NEW AMERICA HIGH INCOME FUND INC
Form 497
October 16, 2003

PROSPECTUS

$30,000,000

THE NEW AMERICA HIGH INCOME FUND, INC.

AUCTION TERM PREFERRED STOCK ("ATP")
1,200 SHARES, SERIES C
LIQUIDATION VALUE -- $25,000 PER SHARE

The New America High Income Fund, Inc. (the "Fund") is offering 1,200 shares of ATP Series C at a price per share of $25,000 plus accumulated dividends, if any, (the "newly issued shares of ATP Series C" or "new shares of ATP Series C"), which will increase the number of shares of its ATP Series C Outstanding to 1,800. The Fund currently has Outstanding 1,400 shares of ATP Series A, 1,000 shares of ATP Series B, 600 shares of ATP Series C and 1,000 shares of ATP Series D. Unless otherwise indicated, references to the ATP in this prospectus (the "Prospectus") are to the ATP Series A, ATP Series B, ATP Series C and ATP Series D. The Fund is a diversified, closed-end management investment company with a leveraged capital structure. The Fund's investment objective is to provide high current income, while seeking to preserve stockholders' capital, through investment in a professionally managed, diversified portfolio of "high-yield" fixed-income securities (commonly known as "junk bonds"). The Fund invests primarily in "high-yield" fixed-income securities rated in the lower categories by established rating agencies and non-rated securities deemed by the Fund's investment adviser to be of comparable quality. The Fund cannot ensure that it will achieve its investment objective. AN INVESTMENT IN THE ATP INVOLVES CERTAIN RISKS AND SPECIAL CONSIDERATIONS AND MAY NOT BE APPROPRIATE FOR ALL INVESTORS. SEE "RISK FACTORS AND SPECIAL CONSIDERATIONS" BEGINNING ON PAGE 28 OF THIS PROSPECTUS.

(TEXT CONTINUED ON THE FOLLOWING PAGE.)

This Prospectus sets forth concisely the information about the Fund that a prospective investor should know before investing and should be retained for future reference. A statement of additional information, dated October 14, 2003, (the "Statement of Additional Information") containing additional information regarding the Fund has been filed with the Commission and is hereby incorporated by reference in its entirety into this Prospectus. You may obtain a free copy of the Statement of Additional Information, the table of contents of which appears on page 38 of this Prospectus, by calling the Fund collect at (617) 263-6400 or by writing to the Fund at 33 Broad Street, Boston, Massachusetts 02109. You may also obtain the Statement of Additional Information and other information regarding the Fund on the Commission's website at http://www.sec.gov.

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES OR DETERMINED IF THIS PROSPECTUS IS TRUTHFUL OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	PRICE TO PUBLIC(1)	SALES LOAD(2)	PROCEED
Per Share	$ 25,000	$ 250	$
Total	$ 30,000,000	$ 300,000	$

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(1) PLUS ACCUMULATED DIVIDENDS, IF ANY.
(2) THE FUND AND THE INVESTMENT ADVISER HAVE AGREED TO INDEMNIFY THE UNDERWRITER AGAINST CERTAIN LIABILITIES UNDER THE SECURITIES ACT. SEE "UNDERWRITING."
(3) BEFORE DEDUCTING OFFERING EXPENSES PAYABLE BY THE FUND, ESTIMATED AT $298,427.

The shares of the ATP Series C offered by this Prospectus are offered by Lehman Brothers Inc. ("Lehman" or the "Underwriter"), subject to prior sale, withdrawal, cancellation or modification of the Offering without notice and to certain further conditions. The newly issued shares of ATP Series C will not be offered on any national securities exchange. The Underwriter expects to deliver the shares of newly issued ATP Series C to Broker-Dealers in book entry form through the Securities Depository, on or about October 17, 2003.

LEHMAN BROTHERS

THE DATE OF THIS PROSPECTUS IS OCTOBER 14, 2003.

