financing activities	7,151	3,200
Net cash provided by financing activities	239,782	250,837
Increase in cash	18,432	18,009

Cash at beginning of period		63,837		51,240
Cash at end of period	$	82,269	$	69,249

See notes to consolidated financial statements.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note A Significant Accounting Policies

The financial statements of Delphi Financial Group, Inc. (the Company, which term includes the Company and its consolidated subsidiaries unless the context indicates otherwise) included herein were prepared in conformity with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The information furnished includes all adjustments and accruals of a normal recurring nature, which, in the opinion of management, are necessary for a fair presentation of results for the interim periods. Certain reclassifications have been made in the September 30, 2008 consolidated financial statements to conform to the September 30, 2009 presentation. Operating results for the three and nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ended December 31, 2009. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2008, as amended by Amendment No. 1 thereto on Form 10-K/A (the 2008 Form 10-K). Capitalized terms used herein without definition have the meanings ascribed to them in the 2008 Form 10-K.

Accounting Changes

Basis of Accounting. In June 2009, the Financial Accounting Standards Board (FASB) adopted the FASB Accounting Standards Codification (the Codification) as the source of authoritative GAAP recognized by the FASB for application by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under federal securities laws are also sources of authoritative GAAP for the SEC registrants. All guidance contained in the Codification carries an equal level of authority. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009, with certain exceptions for nonpublic nongovernmental entities. Since the Codification primarily identifies the sources of authoritative accounting principles that are generally accepted and does not modify any accounting principles, its adoption did not have a material effect on the Company s consolidated financial position or results of operations.

Business Combinations. As of January 1, 2009, the Company adopted new guidance issued by the FASB on business combinations. This new guidance establishes principles and requirements for how the acquirer in a business combination: (a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase and (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This new guidance requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with specified limited exceptions. The new guidance is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Assets and liabilities arising from a business combination having an earlier acquisition date are not to be adjusted upon the effectiveness of this statement. The adoption of the new guidance did not have any effect on the Company s consolidated financial position or results of operations.

In April 2009, the FASB issued new guidance for accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies. This new guidance addresses application issues relating to initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. Acquirers are now required to recognize at fair value an asset acquired or liability assumed in a business combination that arises from a contingency if the acquisition date fair value of that asset or liability can be determined during the measurement period. If the acquisition date fair value cannot be determined during the measurement period, a contingency shall be recognized if information available before the end of the measurement period indicates that it is probable that an asset existed or liability had been incurred at the acquisition date and the amount thereof can be reasonably estimated. The new guidance is effective for assets or liabilities arising from contingencies in business combinations for which the acquisition date is on or after January 1, 2009. The adoption of the new guidance did not have any effect on the Company s consolidated financial position or results of operations.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note A Significant Accounting Policies (Continued)

Noncontrolling Interests. As of January 1, 2009, the Company adopted new guidance issued by the FASB on noncontrolling interests. This new guidance prescribes the accounting for and the financial reporting of a noncontrolling interest in a company s subsidiary, which is the portion of the equity (residual interest) in the subsidiary attributable to owners thereof other than the parent and the parent s affiliates. The new guidance requires that a noncontrolling interest in a consolidated subsidiary be presented in a consolidated statement of financial position as a separate component of equity and that changes in ownership interests in a consolidated subsidiary that does not result in a loss of control be recorded as an equity transaction with no gain or loss recognized. For a change in the ownership interests in a consolidated subsidiary that results in a loss of control or a deconsolidation, a gain or loss is recognized in the amount of the difference between the proceeds of that sale and the carrying amount of the interest sold. In the case of a deconsolidation, the new guidance requires the establishment of a new fair value basis for the remaining noncontrolling ownership interest, with a gain or loss recognized for the difference between that new basis and the historical cost basis of the remaining ownership interest. Upon adoption, the amounts of consolidated net income and consolidated comprehensive income attributable to the parent and the noncontrolling interest must be presented separately on the face of the consolidated financial statements. A detailed reconciliation of the changes in the equity of a noncontrolling interest during the period is also required. The adoption of the new guidance did not have a material effect on the Company s consolidated financial position or results of operations.

Derivative Instruments. As of January 1, 2009, the Company adopted new guidance issued by the FASB concerning disclosures about derivative instruments and hedging activities. This new guidance requires entities to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity s financial position, results of operations and cash flows. The new guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and credit-risk-related contingent features in derivative instruments. The adoption of the new guidance did not have any effect on the Company s consolidated financial position or results of operations.

The Company, at times, enters into futures and option contracts and interest rate and credit default swap agreements in connection with its investment strategy and indexed annuity program. These agreements are primarily utilized to reduce the risk associated with changes in the value of the Company s fixed maturity portfolio and to fund the interest crediting obligations associated with the Company s indexed annuity contracts. These positions are carried at fair value with gains and losses included in income. The Company recognized net investment income of $1.6 million during the nine months ended September 30, 2009 related to these instruments. The Company had no material outstanding futures and option contracts or interest rate and credit default swap agreements at September 30, 2009. The Company, at times, may also invest in non-dollar denominated fixed maturity securities that expose it to fluctuations in foreign currency rates, and, therefore, may hedge such exposure by using currency forward contracts. The Company had no material currency forward contracts outstanding at September 30, 2009.

To mitigate the risk of interest rates rising before the issuance of the 2033 Senior Notes could be completed, the Company entered into a treasury rate lock agreement in September 2002, with a notional amount of $150.0 million and an anticipated debt term of 10 years. The Company paid $13.8 million upon the issuance of the 2033 Senior Notes in May 2003 to settle the treasury rate lock agreement, of which $12.1 million was recorded in accumulated other comprehensive income and the remaining loss was deemed ineffective and recognized as a reduction of net investment income. This transaction was accounted for as a cash flow hedge; accordingly, $12.1 million of the loss on the treasury rate lock agreement is being amortized into interest expense ratably over 10 years. The Company will amortize $1.2 million of such loss into interest expense over the next twelve months. The Company recognized $0.9 million of such loss into interest expense during the first nine months of 2009 and 2008. The net loss on the treasury rate lock agreement included in accumulated other comprehensive loss was $2.9 million (net of an income tax benefit of $1.6 million) at September 30, 2009.

Earnings Per Share. As of January 1, 2009, the Company adopted new guidance issued by the FASB on determining whether instruments granted in share-based payment transactions are participating securities. This new guidance addresses whether unvested instruments granted in share-based payment transactions are participating

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note A Significant Accounting Policies (Continued)

securities which must be included in the earnings allocation in computing earnings per share. The new guidance provides guidance for the calculation of earnings per share for share-based payment awards with rights to dividends or dividend equivalents. The adoption of the new guidance did not have a material effect on the Company s consolidated financial position or results of operations.

Fair Value Measurements. Effective April 1, 2009, the Company adopted new guidance issued by the FASB on interim disclosures about fair value of financial instruments. This new guidance requires disclosures about fair value of financial instruments for interim reporting periods as well as in annual financial statements. The adoption of the new guidance did not have a material effect on the Company s consolidated financial position or results of operations.

Effective April 1, 2009, the Company adopted new guidance issued by the FASB on determining fair value which provides additional guidance for estimating fair value of financial instruments when the volume and level of activity for the asset or liability have significantly decreased. It also provides guidance on identifying circumstances indicating that a transaction is not orderly, and indicates that significant decreases in the volume and level of activity of an asset or liability in relation to normal market activity for the asset or liability require a company to further evaluate transactions or quoted prices and exercise significant judgment in arriving at the fair value. The adoption of the new guidance did not have a material effect on the Company s consolidated financial position or results of operations

Other Than Temporary Impairments. Effective April 1, 2009, the Company adopted new guidance on the recognition and presentation of other than temporary impairments. Under this new guidance, which applies only to debt securities, companies are required to recognize in earnings only the credit component of an other than temporary impairment. The remainder of the impairment will continue to be recognized in other comprehensive income. The new guidance also modifies the existing requirement for a company to assert that it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in its fair value to its amortized cost basis. In lieu of this requirement, a company is only required to assert that it does not have the intent to sell the debt security and that it is more likely than not that it will not be required to sell the debt security before its anticipated recovery. Upon its adoption of the new guidance, the Company recorded an after-tax increase of $2.4 million in retained earnings and a decrease in the same amount in other comprehensive income to reclassify the non-credit related portion of previously recognized other than temporary impairments on fixed maturity securities held as of April 1, 2009.

Subsequent events. In May 2009, the FASB issued new guidance on subsequent events. This new guidance establishes principles for accounting and disclosure of events or transactions that occur after the balance sheet date but before financial statements are issued or are available to be issued. The new guidance requires an entity to (a) recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, (b) disclose the nature and financial effect of subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but must be disclosed to keep the financial statements from being misleading, and (c) evaluate subsequent events for recognition and disclosure through the date the financial statements are issued or are available to be issued. The new guidance also requires entities to disclose the date through which subsequent events have been evaluated. The new guidance is effective for financial statements for interim and annual periods ending after June 15, 2009. Accordingly, the Company evaluated subsequent events for recognition and disclosure through the filing date of this Form 10-Q. The adoption of this new guidance did not have any effect on the Company s consolidated financial position or results of operations.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note A Significant Accounting Policies (Continued)

Recently Issued Accounting Standards

In June 2009, the FASB issued new guidance on the accounting for the transfers of financial assets. This new guidance aims to improve the relevance, representational faithfulness and comparability of the information that a reporting entity provides in its financial reports about transfers of financial assets, the effects of a transfer of financial assets on its financial position, financial performance, and cash flows and a transferor s continuing involvement in transferred financial assets. This new guidance removes the concept of a qualifying special-purpose entity from the existing guidance and removes the exception from applying applicable consolidation guidance to variable interest entities that were considered qualifying special-purpose entities. The new guidance is effective for financial statements for interim and annual periods ending after November 15, 2009 and the transfers occurring on or after the effective date. The Company has not yet determined the impact, if any, that the adoption of SFAS No. 166 will have on its consolidated financial position and results of operations.

In June 2009, the FASB issued new guidance on the accounting for variable interest entities (VIEs). This new guidance requires ongoing assessments of whether an enterprise is a primary beneficiary of a VIE and replaces the quantitative approach to identifying variable interest entities and determining a variable interest entity s primary beneficiary with a qualitative method. The qualitative method is based on an enterprise s (a) power to direct the activities of a VIE that most significantly impact the entity s economic performance and (b) obligation to absorb losses or right to receive benefits that could be potentially material to the VIE. The new guidance also requires enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise s involvement in a VIE. The new guidance is effective for financial statements for interim and annual periods ending after November 15, 2009. The Company has not yet determined the impact, if any, that the adoption of the new guidance will have on its consolidated financial position and results of operations.

In August 2009, the FASB issued guidance clarifying that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value of a liability using techniques such as referring to the quoted price of the identical liability when traded as an asset, the quoted prices for similar liabilities, the quoted price of similar liabilities when traded as assets or a present value technique. The fair value of a liability is not adjusted to reflect the impact of contractual restrictions that prevent its transfer. The new guidance is effective for financial statements for interim and annual periods beginning after August 26, 2009, with early adoption permitted under certain conditions. The Company has not yet determined the impact, if any, that the adoption of the new guidance will have on its consolidated financial position and results of operations.

In September 2009, the FASB issued guidance on determining fair value for investments in certain entities that calculate net asset value per share or its equivalent. This new guidance permits the fair value of an investment in such an entity to be measured on the basis of the entity s reported net asset value per share if the net asset value is calculated in a manner consistent with the measurement principles of GAAP for investment companies and requires enhanced disclosures about the nature and risks of investments in such entities. The standard is effective for interim and annual periods ending after December 15, 2009. The Company has not yet determined the impact, if any, that the adoption of the new guidance will have on its consolidated financial position and results of operations.

Note B Investments

At September 30, 2009, the Company had fixed maturity securities available for sale with a carrying value and a fair value of $4,608.2 million and an amortized cost of $4,666.8 million. At December 31, 2008, the Company had fixed maturity securities available for sale with a carrying value and a fair value of $3,773.4 million and an amortized cost of $4,322.0 million. Declines in market value relative to such securities amortized cost determined to be other than temporary pursuant to the Company s methodology for such determinations, as further discussed below, are reflected as reductions in the amortized cost of such securities.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note B Investments (Continued)

The amortized cost and fair value of investments in fixed maturity securities available for sale are as follows:

	September 30, 2009				
		Gross Unrealized			
	Amortized Cost	Gains	Losses	Other Than Temporary Impairments	Fair Value
	(dollars in thousands)				
Residential mortgage-backed securities	$ 1,493,735	$ 88,050	$ (86,710)	$ (31,048)	$ 1,464,027
Commercial mortgage-backed securities	34,962	164	(6,656)	(785)	27,685
Corporate securities	1,244,356	49,595	(40,421)		1,253,530
Collateralized debt obligations	220,587	384	(100,130)	(1,573)	119,268
U.S. Treasury and other U.S. Government guaranteed securities	100,107	5,875			105,982
U.S. Government-sponsored enterprise securities	6,752	599			7,351
Obligations of U.S. states, municipalities and political subdivisions	1,566,295	75,085	(11,039)		1,630,341
Total fixed maturity securities	$ 4,666,794	$ 219,752	$ (244,956)	$ (33,406)	$ 4,608,184

	December 31, 2008				
		Gross Unrealized			
	Amortized Cost	Gains	Losses	Other Than Temporary Impairments	Fair Value
	(dollars in thousands)				
Residential mortgage-backed securities	$ 1,367,041	$ 40,489	$ (207,905)	$	$ 1,199,625
Commercial mortgage-backed securities	44,190		(18,891)		25,299
Corporate securities	1,339,519	9,688	(183,995)		1,165,212
Collateralized debt obligations	227,229		(116,268)		110,961
U.S. Treasury and other U.S. Government guaranteed securities	51,826	5,905			57,731
U.S. Government-sponsored enterprise securities	22,031	3,147			25,178
Obligations of U.S. states, municipalities and political subdivisions	1,270,166	19,230	(100,020)		1,189,376

Total fixed maturity securities	$ 4,322,002	$ 78,459	$ (627,079)	$	$ 3,773,382

The amortized cost and fair value of fixed maturity securities available for sale at September 30, 2009, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations, with or without prepayment penalties.

	Amortized Cost	Fair Value
	(dollars in thousands)	
Residential mortgage-backed securities	$ 1,493,735	$ 1,464,027
Commercial mortgage-backed securities	34,962	27,685
Other fixed maturity securities:		
One year or less	57,017	57,097
Greater than 1, up to 5 years	493,228	495,930
Greater than 5, up to 10 years	851,477	830,221
Greater than 10 years	1,736,375	1,733,224
Total	$ 4,666,794	$ 4,608,184

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note B Investments (Continued)

The gross unrealized losses and fair value of fixed maturity securities available for sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

	September 30, 2009					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(dollars in thousands)					
Residential mortgage-backed securities	$ 36,605	$ (139)	$ 446,865	$ (117,619)	$ 483,470	$ (117,758)
Commercial mortgage-backed securities			24,111	(7,441)	24,111	(7,441)
Corporate securities	20,419	(180)	313,002	(40,241)	333,421	(40,421)
Collateralized debt obligations			112,854	(101,703)	112,854	(101,703)
U.S. Treasury and other U.S. Government guaranteed securities						
U.S. Government-sponsored enterprise securities						
Obligations of U.S. states, municipalities & political subdivisions	37,128	(196)	142,204	(10,843)	179,332	(11,039)
Total fixed maturity securities	$ 94,152	$ (515)	$ 1,039,036	$ (277,847)	$ 1,133,188	$ (278,362)

	December 31, 2008					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(dollars in thousands)					
Residential mortgage-backed securities	$ 415,738	$ (140,542)	$ 151,971	$ (67,363)	$ 567,709	$ (207,905)
Commercial mortgage-backed securities	22,089	(9,819)	3,211	(9,072)	25,300	(18,891)
Corporate securities	505,595	(67,205)	256,980	(116,790)	762,575	(183,995)
Collateralized debt obligations	76,003	(62,854)	34,958	(53,414)	110,961	(116,268)
U.S. Treasury and other U.S. Government						

guaranteed securities						
U.S. Government-sponsored enterprise securities						
Obligations of U.S. states, municipalities & political subdivisions	520,492	(61,106)	164,817	(38,914)	685,309	(100,020)
Total fixed maturity securities	$ 1,539,917	$ (341,526)	$ 611,937	$ (285,553)	$ 2,151,854	$ (627,079)

Net realized investment losses arose from the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(dollars in thousands)			
Fixed maturity securities, available for sale	$ (41,918)	$ (31,444)	$ (85,929)	$ (48,639)
Other investments	(8,541)	(2,296)	(14,000)	(11,036)
	$ (50,459)	$ (33,740)	$ (99,929)	$ (59,675)

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note B Investments (Continued)

Proceeds from sales of fixed maturity securities during the first nine months of 2009 and 2008 were $394.2 million and $196.8 million, respectively. Gross gains of $17.4 million and gross losses of $(25.6) million were realized on the 2009 sales and gross gains of $2.6 million and gross losses of $(9.9) million were realized on the 2008 sales. Proceeds from sales of fixed maturity securities during the third quarters of 2009 and 2008 were $76.2 million and $90.7 million, respectively. Gross gains of $3.7 million and gross losses of $(3.1) million were realized on sales during the third quarter of 2009 and gross gains of $0.4 million and gross losses of $(5.6) million were realized on sales during the third quarter of 2008. Net realized investment gains and losses on investment sales are determined under the specific identification method and are included in income. In the first nine months of 2009 and 2008 the net losses realized on fixed maturity securities also include provisions for the other than temporary declines in the values of certain fixed maturity securities of $(77.7) million and $(41.4) million, respectively. The change in unrealized appreciation and depreciation on investments, primarily relating to fixed maturity securities, is included as a component of accumulated other comprehensive income or loss.

The Company regularly evaluates its investment portfolio utilizing its established methodology to determine whether declines in the fair values of its investments are other than temporary. Under this methodology, management evaluates, among other things, the financial position and prospects of the issuer, conditions in the issuer s industry and geographic area, liquidity of the investment, changes in the amount or timing of expected future cash flows from the investment and recent changes in credit ratings of the issuer by nationally recognized rating agencies to determine if and when a decline in the fair value of an investment below amortized cost is other than temporary. Management also considers the length of time and extent to which the fair value of the investment is lower than its amortized cost and evaluates whether the Company intends to, or will more likely than not be required to, sell the investment before the anticipated recovery in the investment s fair value. In addition, the Company evaluates loan to collateral value ratios, current levels of subordination and vintages of its residential and commercial mortgage-backed securities.

If the fair value of a fixed maturity security declines in value below the Company s amortized cost and the Company intends to sell or determines that it will more likely than not be required to sell the security before recovery of its amortized cost basis, management considers the security to be other than temporarily impaired and reports its decline in fair value as a realized investment loss. If, however, the Company does not intend to sell the security and determines that it is not more likely than not that it will not be required to do so, declines in the fair value that are considered in the judgment of management to be other than temporary are separated into the amounts representing credit losses and the amounts related to other factors. Amounts representing credit losses are reported as realized investment losses in the income statement and amounts related to other factors are included as a component of accumulated other comprehensive income or loss, net of the related income tax benefit and the related adjustment to cost of business acquired. The amount of credit loss is determined by discounting the security s expected cash flows at its effective interest rate, taking into account the security s purchase price. Declines in the fair value of all other investments that are considered in the judgment of management to be other than temporary are reported as realized investment losses.