The dividend rate for the initial Dividend Period for the shares of the ATP Series C issued pursuant to the Offering will be 1.15% per annum. For each Dividend Period following the initial Dividend Period, the dividend rate on the shares of ATP Series C will be the Applicable Rate for such series in effect from time to time as determined, except as described herein, on the basis of Orders placed in an Auction conducted on the Business Day preceding the commencement of such Dividend Period, as set forth herein. The Applicable Rate that results from an Auction for any Dividend Period will not be greater than the Maximum Applicable Rate then in effect.

Dividends on the newly issued shares of ATP Series C shall accumulate at the Applicable Rate from the Date of Original Issue, which is October 17, 2003, and shall be payable on each Dividend Payment Date thereafter. The initial Dividend Period for the newly issued shares of ATP Series C will be four days and the initial Dividend Payment Date will be October 21, 2003. Dividend Periods after the initial Dividend Period for the shares of ATP Series C shall be either Standard Term Periods or, subject to certain conditions and with notice to the holders of shares, periods longer or shorter than 28 days and having such durations as the Board of Directors shall specify (each, an "Alternate Term Period"). The initial Auction Date will be October 20, 2003.

You should rely only on the information contained in or incorporated by reference in this Prospectus. Neither the Fund nor the Underwriter has authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. Neither the Fund nor the Underwriter is making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this Prospectus is accurate as of the date on the front cover of this Prospectus only. The Fund's financial condition and prospects may have changed since that date.

T. Rowe Price Associates, Inc. (the "Investment Adviser" or "T. Rowe Price") serves as the investment adviser for the Fund. It is a wholly owned subsidiary of T. Rowe Price Group, Inc. ("Price Group").

The Fund's address is 33 Broad Street, Boston, Massachusetts 02109 and its

telephone number is (617) 263-6400.

Certain capitalized terms not otherwise defined in this Prospectus have the meanings provided in the Glossary included as part of this Prospectus.

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PROSPECTUS SUMMARY

This summary highlights some information from this Prospectus. It does not contain all of the information that you should consider before investing in the ATP Series C. To understand the Offering fully, you should read the more detailed information contained in this Prospectus and the Statement of Additional Information, especially information set forth under the heading "Risk Factors and Special Considerations."

THE FUND; INVESTMENT OBJECTIVE AND POLICIES

The Fund is a diversified, closed-end management investment company, organized as a Maryland corporation in 1987 and registered under the 1940 Act, with a leveraged capital structure. As of September 30, 2003, the Fund had outstanding 93,528,394 shares of Common Stock, and 4,000 Outstanding shares of Preferred Stock of which 1,400 are classified as ATP Series A, 1,000 are classified as ATP Series B, 600 are classified as ATP Series C and 1,000 are classified as ATP Series D. The Fund's investment objective is to provide high current income, while seeking to preserve stockholders' capital, through investment in a professionally managed, diversified portfolio of "high-yield" fixed-income securities, commonly known as "junk bonds." The Fund will generally invest in securities that are rated below investment grade by recognized rating agencies or that are non-rated. Securities rated below investment grade are considered by rating agencies, on balance, as predominantly speculative with respect to their capacity to pay interest and repay principal in accordance with the terms of the obligation and thus are generally considered to involve greater credit risk than securities in the higher-rating categories. The market values of the lower-quality securities tend to reflect individual corporate developments or negative economic changes to a greater extent than higher-quality securities. Credit ratings do not reflect this market risk. An investment in the Fund involves a number of significant risks, which are magnified due to the Fund's leveraged capital structure. No assurance can be given that the Fund will achieve its investment objective. See "The Fund," "Investment Objective and Policies," and "Risk Factors and Special Considerations."

The Fund has had a leveraged capital structure since it began operation. The Fund is subject to various portfolio diversification and related asset coverage requirements under guidelines established by Moody's and Fitch in connection with such rating agencies' issuance of ratings of Aaa and AAA, respectively, with respect to the Fund's ATP. Compliance with these guidelines limits the Fund's flexibility to invest in certain types of securities that might otherwise be attractive investments, including private placements. See "Rating Agency Guidelines," "Investment Objective and Policies" and "Risk Factors and Special Considerations."