During the first nine months of 2009, the Company recognized $89.1 million of after-tax other than temporary impairment losses, of which $61.5 million was recognized as after-tax realized investment losses in the income statement related to credit losses and $27.6 million was recognized, net of the related income tax benefit, as a component of accumulated other comprehensive income on the balance sheet related to noncredit losses.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note B Investments (Continued)

The following table provides a reconciliation of the beginning and ending balances of other than temporary impairments on fixed maturity securities held by the Company for which a portion of the other than temporary impairment was recognized in accumulated other comprehensive income or loss (dollars in thousands):

	Three months ended September 30, 2009	Nine months ended September 30, 2009
Balance at the beginning of period	$ 59,420	$
Increases attributable to credit losses on securities for which an other than temporary impairment was not previously recognized	17,775	77,384
Increases attributable to credit losses on securities for which an other than temporary impairment was previously recognized	2,332	2,143
Reductions due to sales, maturities, pay downs or prepayments of securities for which an other than temporary impairment was previously recognized	(9,454)	(9,454)
Balance at the end of the period	$ 70,073	$ 70,073

The gross unrealized losses at September 30, 2009 are attributable to over eight hundred fixed maturity security positions, with the largest unrealized loss associated with any one security equal to $6.1 million. Unrealized losses attributable to fixed maturity securities having investment grade ratings by a nationally recognized statistical rating organization comprised 51% of the aggregate gross unrealized losses at September 30, 2009, with the remainder of such losses being attributable to non-investment grade fixed maturity securities.

At September 30, 2009, the Company held approximately $1,145.6 million of insured municipal fixed maturity securities, which represented approximately 20% of the Company s total invested assets. These securities had a weighted average credit rating of AA by nationally recognized statistical rating organizations at September 30, 2009. For the portion of these securities having ratings by nationally recognized statistical rating organizations without giving effect to the credit enhancement provided by the insurance, which totaled $817.2 million at September 30, 2009, the weighted average credit rating at such date by such organizations was also AA . Insurers of significant portions of the municipal fixed maturity securities held by the Company at September 30, 2009 included National Public Finance Guarantee Corp. ($322.9 million), Financial Security Assurance Inc. ($171.2 million), Ambac Financial Group, Inc. ($146.1 million), and Financial Guaranty Insurance Company ($40.9 million). At September 30, 2009, the Company did not have significant holdings of credit enhanced asset-backed or mortgage-backed securities, nor did it have any significant direct investments in the guarantors of the municipal fixed maturity securities held by the Company.

Net investment income was attributable to the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
	(dollars in thousands)			
Gross investment income:				
Fixed maturity securities, available for sale	$ 77,648	$ 35,476	$ 225,354	$ 142,526

Mortgage loans	1,121	3,072	2,527	10,274
Short-term investments	26	1,953	348	7,114
Other	16,510	(14,042)	38,586	(24,877)
	95,305	26,459	266,815	135,037
Less: Investment expenses	(6,623)	(7,052)	(23,255)	(22,543)
	$ 88,682	$ 19,407	$ 243,560	$ 112,494

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note C Fair Value Measurements

The Company measures its assets and liabilities recorded at fair value in the consolidated balance sheet based on the framework set forth in the GAAP fair value accounting guidance. This framework establishes a fair value hierarchy of three levels based upon the transparency and availability of information used in measuring the fair value of assets or liabilities as of the measurement date. The levels are categorized as follows:

Level 1- Valuation is based upon quoted prices for identical assets or liabilities in active markets. Level 1 fair value is not subject to valuation adjustments or block discounts.

Level 2 Valuation is based upon quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar instruments in markets that are not active. In addition, a company may use various valuation techniques or pricing models that use observable inputs to measure fair value.

Level 3 Valuation is generated from techniques in which one or more of the significant inputs for valuing such assets or liabilities are not observable. These inputs may reflect the Company s best estimates of the various assumptions that market participants would use in valuing the financial assets and financial liabilities.

For these purposes, the Company determines the existence of an active market for an asset or liability based on its judgment as to whether transactions for the asset or liability occur in such market with sufficient frequency and volume to provide reliable pricing information. If the Company concludes that there has been a significant decrease in the volume and level of activity for an investment in relation to normal market activity for such investment, adjustments to transactions and quoted prices are made to estimate fair value.

The Company s investments in fixed maturity securities available for sale, equity securities available for sale, trading account securities, assets held in the separate account and securities sold, not yet purchased are carried at fair value. The methodologies and valuation techniques used by the Company to value its assets and liabilities measured at fair value are described below.

Instruments included in fixed maturity securities available for sale include mortgage-backed and corporate securities, U.S. Treasury and other U.S. government guaranteed securities, securities issued by U.S. government-sponsored enterprises, and obligations of U.S. states, municipalities and political subdivisions. The market liquidity of each security is taken into consideration in the valuation technique used to value such security. For securities where market transactions involving identical or comparable assets generate sufficient relevant information, the Company employs a market approach to valuation. If sufficient information is not generated from market transactions involving identical or comparable assets, the Company uses an income approach to valuation. The majority of the instruments included in fixed maturity securities available for sale are valued utilizing observable inputs; accordingly, they are categorized in either Level 1 or Level 2 of the fair value hierarchy described above. However, in instances where significant inputs utilized are unobservable, the securities are categorized in Level 3 of the fair value hierarchy.

The inputs used in the valuation techniques employed by the Company are provided by nationally recognized pricing services, external investment managers and internal resources. To assess these inputs, the Company s review process includes, but is not limited to, quantitative analysis including benchmarking, initial and ongoing evaluations of methodologies used by external parties to calculate fair value, and ongoing evaluations of fair value estimates based on the Company s knowledge and monitoring of market conditions.

Residential mortgage-backed securities and commercial mortgage-backed securities include U.S. agency securities and collateralized mortgage obligations. The Company uses various valuation techniques and pricing models to measure the fair value of these instruments, including option-adjusted spread models, volatility-driven multi-dimensional single cash flow stream models and matrix correlation to comparable securities. A portion of the Company s investments in mortgage-backed securities are valued using observable inputs and therefore categorized in Level 2 of the fair value hierarchy. The remaining mortgage-backed securities are valued using varying numbers of non-binding broker quotes or a discount rate adjustment technique based on internal assumptions for expected cash flows and appropriately risk-adjusted discount rates. These methodologies rely on unobservable inputs and thus these securities are categorized in Level 3 of the fair value hierarchy.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note C Fair Value Measurements (Continued)

Corporate securities primarily include fixed rate corporate bonds, floating and variable rate notes and securities acquired through private placements. The Company uses recently executed transactions, market price quotations, benchmark yields and issuer spreads to arrive at the fair value of its investments in corporate securities and collateralized debt obligations. The majority of the corporate securities, other than securities acquired through private placements, are categorized in Level 2 of the fair value hierarchy. Collateralized debt obligations and private placement corporate securities are valued with cash flow models using yield curves, issuer-provided information and material events as key inputs. As these inputs are generally unobservable, collateralized debt obligations and private placement securities are categorized in Level 3 of the fair value hierarchy.

U.S. Treasury and other U.S. government guaranteed securities include U.S. Treasury bonds and notes, Treasury Inflation Protected Securities (TIPS) and other U.S. government guaranteed securities. The fair values of the U.S. Treasury securities and TIPS are based on quoted prices in active markets and are generally categorized in Level 1 of the fair value hierarchy.

Other U.S. government guaranteed securities are valued based on observable inputs including interest rate yield curves, maturity dates, and credit spreads relating to similar instruments. Accordingly, these securities are generally categorized in Level 2 of the fair value hierarchy.

U.S. government-sponsored enterprise securities include issues of medium term notes by U.S. government-sponsored enterprises. The Company uses recently executed transactions, market price quotations, benchmark yields and issuer spreads to arrive at the fair value of these instruments. These inputs are generally observable and these securities are generally categorized in Level 2 of the fair value hierarchy.

Obligations of U.S. states, municipalities and political subdivisions primarily include bonds or notes issued by U.S municipalities. The Company values these securities using recently executed transactions, spreads, benchmark curves including treasury benchmarks, and trustee reports. These inputs are generally observable and these securities are generally categorized in Level 2 of the fair value hierarchy.

Other investments held at fair value primarily consist of equity securities available for sale and trading account securities. These investments are primarily valued at quoted active market prices and are therefore categorized in Level 1 of the fair value hierarchy. For private equity investments, since quoted market prices are not available, the transaction price is used as the best estimate of fair value at inception. When evidence is believed to support a change to the carrying value from the transaction price, adjustments are made to reflect expected exit values. Ongoing reviews by Company management are based on assessments of each underlying investment, incorporating, among other things, the evaluation of financing and sale transactions with third parties, expected cash flows, material events and market-based information. These investments are included in Level 3 of the fair value hierarchy.

Assets held in the separate account represent funds invested in a separately administered variable life insurance product for which the policyholder, rather than the Company, bears the investment risk. These assets are invested in a limited liability company that invests in entities which trade in various financial instruments. The Company concluded that the value calculated using the equity method of accounting was reflective of the fair market value of such investments. The investment portfolios of the funds in which the fund investments are maintained vary from fund to fund, but are generally comprised of liquid, publicly traded securities that have readily determinable market values and which are carried at fair value on the financial statements of such funds, substantially all of which are audited annually. The amount that an investor is entitled to receive upon the redemption of its investment from the applicable fund is determined by reference to such security values. The Company utilizes the financial statements furnished by the funds to determine the values of its investments in such funds and the carrying value of each such investment, which is based on its proportionate interest in the relevant fund as of the balance sheet date. These investments are included in Level 3 of the fair value hierarchy.

Other liabilities measured at fair value include securities sold, not yet purchased. These securities are valued using the quoted active market prices of the securities sold and are categorized in Level 1 of the fair value hierarchy.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Note C Fair Value Measurements (Continued)

Assets and liabilities measured at fair value in the consolidated balance sheet on a recurring basis are summarized below:

	September 30, 2009			
	Total	Level 1	Level 2	Level 3
	(dollars in thousands)			
Assets:				
Fixed maturity securities, available for sale:				
Residential mortgage-backed securities	$ 1,464,027	$ 761	$ 1,303,745	$ 159,521
Commercial mortgage-backed securities	27,685			27,685
Corporate securities	1,253,530	2,958	1,131,255	119,317
Collateralized debt obligations	119,268			119,268
U.S. Treasury and other U.S. Government guaranteed securities	105,982	74,135	29,110	2,737
U.S. Government-sponsored enterprise securities	7,351		7,351	
Obligations of U.S. states, municipalities and political subdivisions	1,630,341		1,630,341	
Other investments	128,041	111,574		16,467
Assets held in separate account	109,016			109,016
Total	$ 4,845,241	$ 189,428	$ 4,101,802	$ 554,011
Liabilities:				
Other liabilities	$ 58,695	$ 58,695	$	$

The following table provides reconciliations for Level 3 assets measured at fair value on a recurring basis.

Three Months Ended September 30, 2009					
Residential Mortgage-backed	Commercial Mortgage-backed	Corporate	Collateralized Debt	U.S. Treasury and Other U.S. Gov t	Assets held in

1,600 1,618

Regal Trust

2.207% (D11COF + 1.500%) due 09/29/2031 ~

75 72

Residential Accredit Loans, Inc. Trust

4.363% due 01/25/2036 ^~

448 391

6.000% due 08/25/2035 ^

302 283

6.500% due 09/25/2037 ^

297 264

Residential Asset Securitization Trust

6.000% due 03/25/2037 ^

247 178

Residential Funding Mortgage Securities, Inc. Trust

6.000% due 06/25/2036 ^

292 290

Royal Bank of Scotland Capital Funding Trust

6.068% due 02/17/2051 ~

2,744 2,740

Structured Adjustable Rate Mortgage Loan Trust

3.395% due 11/25/2036 ^~

29 29

3.430% due 04/25/2036 ^~(l)

432 377

3.440% due 01/25/2036 ^~

380 306

3.627% due 09/25/2036 ^~

222 204

Structured Asset Mortgage Investments Trust

1.447% (US0001M + 0.210%) due 08/25/2036 ^~(l)

989 901

TBW Mortgage-Backed Trust

6.000% due 07/25/2036 ^

166 134

Wachovia Bank Commercial Mortgage Trust

1.039% due 10/15/2041 ~(a)

1,160 0

5.691% due 10/15/2048 ~

200 201

5.720% due 10/15/2048 ~(l)

2,400 2,334

WaMu Mortgage Pass-Through Certificates Trust

1.727% (US0001M + 0.490%) due 06/25/2044 ~

590 550

2.207% (COF 11 + 1.500%) due 11/25/2046 ~

500 478

3.071% due 12/25/2036 ^~(l)

446 425

Washington Mutual Mortgage Pass-Through Certificates Trust

6.500% due 08/25/2036 ^(l)

1,608 1,235

Wells Fargo Alternative Loan Trust

5.500% due 07/25/2022

30 30

Wells Fargo-RBS Commercial Mortgage Trust

0.982% due 02/15/2044 ~(a)(l)

16,155 346

Total Non-Agency Mortgage-Backed Securities
(Cost $66,658) 74,101

ASSET-BACKED SECURITIES 67.1%

Airspeed Ltd.

1.504% (LIBOR01M + 0.270%) due 06/15/2032 ~

625 555

Asset-Backed Securities Corp. Home Equity Loan Trust

2.332% (US0001M + 1.095%) due 02/25/2035 ~(l)

3,374 3,429

2.962% (US0001M + 1.725%) due 12/25/2034 ~(l)	1,844	1,841
4.487% (US0001M + 3.250%) due 06/21/2029 ~	148	145
Associates Manufactured Housing Pass-Through Certificates		
7.150% due 03/15/2028 ~	405	445
Bayview Financial Acquisition Trust		
1.514% (US0001M + 0.280%) due 12/28/2036 ~	126	126
Bear Stearns Asset-Backed Securities Trust		
1.617% (US0001M + 0.380%) due 04/25/2036 ~(l)	2,706	2,721
1.617% (US0001M + 0.380%) due 06/25/2036 ~	16	16
3.296% due 07/25/2036 ~	316	303
Bombardier Capital Mortgage Securitization Corp.		
7.830% due 06/15/2030 ~	1,185	534
Centex Home Equity Loan Trust		
1.987% (US0001M + 0.750%) due 01/25/2035 ~(l)	1,643	1,558
Citigroup Mortgage Loan Trust		
1.397% (US0001M + 0.160%) due 12/25/2036 ~(l)	1,748	1,168
1.457% (US0001M + 0.220%) due 12/25/2036 ~	924	511
1.687% (US0001M + 0.450%) due 11/25/2045 ~(l)	5,230	5,168
1.937% (US0001M + 0.700%) due 11/25/2046 ~	1,900	1,126
Citigroup Mortgage Loan Trust, Inc.		
1.497% (US0001M + 0.260%) due 03/25/2037 ~(l)	4,256	3,593
Conseco Finance Securitizations Corp.		
7.960% due 05/01/2031	372	254
9.163% due 03/01/2033 ~	905	869
Countrywide Asset-Backed Certificates		
1.367% (US0001M + 0.130%) due 12/25/2036 ^~	1,301	1,298
1.377% (US0001M + 0.140%) due 06/25/2035 ~(l)	2,767	2,381
1.377% (US0001M + 0.140%) due 06/25/2047 ^~(l)	3,106	2,496
1.387% (US0001M + 0.150%) due 04/25/2047 ~(l)	1,229	1,199
1.437% (US0001M + 0.200%) due 06/25/2037 ^~(l)	881	740
1.477% (US0001M + 0.240%) due 05/25/2036 ~(l)	8,686	4,914
2.887% (US0001M + 1.650%) due 06/25/2035 ~(l)	4,000	3,527
Countrywide Asset-Backed Certificates Trust		
1.507% (US0001M + 0.270%) due 09/25/2046 ~	5,000	3,233
Crecera Americas LLC		
4.567% due 08/31/2020 ~	1,900	1,899
EMC Mortgage Loan Trust		
2.284% (US0001M + 0.700%) due 05/25/2040 ~	675	602
2.534% (LIBOR01M + 0.650%) due 02/25/2041 ~	344	338
Fremont Home Loan Trust		
1.417% (US0001M + 0.180%) due 04/25/2036 ~	1,192	1,072
GE Capital Mortgage Services, Inc. Trust		
6.705% due 04/25/2029 ~	115	99
GSAMP Trust		
2.987% (US0001M + 1.750%) due 12/25/2034 ~	2,116	1,271
3.037% (US0001M + 1.800%) due 06/25/2035 ~(l)	2,200	2,183
Home Equity Mortgage Loan Asset-Backed Trust		
1.477% (US0001M + 0.240%) due 04/25/2037 ~(l)	5,187	3,556

HSI Asset Securitization Corp. Trust		
1.347% (US0001M + 0.110%) due 04/25/2037 ~(l)	4,126	2,466
Lehman XS Trust		
5.420% due 11/25/2035 ^	183	183
MASTR Asset-Backed Securities Trust		
1.347% (US0001M + 0.110%) due 08/25/2036 ~(l)	3,528	1,964
Morgan Stanley ABS Capital, Inc. Trust		
2.017% (US0001M + 0.780%) due 12/25/2034 ~	180	168
Morgan Stanley Home Equity Loan Trust		
2.302% (US0001M + 1.065%) due 05/25/2035 ~	1,978	1,260
National Collegiate Commutation Trust		
0.000% (7-DayAuc) due 03/25/2038 ~	3,500	1,619
People s Financial Realty Mortgage Securities Trust		
1.367% (US0001M + 0.130%) due 09/25/2036 ~	1,570	511
Renaissance Home Equity Loan Trust		
7.238% due 09/25/2037 ^(l)	4,155	2,414
Residential Asset Mortgage Products Trust		
1.977% (US0001M + 0.740%) due 09/25/2032 ~	40	39
2.332% (US0001M + 1.095%) due 12/25/2033 ~	671	647
Residential Asset Securities Corp. Trust		
1.927% (US0001M + 0.690%) due 08/25/2035 ~(l)	4,350	3,782
Securitized Asset-Backed Receivables LLC Trust		
1.687% (US0001M + 0.450%) due 10/25/2035 ~(l)	5,500	5,286
1.882% (LIBOR01M + 0.645%) due 01/25/2035 ~(l)	1,430	1,287
SoFi Professional Loan Program LLC		
0.000% due 03/25/2036 +(g)	10	283
0.000% due 01/25/2039 +(g)	1,000	662
0.000% due 05/25/2040 +(g)	1,000	516
0.000% due 09/25/2040 +(g)	339	191
Southern Pacific Secured Asset Corp.		
1.577% (US0001M + 0.340%) due 07/25/2029 ~	16	16
Structured Asset Investment Loan Trust		
2.962% (US0001M + 1.725%) due 10/25/2034 ~(l)	1,986	1,886
5.737% (US0001M + 4.500%) due 10/25/2033 ~	68	64
UCFC Manufactured Housing Contract		
7.900% due 01/15/2028 ^~	430	423