THE OFFERING

The Fund is offering an aggregate of 1,200 newly issued shares of ATP Series C, $1.00 par value, at a price of $25,000 per share plus accumulated dividends, if any. Except for the Date of Original Issue, the initial Dividend Period, the initial Dividend Payment Date and the Applicable Rate for the initial Dividend Period, the terms of the newly issued shares of ATP Series C are the same as the terms of the Fund's currently Outstanding shares of ATP

Series C. The shares offered by this Prospectus represent additional shares of the Fund's existing ATP Series C, rather than a separate series or class of the ATP. Unless otherwise indicated, references to the ATP in this Prospectus are to the ATP Series A, ATP Series B, ATP Series C and ATP Series D. 1,200 shares of ATP Series C are being offered by the Underwriter. Lehman has agreed, subject to the terms and conditions of the Underwriting Agreement with the Fund and the Investment Adviser, to purchase from the Fund all of the shares of ATP Series C offered hereby. See "Underwriting."

RISK FACTORS

An investment in the Fund involves certain risks. Before investing in the new shares of ATP Series C pursuant to the Offering, you should consider all of the risk factors described in the "Risk Factors and Special Considerations" section of this Prospectus. These factors include the risks involved in investing in ATP (including

auction risk, secondary market risk, ratings and asset coverage risk, inflation risk, indebtedness risk and leverage), payment restrictions, the risks associated with swap arrangements, the risks associated with investing in private placement securities and other general risks of investing in the Fund.

TRADING MARKET

The shares of ATP Series C being offered by this Prospectus will not be listed on an exchange. Instead, you may buy or sell the ATP at an Auction that generally is held every 28 days by submitting to a Broker-Dealer by telephone or otherwise a Hold Order, a Hold/Sell Order or a Sell Order and the Broker-Dealer will contact Potential Holders to determine the Buy Orders, if any, to be made by such Potential Holders. The first Auction Date for the ATP Series C will be October 20, 2003. See "Auction Procedures."

The Underwriter has indicated that it intends to make a secondary trading market in the ATP Series C as permitted by applicable laws and regulations. However, the Underwriter is not obligated to make a market in the ATP between Auctions and such market making may be discontinued at any time at the Underwriter's sole discretion. See "Risk Factors and Special Considerations -- Risks of Investing in ATP." If developed, there is no assurance that a secondary market will provide stockholders with liquidity or that the trading price in any secondary market would be $25,000.

You may transfer shares of the ATP outside of an Auction only through a Broker-Dealer, to a person that has delivered a signed Master Purchaser's Letter to the Auction Agent or to the Fund. Lehman will act in Auctions for the ATP Series C as a Broker-Dealer and will be entitled to fees for services as a Broker-Dealer as set forth under "Auction Procedures -- Broker-Dealers; Commissions."

DIVIDENDS AND DIVIDEND PERIODS

"Dividend Periods" are periods of time established by the Fund for each series of the ATP during which dividends will accrue at a determined rate. After the Date of Original Issue, each Dividend Period will be either a "Standard Term Period" (a Dividend Period of 28 days, unless such 28th day is not a Business Day, then the number of days ending on the Business Day next preceding such 28th day) or, subject to certain conditions and with notice to the holders of shares, an "Alternate Term Period" (a period longer or shorter than 28 days and having such durations as the Board of Directors shall specify).

Dividends on the newly issued shares of ATP Series C will accumulate at the Applicable Rate per annum from the Date of Original Issue and will be payable, when, and if declared by the Board of Directors of the Fund out of funds legally available therefor, commencing on October 21, 2003. Thereafter, dividends will accumulate at the Applicable Rate determined from an Auction of the newly issued ATP Series C together with all existing shares of ATP Series C. The initial Dividend Period for the newly issued shares of ATP Series C will be four days at a dividend rate of 1.15% per annum. As noted above, subsequent Dividend Periods generally will be 28 days.

LIQUIDATION PREFERENCE

The liquidation preference for the newly issued shares of ATP Series C will be $25,000 per share plus accumulated and unpaid dividends, if any. See "Description of ATP -- Liquidation Preference."