UPS Capital Business Credit			
6.984% (US0001M + 5.750%) due 04/15/2026 +~		1,856	39
Total Asset-Backed Securities (Cost $75,175)			80,876
		SHARES	
COMMON STOCKS 0.5%			
ENERGY 0.5%			
Forbes Energy Services Ltd. (f)(j)		35,625	606
Warren Resources, Inc. +		7,681	10
Total Common Stocks (Cost $2,757)			616
WARRANTS 0.0%			
INDUSTRIALS 0.0%			
Sequa Corp. - Exp. 04/28/2024 +		118,000	45
UTILITIES 0.0%			
Dynegy, Inc. - Exp. 02/02/2024		8,621	2
Total Warrants (Cost $23)			47
PREFERRED SECURITIES 1.8%			
BANKING & FINANCE 0.1%			
Vici Properties LLC			
0.000% due 10/04/2035 +(j)		4,956	103
INDUSTRIALS 1.7%			
Sequa Corp.			
9.000% +		2,185	2,076
Total Preferred Securities (Cost $2,266)			2,179
SHORT-TERM INSTRUMENTS 6.9%			
REPURCHASE AGREEMENTS (k) 0.5%			604
		PRINCIPAL AMOUNT (000S)	
SHORT-TERM NOTES 5.2%			
Federal Home Loan Bank			
1.014% due 10/03/2017 - 10/12/2017 (g)(h)	$	4,700	4,700
1.041% due 10/27/2017 (g)(h)		1,500	1,499

			6,199
U.S. TREASURY BILLS 1.2%			
0.990% due 11/09/2017 (g)(h)(o)	1,478		1,476
Total Short-Term Instruments (Cost $8,278)			8,279
Total Investments in Securities (Cost $183,437)			195,815
Total Investments 162.5% **(Cost $183,437)**		**$**	**195,815**
Financial Derivative Instruments (m)(n) (1.4)% **(Cost or Premiums, net $(1,510))**			**(1,708)**
Other Assets and Liabilities, net (61.1)%			**(73,624)**
Net Assets Applicable to Common Shareholders 100.0%		**$**	**120,483**

Notes to Schedule of Investments (amounts in thousands*):

*** A zero balance may reflect actual amounts rounding to less than one thousand.**

^ Security is in default.

+ Security valued using significant unobservable inputs (Level 3).

~ Variable or Floating rate security. Rate shown is the rate in effect as of period end. Certain variable rate securities are not based on a published reference rate and spread, rather are determined by the issuer or agent and are based on current market conditions. These securities may not indicate a reference rate and/or spread in their description.

(a) Interest only security.

(b) Principal only security.

(c) When-issued security.

(d) Payment in-kind security.

(e) Security is not accruing income as of the date of this report.

(f) Security did not produce income within the last twelve months.

(g) Zero coupon security.

(h) Coupon represents a yield to maturity.

(i) Security is subject to a forbearance agreement entered into by the Fund which forbears the Fund from taking action to, among other things, accelerate and collect payments on the subject note with respect to specified events of default.

(j) Restricted Securities:

Issuer Description	Acquisition Date	Cost	Market Value	Market Value as Percentage of Net Assets
Forbes Energy Services Ltd.	07/29/2014	$ 1,769	$ 606	0.50%
Vici Properties PLC 0000% due 10/04/2035	09/27/2017	4,956	103	0.09
		$ 6,725	$ 709	0.59%

Borrowings and Other Financing Transactions

(k) Repurchase Agreements:

Counterparty	Lending Rate	Settlement Date	Maturity Date	Principal Amount	Collateralized By	Collateral (Received)	Repurchase Agreements, at Value	Repurchase Agreement Proceeds to be Received [1]
FICC	0.500%	09/29/2017	10/02/2017	$ 604	U.S. Treasury Notes 2.625% due 08/15/2020	$ (620)	$ 604	$ 604
Total Repurchase Agreements						**$ (620)**	**$ 604**	**$ 604**

Reverse Repurchase Agreements:

Counterparty	Borrowing Rate [2]	Settlement Date	Maturity Date	Amount Borrowed [2]	Payable for Reverse Repurchase Agreements
BCY	8.147%	07/03/2017	10/03/2017	$ (4,557)	$ (4,589)
	2.817	07/26/2017	10/26/2017	(554)	(557)
	2.817	08/23/2017	11/27/2017	(857)	(860)
	8.454	09/05/2017	12/05/2017	(3,021)	(3,027)
BPS	2.804	07/10/2017	10/10/2017	(1,341)	(1,350)
DEU	2.280	08/24/2017	11/24/2017	(1,212)	(1,215)
	2.210	08/09/2017	11/09/2017	(236)	(237)
	2.280	08/30/2017	11/30/2017	(1,102)	(1,104)
GLM	2.621	09/15/2017	12/15/2017	(1,202)	(1,204)
GSC	2.484	09/15/2017	10/17/2017	(772)	(773)
JPS	2.666	09/01/2017	12/01/2017	(315)	(316)
MSC	2.304	07/19/2017	10/19/2017	(659)	(662)
	2.929	05/08/2017	11/08/2017	(1,381)	(1,387)
RBC	13.750	08/02/2017	02/02/2018	(3,342)	(3,357)

	8.250	08/07/2017	02/07/2018	(1,517)	(1,524)
	11.000	09/13/2017	03/12/2018	(1,987)	(1,990)
	2.720	05/26/2017	11/27/2017	(298)	(301)
	2.750	09/11/2017	03/12/2018	(3,437)	(3,443)
	2.750	09/13/2017	03/12/2018	(1,170)	(1,172)
	2.780	09/20/2017	03/20/2018	(1,163)	(1,164)
RDR	1.720	08/23/2017	11/27/2017	(749)	(750)
RTA	2.553	07/25/2017	01/16/2018	(2,429)	(2,441)
	2.559	10/07/2016	10/06/2017	(2,678)	(2,747)
	2.568	11/09/2016	11/08/2017	(2,739)	(2,803)
	2.704	09/13/2017	03/12/2018	(1,592)	(1,594)
	2.719	05/26/2017	11/27/2017	(236)	(238)
	2.813	02/03/2017	01/31/2018	(1,715)	(1,747)
	2.879	05/08/2017	05/07/2018	(3,436)	(3,476)
	2.888	05/11/2017	05/07/2018	(4,415)	(4,466)
	2.889	04/13/2017	04/05/2018	(3,009)	(3,051)
	2.918	03/14/2017	03/08/2018	(2,261)	(2,298)
SAL	2.199	07/05/2017	10/05/2017	(1,366)	(1,373)
SOG	1.880	09/01/2017	11/30/2017	(880)	(881)
	1.850	07/25/2017	10/24/2017	(1,746)	(1,752)
	1.880	08/30/2017	11/30/2017	(926)	(928)
	1.880	09/01/2017	11/30/2017	(823)	(824)
	1.880	09/15/2017	12/14/2017	(482)	(482)
	2.965	05/15/2017	11/15/2017	(494)	(496)
	3.000	07/10/2017	01/10/2018	(1,011)	(1,018)
UBS	2.260	07/21/2017	10/23/2017	(1,304)	(1,310)
	2.813	08/03/2017	11/03/2017	(1,614)	(1,622)
	5.474	08/09/2017	11/09/2017	(2,999)	(3,011)
	5.478	08/23/2017	11/27/2017	(5,654)	(5,671)
Total Reverse Repurchase Agreements					**$ (75,211)**

(l) Securities with an aggregate market value of $105,146 have been pledged as collateral under the terms of master agreements as of September 30, 2017.

[1] *Includes accrued interest.*

[2] *The average amount of borrowings outstanding during the period ended September 30, 2017 was $(70,620) at a weighted average interest rate of 2.604%. Average borrowings may include sale-buyback transactions and reverse repurchase agreements, if held during the period.*

(m) Financial Derivative Instruments: Exchange-traded or Centrally Cleared Swap Agreements:

Credit Default Swaps on Corporate Issues - Sell Protection [1]

Reference Entity	Fixed Receive Rate	Payment Frequency	Maturity Date	Implied Credit Spread at September 30, 2017 [2]	Notional Amount [3]	Premiums Paid/(Received)	Unrealized Appreciation/(Depreciation)	Market Value	Variation Margin Asset	Variation Margin Liability
Frontier Communications Corp.	5.000%	Quarterly	06/20/2020	10.379%	$ 590	$ (33)	$ (37)	$ (70)	$ 0	$ (1)
Sprint Communications, Inc.	5.000	Quarterly	12/20/2021	1.540	300	9	33	42	0	0
						$ (24)	$ (4)	$ (28)	$ 0	$ (1)

Interest Rate Swaps

y/Receive oating Rate	Floating Rate Index	Fixed Rate	Payment Frequency	Maturity Date	Notional Amount	Premiums Paid/(Received)	Unrealized Appreciation/ (Depreciation)	Market Value	Variation Mar Asset	Liabili
ceive	3-Month USD-LIBOR	1.500%	Semi-Annual	12/21/2021	$ 1,500	$ 22	$ (45)	$ (23)	$ 0	$ (
ceive	3-Month USD-LIBOR	1.750	Semi-Annual	12/21/2023	60,000	1,131	(2,122)	(991)	0	(10
ceive	3-Month USD-LIBOR	1.750	Semi-Annual	12/21/2026	3,200	77	(206)	(129)	0	(
ceive[4]	3-Month USD-LIBOR	2.750	Semi-Annual	12/20/2037	19,800	(673)	32	(641)	1	
ceive[4]	3-Month USD-LIBOR	2.750	Semi-Annual	01/05/2048	1,500	(52)	(2)	(54)	0	(
						$ 505	$ (2,343)	$ (1,838)	$ 1	$ (12
tal Swap Agreements						**$ 481**	**$ (2,347)**	**$ (1,866)**	**$ 1**	**$ (12**

Cash of $1,286 has been pledged as collateral for exchange-traded and centrally cleared financial derivative instruments as of September 30, 2017.

(1) *If the Fund is a seller of protection and a credit event occurs, as defined under the terms of that particular swap agreement, the Fund will either (i) pay to the buyer of protection an amount equal to the notional amount of the swap and take delivery of the referenced obligation or underlying securities comprising the referenced index or (ii) pay a net settlement amount in the form of cash, securities or other deliverable obligations equal to the notional amount of the swap less the recovery value of the referenced obligation or underlying securities comprising the referenced index.*

(2) *Implied credit spreads, represented in absolute terms, utilized in determining the market value of credit default swap agreements on issues as of period end serve as indicators of the current status of the payment/performance risk and represent the likelihood or risk of default for the credit derivative. The implied credit spread of a particular referenced entity reflects the cost of buying/selling protection and may include upfront payments required to be made to enter into the agreement. Wider credit spreads represent a deterioration of the referenced entity s credit soundness and a greater likelihood or risk of default or other credit event occurring as defined under the terms of the agreement.*

(3) *The maximum potential amount the Fund could be required to pay as a seller of credit protection or receive as a buyer of credit protection if a credit event occurs as defined under the terms of that particular swap agreement.*

(4) *This instrument has a forward starting effective date.*

(n) Financial Derivative Instruments: Over the Counter Swap Agreements:

Credit Default Swaps on Credit Indices - Sell Protection (1)

							Swap Agreen
dex/Tranches	**Fixed Receive Rate**	**Payment Frequency**	**Maturity Date**	**Notional Amount (2)**	**Premiums Paid/(Received)**	**Unrealized Appreciation/ (Depreciation)**	**Asset**
MBX.NA.BBB-.6 dex	3.000%	Monthly	05/11/2063	$ 300	$ (16)	$ (29)	$ 0
MBX.NA.BBB-.8 dex	3.000	Monthly	10/17/2057	600	(69)	(36)	0
MBX.NA.BBB-.9 dex	3.000	Monthly	09/17/2058	300	(38)	0	0
MBX.NA.BBB-.8 dex	3.000	Monthly	10/17/2057	100	(16)	(1)	0
BX.HE.AA.6-1 Index	0.320	Monthly	07/25/2045	5,943	(1,183)	591	0
BX.HE.PENAAA.7-1 dex	0.090	Monthly	08/25/2037	1,467	(284)	33	0
MBX.NA.A.6 Index	2.000	Monthly	05/11/2063	500	(25)	(4)	0
MBX.NA.BB.6 Index	5.000	Monthly	05/11/2063	300	(41)	(32)	0
MBX.NA.BBB-.6 dex	3.000	Monthly	05/11/2063	700	(39)	(67)	0
MBX.NA.BBB-.7 dex	3.000	Monthly	01/17/2047	100	(5)	(6)	0
MBX.NA.BBB-.9 dex	3.000	Monthly	09/17/2058	700	(87)	(2)	0
MBX.NA.BBB-.10 dex	3.000	Monthly	11/17/2059	1,200	(126)	(17)	0
MBX.NA.BBB-.7 dex	3.000	Monthly	01/17/2047	300	(13)	(20)	0
MBX.NA.BBB-.8 dex	3.000	Monthly	10/17/2057	100	(12)	(6)	0
MBX.NA.BBB-.9 dex	3.000	Monthly	09/17/2058	300	(37)	(1)	0
					$ (1,991)	$ 403	$ 0
ements					**$ (1,991)**	**$ 403**	**$ 0**

(o) Securities with an aggregate market value of $1,477 have been pledged as collateral for financial derivative instruments as governed by International Swaps and Derivatives Association, Inc. master agreements as of September 30, 2017.

(1) *If the Fund is a seller of protection and a credit event occurs, as defined under the terms of that particular swap agreement, the Fund will either (i) pay to the buyer of protection an amount equal to the notional amount of the swap and take delivery of the referenced obligation or underlying securities comprising the referenced index or (ii) pay a net settlement amount in the form of cash, securities or other deliverable obligations equal to the notional amount of the swap less the recovery value of the referenced obligation or underlying securities comprising the referenced index.*

(2) *The maximum potential amount the Fund could be required to pay as a seller of credit protection or receive as a buyer of credit protection if a credit event occurs as defined under the terms of that particular swap agreement.*

(3) *The prices and resulting values for credit default swap agreements on credit indices serve as indicators of the current status of the payment/performance risk and represent the likelihood of an expected liability (or profit) for the credit derivative should the notional amount of the swap agreement be closed/sold as of the period end. Increasing market values, in absolute terms when compared to the notional amount of the swap, represent a deterioration of the referenced indices credit soundness and a greater likelihood or risk of default or other credit event occurring as defined under the terms of the agreement.*

Fair Value Measurements

The following is a summary of the fair valuations according to the inputs used as of September 30, 2017 in valuing the Fund s assets and liabilities:

Category and Subcategory	**Level 1**	**Level 2**	**Level 3**	**Fair Value at 09/30/2017**
Investments in Securities, at Value				
Loan Participations and Assignments	$ 0	$ 4,775	$ 453	$ 5,228
Corporate Bonds & Notes				
Banking & Finance	0	4,571	781	5,352
Industrials	12	11,802	0	11,814
Utilities	0	1,455	0	1,455
Municipal Bonds & Notes				
Arkansas	0	363	0	363
West Virginia	0	808	0	808
U.S. Government Agencies	0	4,697	0	4,697
Non-Agency Mortgage-Backed Securities	0	73,364	737	74,101
Asset-Backed Securities	0	79,185	1,691	80,876
Common Stocks				
Energy	606	0	10	616
Warrants				
Industrials	0	0	45	45
Utilities	2	0	0	2
Preferred Securities				
Banking & Finance	0	0	103	103
Industrials	0	0	2,076	2,076
Short-Term Instruments				
Repurchase Agreements	0	604	0	604

Short-Term Notes		0		6,199		0		6,199
U.S. Treasury Bills		0		1,476		0		1,476
Total Investments	$	620	$	189,299	$	5,896	$	195,815
Financial Derivative Instruments - Assets								
Exchange-traded or centrally cleared	$	0	$	1	$	0	$	1
Financial Derivative Instruments - Liabilities								
Exchange-traded or centrally cleared		0		(121)		0		(121)
Over the counter		0		(1,588)		0		(1,588)
	$	0	$	(1,709)	$	0	$	(1,709)
Total Financial Derivative Instruments	$	0	$	(1,708)	$	0	$	(1,708)
Totals	$	620	$	187,591	$	5,896	$	194,107

There were no significant transfers among Levels 1 and 2 during the period ended September 30, 2017.

The following is a reconciliation of the fair valuations using significant unobservable inputs (Level 3) for the Fund during the period ended September 30, 2017:

Category and Subcategory	Beginning Balance at 06/30/2017	Net Purchases	Net Sales	Accrued Discounts/ (Premiums)	Realized Gain/ (Loss)	Net Change in Unrealized Appreciation/ (Depreciation) [1]	Transfers into Level 3	Transfers out of Level 3	Ending Balance at 09/30/2017	Net Change in Unrealized Appreciation/ (Depreciation) on Investments Held at 09/30/2017 [1]
Investments in Securities, at Value										
Loan Participations and Assignments	$ 438	$ 7	$ 0	$ 3	$ 0	$ 5	$ 0	$ 0	$ 453	$ 5
Corporate Bonds & Notes										
Banking & Finance	780	0	0	1	0	0	0	0	781	0
Industrials	1,292	0	(1,313)	0	14	7	0	0	0	0
Non-Agency Mortgage-Backed Securities	767	0	(17)	1	1	(15)	0	0	737	(14)
Asset-Backed Securities	3,133	192	0	25	0	(40)	0	(1,619)	1,691	(33)
Common Stocks										
Energy	10	0	0	0	0	0	0	0	10	0
Warrants										
Industrials	56	0	0	0	0	(11)	0	0	45	(11)
Preferred Securities										
Banking & Finance	0	81	0	0	0	22	0	0	103	22
Industrials	2,131	0	0	0	0	(55)	0	0	2,076	(56)
Totals	$ 8,607	$ 280	$ (1,330)	$ 30	$ 15	$ (87)	$ 0	$ (1,619)	$ 5,896	$ (87)

The following is a summary of significant unobservable inputs used in the fair valuations of assets and liabilities categorized within Level 3 of the fair value hierarchy:

Category and Subcategory	Ending Balance at 09/30/2017	Valuation Technique	Unobservable Inputs	Input Value(s) (% Unless Noted Otherwise)
Investments in Securities, at Value				
Loan Participations and Assignments	$ 453	Other Valuation Techniques [2]		

Corporate Bonds & Notes					
Banking & Finance	781	Reference Instrument	Spread movement		275.000bps
Non-Agency Mortgage-Backed Securities	737	Proxy Pricing	Base Price		5.510 - 100.824
Asset-Backed Securities	1,652	Proxy Pricing	Base Price		52.800 - 2,609.000
	39	Third Party Vendor	Broker Quote		2.125
Common Stocks					
Energy	10	Other Valuation Techniques [2]			
Warrants					
Industrials	45	Other Valuation Techniques [2]			
Preferred Securities					
Banking & Finance	103	Proxy Pricing	Base Price	$	20.833
Industrials	2,076	Indicative Market Quotation	Broker Quote	$	950.000
Total	$ 5,896				

(1) *Any difference between Net Change in Unrealized Appreciation/(Depreciation) and Net Change in Unrealized Appreciation/(Depreciation) on Investments Held at September 30, 2017 may be due to an investment no longer held or categorized as Level 3 at period end.*

(2) *Includes valuation techniques not defined in the Supplementary Notes to Schedule of Investments as securities valued using such techniques are not considered significant to the Fund.*

See Accompanying Notes

Notes to Financial Statements

1. INVESTMENT VALUATION AND FAIR VALUE MEASUREMENTS

(a) Investment Valuation Policies The net asset value (NAV) of the Fund s shares is determined by dividing the total value of portfolio investments and other assets attributable to that Fund less any liabilities by the total number of shares outstanding of the Fund.