REDEMPTION

If certain conditions are met, the Fund has the option to redeem some or all outstanding shares of ATP at a redemption price per share equal to their Liquidation Value per share, plus accumulated and unpaid dividends (plus in the case of a Dividend Period of one year or more, a redemption premium as may be determined by the

Board of Directors). For a discussion of these conditions, as well as the method the Fund will use to determine the redemption price, see "Description of ATP -- Optional Redemption."

In addition, if the Fund fails to maintain the Aaa/AAA Credit Rating for the ATP or, on any Valuation Date or the last Business Day of any month, the Fund fails to meet the ATP Basic Maintenance Amount or the 1940 Act ATP Asset Coverage, the Fund is required to redeem shares of ATP. For a further description of these circumstances and the method the Fund will use to determine the shares it must redeem and the redemption price for the shares, see "Description of ATP -- Mandatory Redemption."

RATINGS

It is a condition of the Underwriter's obligation to purchase the newly issued shares of ATP Series C that they will be rated Aaa by Moody's and AAA by Fitch. See "Description of ATP -- Ratings." These ratings are an assessment of the capacity and willingness of an issuer to pay preferred stock obligations. The rating on the ATP is not a recommendation to purchase, hold or sell those shares inasmuch as the rating does not comment as to market price or suitability for a particular investor.

THE INVESTMENT ADVISER

T. Rowe Price was selected by the Fund's Board of Directors to serve as the Fund's investment adviser and has served as the investment adviser since December 2, 2002, pursuant to an investment advisory agreement dated as of that date. T. Rowe Price's principal offices are located at 100 East Pratt Street, Baltimore, Maryland 21202, and its telephone number is (410) 345-2000. As of June 30, 2003, T. Rowe Price and its affiliates managed approximately $161.2 billion of assets, including approximately $52.3 billion of fixed-income securities. "High-yield" investments represented approximately $8.7 billion of these totals. T. Rowe Price has provided investment advisory services to investment companies since 1937. T. Rowe Price is not affiliated with the Fund's officers or its Board of Directors. See "Management of the Fund."

FINANCIAL INFORMATION SUMMARY

FINANCIAL HIGHLIGHTS

The table below sets forth certain financial data for a share of Common Stock outstanding throughout the periods presented. The financial highlights have been derived from the Fund's financial statements which have been audited by the Fund's current independent public accountants, KPMG LLP, for the fiscal year ended December 31, 2002 and by the Fund's former independent public accountants, Arthur Andersen LLP, for the fiscal years ended December 31, 2001, 2000, 1999, 1998, 1997, 1996, 1995, 1994 and 1993, as indicated in their respective reports thereto included with the Fund's audited financial statements. The Financial Highlights for the period commencing January 1, 2003 and concluding June 30, 2003 are unaudited. The following information should be read in conjunction with the financial statements and related notes included therein.

	SIX MONTHS ENDED JUNE 30, 2003 (UNAUDITED)	FOR THE YEARS E
		2002(d)
	(FOR EACH SHARE OF COMMON STOCK OUTSTAND	
NET ASSET VALUE:		
Beginning of period	$ 1.89	$ 2.61
NET INVESTMENT INCOME	.14	.37
NET REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS AND OTHER FINANCIAL INSTRUMENTS	.29	(.72)
DISTRIBUTIONS FROM NET INVESTMENT INCOME RELATED TO PREFERRED STOCK	(.03)	(.08)
TOTAL FROM INVESTMENT OPERATIONS	.40	(.43)
DISTRIBUTIONS TO COMMON SHAREHOLDERS:		
From net investment income	(.10)	(.29)
In excess of net investment income	--	--
TOTAL DISTRIBUTIONS	(.10)	(.29)
Effect of rights offering and related expenses; and Auction Term Preferred Stock offering costs and sales load	--	--
NET ASSET VALUE:		
End of period	$ 2.19	$ 1.89
PER SHARE MARKET VALUE:		
End of period	$ 2.20	$ 2.01
TOTAL INVESTMENT RETURN+	14.57%	(12.97)%
NET ASSETS, END OF PERIOD, APPLICABLE TO COMMON STOCK(a)	$ 153,228	$ 131,170