On each day that the New York Stock Exchange (NYSE) is open, Fund shares are ordinarily valued as of the close of regular trading (NYSE Close). Information that becomes known to the Fund or its agents after the time as of which NAV has been calculated on a particular day will not generally be used to retroactively adjust the price of a security or the NAV determined earlier that day. The Fund reserves the right to change the time as of which its NAV is calculated if the Fund closes earlier, or as permitted by the U.S. Securities and Exchange Commission (the SEC).

For purposes of calculating a NAV, portfolio securities and other assets for which market quotes are readily available are valued at market value. Market value is generally determined on the basis of official closing prices or the last reported sales prices, or if no sales are reported, based on quotes obtained from established market makers or prices (including evaluated prices) supplied by the Fund s approved pricing services, quotation reporting systems and other third-party sources (together, Pricing Services). The Fund will normally use pricing data for domestic equity securities received shortly after the NYSE Close and does not normally take into account trading, clearances or settlements that take place after the NYSE Close. If market value pricing is used, a foreign (non-U.S.) equity security traded on a foreign exchange or on more than one exchange is typically valued using pricing information from the exchange considered by Pacific Investment Management Company LLC (PIMCO or the Manager) to be the primary exchange. A foreign (non-U.S.) equity security will be valued as of the close of trading on the foreign exchange, or the NYSE Close, if the NYSE Close occurs before the end of trading on the foreign exchange. Domestic and foreign (non-U.S.) fixed income securities, non-exchange traded derivatives, and equity options are normally valued on the basis of quotes obtained from brokers and dealers or Pricing Services using data reflecting the earlier closing of the principal markets for those securities. Prices obtained from Pricing Services may be based on, among other things, information provided by market makers or estimates of market values obtained from yield data relating to investments or securities with similar characteristics. Certain fixed income securities purchased on a delayed-delivery basis are marked to market daily until settlement at the forward settlement date. Exchange-traded options, except equity options, futures and options on futures are valued at the settlement price determined by the relevant exchange. Swap agreements are valued on the basis of bid quotes obtained from brokers and dealers or market-based prices supplied by Pricing Services. The Fund s investments in open-end management investment companies, other than exchange-traded funds (ETFs), are valued at the NAVs of such investments. Open-end management investment companies may include affiliated funds.

If a foreign (non-U.S.) equity security s value has materially changed after the close of the security s primary exchange or principal market but before the NYSE Close, the security may be valued at fair value based on procedures established and approved by the Board of Trustees (the Board). Foreign (non-U.S.) equity securities that do not trade when the NYSE is open are also valued at fair value. With respect to foreign (non-U.S.) equity securities, the Fund may determine the fair value of investments based on information provided by Pricing Services and other third-party vendors, which may recommend fair value or adjustments with reference to other securities, indices or assets. In considering whether fair valuation is required and in determining fair values, the Fund may, among other things, consider significant events (which may be considered to include changes in the value of U.S. securities or securities indices) that occur after the close of the relevant market and before the NYSE Close. The Fund may utilize modeling tools provided by third-party vendors to determine fair values of non-U.S. securities. Foreign exchanges may permit trading in foreign (non-U.S.) equity securities on days when the Trust is not open for business, which may result in the Fund s portfolio investments being affected when shareholders are unable to buy or sell shares.

Senior secured floating rate loans for which an active secondary market exists to a reliable degree will be valued at the mean of the last available bid/ask prices in the market for such loans, as provided by a Pricing Service. Senior secured floating rate loans for which an active secondary market does not exist to a reliable degree will be valued at fair value, which is intended to approximate market value. In valuing a senior secured floating rate loan at fair value, the factors considered may include, but are not limited to, the following: (a) the creditworthiness of the borrower and any intermediate participants, (b) the terms of the loan, (c) recent prices in the market for similar loans, if any, and (d) recent prices in the market for instruments of similar quality, rate, period until next interest rate reset and maturity.

Investments valued in currencies other than the U.S. dollar are converted to the U.S. dollar using exchange rates obtained from Pricing Services. As a result, the value of such investments and, in turn, the NAV of the Fund s shares may be affected by changes in the value of currencies in relation to the U.S. dollar. The value of investments traded in markets outside the United States or denominated in currencies other than the U.S. dollar may be affected significantly on a day that the Fund is not open for business. As a result, to the extent that the Fund holds foreign (non-U.S.) investments, the value of those investments may change at times when shareholders are unable to buy or sell shares and the value of such investments will be reflected in the Fund s next calculated NAV.

Investments for which market quotes or market based valuations are not readily available are valued at fair value as determined in good faith by the Board or persons acting at their direction. The Board has adopted methods for valuing securities and other assets in circumstances where market quotes are not readily available, and has delegated to PIMCO the responsibility for applying the fair valuation methods. In the event that market quotes or market based valuations are not readily available, and the security or asset cannot be valued pursuant to a Board approved valuation method, the value of the security or asset will be determined in good faith by the Valuation Oversight Committee of the Board (Valuation Oversight Committee), generally based on recommendations provided by the Manager. Market quotes are considered not readily available in circumstances where there is an absence of current or reliable market-based data (e.g., trade information, bid/ask information, indicative market quotations (Broker Quotes), Pricing Services prices), including where events occur after the close of the relevant market, but prior to the NYSE Close, that materially affect the values of the Fund s securities or assets. In addition, market quotes are considered not readily available when, due to extraordinary circumstances, the exchanges or markets on which the securities trade do not open for trading for the entire day and no other market prices are available. The Board has delegated to the Manager the responsibility for monitoring significant events that may materially affect the values of the Fund s securities or assets and for determining whether the value of the applicable securities or assets should be reevaluated in light of such significant events.

When the Fund uses fair valuation to determine the value of a portfolio security or other asset for purposes of calculating its NAV, such investments will not be priced on the basis of quotes from the primary market in which they are traded, but rather may be priced by another method that the Board or persons acting at their direction believe reflects fair value. Fair valuation may require subjective determinations about the value of a security. While the Fund s policy is intended to result in a calculation of the Fund s NAV that fairly reflects security values as of the time of pricing, the Fund cannot ensure that fair values determined by the Board or persons acting at their direction would accurately reflect the price that the Fund could obtain for a security if it were to dispose of that security as of the time of pricing (for instance, in a forced or distressed sale). The prices used by the Fund may differ from the value that would be realized if the securities were sold.

(b) Fair Value Hierarchy U.S. GAAP describes fair value as the price that the Fund would receive to sell an asset or pay to transfer a liability in an orderly transaction between market participants at the measurement date. It establishes a fair value hierarchy that prioritizes inputs to valuation methods and requires disclosure of the fair value hierarchy, separately for each major category of assets and liabilities, that segregates fair value measurements into levels (Level 1, 2, or 3). The inputs or methodology used for valuing securities are not necessarily an indication of the risks associated with investing in those securities. Levels 1, 2, and 3 of the fair value hierarchy are defined as follows:

Level 1 Quoted prices in active markets or exchanges for identical assets and liabilities.

Level 2 Significant other observable inputs, which may include, but are not limited to, quoted prices for similar assets or liabilities in markets that are active, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the assets or liabilities (such as interest rates, yield curves, volatilities, prepayment speeds, loss severities, credit risks and default rates) or other market corroborated inputs.

Level 3 Significant unobservable inputs based on the best information available in the circumstances, to the extent observable inputs are not available, which may include assumptions made by the Board or persons acting at their direction that are used in determining the fair value of investments.

Assets or liabilities categorized as Level 2 or 3 as of period end have been transferred between Levels 2 and 3 since the prior period due to changes in the method utilized in valuing the investments. Transfers from Level 3 to Level 2 are a result of the availability of current and reliable market-based data provided by Pricing Services or other valuation techniques which utilize significant observable inputs. In accordance with the requirements of U.S. GAAP, the amounts of transfers between Levels 1 and 2 and transfers into and out of Level 3, if material, are disclosed in the Notes to Schedule of Investments for the Fund.

For fair valuations using significant unobservable inputs, U.S. GAAP requires a reconciliation of the beginning to ending balances for reported fair values that presents changes attributable to realized gain (loss), unrealized appreciation (depreciation), purchases and sales, accrued discounts (premiums), and transfers into and out of the Level 3 category during the period. The end of period value is used for the transfers between Levels of the Fund s assets and liabilities. Additionally, U.S. GAAP requires quantitative information regarding the significant unobservable inputs used in the determination of fair value of assets or liabilities categorized as Level 3 in the fair value hierarchy. In accordance with the requirements of U.S. GAAP, a fair value hierarchy, and if material, a Level 3 reconciliation and details of significant unobservable inputs, have been included in the Notes to Schedule of Investments for the Fund.

(c) Valuation Techniques and the Fair Value Hierarchy

Level 1 and Level 2 trading assets and trading liabilities, at fair value The valuation methods (or techniques) and significant inputs used in determining the fair values of portfolio securities or other assets and liabilities categorized as Level 1 and Level 2 of the fair value hierarchy are as follows:

Fixed income securities including corporate, convertible and municipal bonds and notes, U.S. government agencies, U.S. treasury obligations, sovereign issues, bank loans, convertible preferred securities and non-U.S. bonds are normally valued on the basis of quotes obtained from brokers and dealers or Pricing Services that use broker-dealer quotations, reported trades or valuation estimates from their internal pricing models. The Pricing Services internal models use inputs that are observable such as issuer details, interest rates, yield curves, prepayment speeds, credit risks/spreads, default rates and quoted prices for similar assets. Securities that use similar valuation techniques and inputs as described above are categorized as Level 2 of the fair value hierarchy.

Fixed income securities purchased on a delayed-delivery basis or as a repurchase commitment in a sale-buyback transaction are marked to market daily until settlement at the forward settlement date and are categorized as Level 2 of the fair value hierarchy.

Mortgage-related and asset-backed securities are usually issued as separate tranches, or classes, of securities within each deal. These securities are also normally valued by Pricing Services that use broker-dealer quotations, reported trades or valuation estimates from their internal pricing models. The pricing models for these securities usually consider tranche-level attributes, current market data, estimated cash flows and market-based yield spreads for each tranche, and incorporate deal collateral performance, as available. Mortgage-related and asset-backed securities that use similar valuation techniques and inputs as described above are categorized as Level 2 of the fair value hierarchy.

Common stocks, ETFs, exchange-traded notes and financial derivative instruments, such as futures contracts, rights and warrants, or options on futures that are traded on a national securities exchange, are stated at the last reported sale or settlement price on the day of valuation. To the extent these securities are actively traded and valuation adjustments are not applied, they are categorized as Level 1 of the fair value hierarchy.

Valuation adjustments may be applied to certain securities that are solely traded on a foreign exchange to account for the market movement between the close of the foreign market and the NYSE Close. These securities are valued using Pricing Services that consider the correlation of the trading patterns of the foreign security to the intraday trading in the U.S. markets for investments. Securities using these valuation adjustments are categorized as Level 2 of the fair value hierarchy. Preferred securities and other equities traded on inactive markets or valued by reference to similar instruments are also categorized as Level 2 of the fair value hierarchy.

Equity exchange-traded options and over the counter financial derivative instruments, such as forward foreign currency contracts and options contracts derive their value from underlying asset prices, indices, reference rates, and other inputs or a combination of these factors. These contracts are normally valued on the basis of quotes obtained from a quotation reporting system, established market makers or Pricing Services (normally determined as of the NYSE Close). Depending on the product and the terms of the transaction, financial derivative instruments can be valued by Pricing Services using a series of techniques, including simulation pricing models. The pricing models use inputs that are observed from actively quoted markets such as quoted prices, issuer details, indices, bid/ask spreads, interest rates, implied volatilities, yield curves, dividends and exchange rates. Financial derivative instruments that use similar valuation techniques and inputs as described above are categorized as Level 2 of the fair value hierarchy.

Centrally cleared swaps and over the counter swaps derive their value from underlying asset prices, indices, reference rates, and other inputs or a combination of these factors. They are valued using a broker-dealer bid quotation or on market-based prices provided by Pricing Services (normally determined as of the NYSE close). Centrally cleared swaps and over the counter swaps can be valued by Pricing Services using a series of techniques, including simulation pricing models. The pricing models may use inputs that are observed from actively quoted markets such as the overnight index swap rate (OIS), London Interbank Offered Rate (LIBOR) forward rate, interest rates, yield curves and credit spreads. These securities are categorized as Level 2 of the fair value hierarchy.

Level 3 trading assets and trading liabilities, at fair value When a fair valuation method is applied by PIMCO that uses significant unobservable inputs, investments will be priced by a method that the Board or persons acting at their direction believe reflects fair value and are categorized as Level 3 of the fair value hierarchy. The valuation techniques and significant inputs used in determining the fair values of portfolio assets and liabilities categorized as Level 3 of the fair value hierarchy are as follows:

Proxy pricing procedures set the base price of a fixed income security and subsequently adjust the price proportionally to market value changes of a pre-determined security deemed to be comparable in duration, generally a U.S. Treasury or sovereign note based on country of issuance. The base price may be a broker-dealer quote, transaction price, or an internal value as derived by analysis of market data. The base price of the security may be reset on a periodic basis based on the availability of market data and procedures approved by the Valuation Oversight Committee. Significant changes in the unobservable inputs of the proxy pricing process (the base price) would result in direct and proportional changes in the fair value of the security. These securities are categorized as Level 3 of the fair value hierarchy.

If third-party evaluated vendor pricing is not available or not deemed to be indicative of fair value, the Manager may elect to obtain Broker Quotes directly from the broker-dealer or passed through from a third-party vendor. In the event that fair value is based upon a single sourced Broker Quote, these securities are categorized as Level 3 of the fair value hierarchy. Broker Quotes are typically received from established market participants. Although independently received, the Manager does not have the transparency to view the underlying inputs which support the market quotation. Significant changes in the Broker Quote would have direct and proportional changes in the fair value of the security.

Reference instrument valuation estimates fair value by utilizing the correlation of the security to one or more broad-based securities, market indices, and/or other financial instruments, whose pricing information is readily available. Unobservable inputs may include those used in algorithm formulas based on percentage change in the reference instruments and/or weights of each reference instrument. Significant changes in the unobservable inputs would result in direct and proportional changes in the fair value of the security. These securities are categorized as Level 3 of the fair value hierarchy.

Short-term debt instruments (such as commercial paper) having a remaining maturity of 60 days or less may be valued at amortized cost, so long as the amortized cost value of such short-term debt instruments is approximately the same as the fair value of the instrument as determined without the use of amortized cost valuation. These securities are categorized as Level 2 or Level 3 of the fair value hierarchy depending on the source of the base price.

2. FEDERAL INCOME TAX MATTERS

The Fund intends to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code (the Code) and distribute all of its taxable income and net realized gains, if applicable, to shareholders. Accordingly, no provision for Federal income taxes has been made.

The Fund may be subject to local withholding taxes, including those imposed on realized capital gains. Any applicable foreign capital gains tax is accrued daily based upon net unrealized gains, and may be payable following the sale of any applicable investments.

In accordance with U.S. GAAP, the Manager has reviewed the Fund s tax positions for all open tax years. As of September 30, 2017, the Fund has recorded no liability for net unrecognized tax benefits relating to uncertain income tax positions it has taken or expects to take in future tax returns.

The Fund files U.S. federal, state, and local tax returns as required. The Fund s tax returns are subject to examination by relevant tax authorities until expiration of the applicable statute of limitations, which is generally three years after the filing of the tax return but which can be extended to six years in certain circumstances. Tax returns for open years have incorporated no uncertain tax positions that require a provision for income taxes.

As of September 30, 2017, the aggregate cost and the net unrealized appreciation (depreciation) of investments for Federal income tax purposes are as follows (amounts in thousands):

Federal Tax Cost	Aggregate Gross Unrealized Appreciation	Aggregate Gross Unrealized (Depreciation)	Net Unrealized Appreciation/ (Depreciation) [1]
$ 181,927	$ 20,866	$ (10,432)	$ 10,434

[1] *Primary differences, if any, between book and tax net unrealized appreciation (depreciation) are attributable to wash sale loss deferrals for Federal income tax purposes.*

GLOSSARY: (abbreviations that may be used in the preceding statements) (Unaudited)

Counterparty Abbreviations:

BCY	Barclays Capital, Inc.	GLM	Goldman Sachs Bank USA	RBC	Royal Bank of Canada
BPS	BNP Paribas S.A.	GSC	Goldman Sachs & Co.	RDR	RBC Capital Markets
DEU	Deutsche Bank Securities, Inc.	GST	Goldman Sachs International	RTA	Bank of New York Mellon Corp.
DUB	Deutsche Bank AG	JPS	JPMorgan Securities, Inc.	SAL	Citigroup Global Markets, Inc.
FBF	Credit Suisse International	MSC	Morgan Stanley & Co., Inc.	SOG	Societe Generale
FICC	Fixed Income Clearing Corporation	MYC	Morgan Stanley Capital Services, Inc.	UBS	UBS Securities LLC

Currency Abbreviations:

USD (or $)	United States Dollar

Index/Spread Abbreviations:

12MTA	12 Month Treasury Average	COF 11	Cost of Funds - 11th District of San Francisco	US0001M	1 Month USD Swap Rate
7-DayAuc	7 Day Auction Rate	D11COF	Cost of Funds - 11th District of San Francisco	US0003M	3 Month USD Swap Rate
ABX.HE	Asset-Backed Securities Index - Home Equity	LIBOR01M	1 Month USD-LIBOR	US0012M	12 Month USD Swap Rate
CMBX	Commercial Mortgage-Backed Index				

Other Abbreviations:

ABS	Asset-Backed Security	LIBOR	London Interbank Offered Rate	TBA	To-Be-Announced
ALT	Alternate Loan Trust	PIK	Payment-in-Kind	TBD%	Interest rate to be determined when loan settles

Item 2. Controls and Procedures

(a) The principal executive officer and principal financial & accounting officer have concluded that the registrant s disclosure controls and procedures (as defined in Rule 30a-3(c) under the Investment Company Act of 1940, as amended (the 1940 Act) (17 CFR 270.30a-3(c))), are effective based on their evaluation of these controls and procedures as of a date within 90 days of the filing date of this report.

(b) There were no changes in the registrant s internal control over financial reporting (as defined in Rule 30a-3(d) under the 1940 Act (17 CFR 270.30a-3(d))) that occurred during the registrant s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the registrant s internal control over financial reporting.

Item 3. Exhibits

A separate certification for each principal executive officer and principal financial & accounting officer of the registrant as required by Rule 30a-2 under the 1940 Act is attached as Exhibit 99.CERT.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PCM Fund Inc.

By: /s/ Peter G. Strelow
Peter G. Strelow
President (Principal Executive Officer)

Date: November 27, 2017

By: /s/ William G. Galipeau
William G. Galipeau
Treasurer (Principal Financial & Accounting Officer)

Date: November 27, 2017

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Peter G. Strelow
Peter G. Strelow
President (Principal Executive Officer)

Date: November 27, 2017

By: /s/ William G. Galipeau
William G. Galipeau
Treasurer (Principal Financial & Accounting Officer)

Date: November 27, 2017