NET ASSETS, END OF PERIOD, APPLICABLE TO PREFERRED STOCK(a)	$ 100,000	$ 100,000	$
TOTAL NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK, END OF PERIOD(a)	$ 253,228	$ 231,170	$

	FOR THE YEARS ENDED DECEMBER 31,	
	1999	1998(b)
	(FOR EACH SHARE OF COMMON STOCK OUTSTANDING THROUGHOUT THE PERIOD)	
NET ASSET VALUE:		
Beginning of period	$ 4.16	$ 5.03
NET INVESTMENT INCOME	.66	.71#
NET REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS AND OTHER FINANCIAL INSTRUMENTS	(.30)	(.81)#
DISTRIBUTIONS FROM NET INVESTMENT INCOME RELATED TO PREFERRED STOCK	(.18)	(.17)
TOTAL FROM INVESTMENT OPERATIONS	.18	(.27)
DISTRIBUTIONS TO COMMON SHAREHOLDERS:		
From net investment income	(.48)	(.54)
In excess of net investment income	--	--
TOTAL DISTRIBUTIONS	(.48)	(.54)
Effect of rights offering and related expenses; and Auction Term Preferred Stock offering costs and sales load	--	(.06)
NET ASSET VALUE:		
End of period	$ 3.86	$ 4.16
PER SHARE MARKET VALUE:		
End of period	$ 3.13	$ 4.25
TOTAL INVESTMENT RETURN+	(16.92)%	(15.15)%
NET ASSETS, END OF PERIOD, APPLICABLE TO COMMON STOCK(a)	$ 258,215	$ 273,518
NET ASSETS, END OF PERIOD, APPLICABLE TO PREFERRED STOCK(a)	$ 210,000	$ 210,000
TOTAL NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK, END OF PERIOD(a)	$ 468,215	$ 483,518

	SIX MONTHS ENDED JUNE 30, 2003 (UNAUDITED)	FOR THE YEARS E... 2002(d)	2...
	(FOR EACH SHARE OF COMMON STOCK OUTSTAND...		
EXPENSE RATIOS:			
Ratio of interest expense to average net assets*	--	--	
Ratio of preferred and other debt expenses to average net assets*	.17%**	.18%	
Ratio of operating expenses to average net assets*	1.85%**	1.46%	
Ratio of Litigation Settlement Expense to average net assets*	--	--	
RATIO OF TOTAL EXPENSES TO AVERAGE NET ASSETS*	2.02%**	1.64%	
RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS*	13.90%**	16.48%	
RATIO OF TOTAL EXPENSES TO AVERAGE NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK	1.19%**	.89%	
RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK	8.18%**	8.91%	
PORTFOLIO TURNOVER RATE	156.63%**	82.47%	

	FOR THE YEARS ENDED DECEMBER 31, 1999	1998(b)
	(FOR EACH SHARE OF COMMON STOCK OUTSTANDING THROUGHOUT THE PERIOD)	
EXPENSE RATIOS:		
Ratio of interest expense to average net assets*	--	--
Ratio of preferred and other debt expenses to average net assets*	.18%	.14%
Ratio of operating expenses to average net assets*	.89%	.82%
Ratio of Litigation Settlement Expense to average net assets*	--	--
RATIO OF TOTAL EXPENSES TO AVERAGE NET ASSETS*	1.07%	.96%
RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS*	16.36%	15.22%
RATIO OF TOTAL EXPENSES TO AVERAGE NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK	.60%	.58%
RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK	9.16%	9.26%
PORTFOLIO TURNOVER RATE	66.74%	124.67%

	FOR THE YEARS ENDED D		
	1997(b)	1996	1995
	(FOR EACH SHARE OF COMMON STOCK OUTSTAN		
NET ASSET VALUE:			
Beginning of period	$ 4.94	$ 4.71	$ 4.13
NET INVESTMENT INCOME	.70#	.69	.67
NET REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS AND OTHER FINANCIAL INSTRUMENTS	.25#	.22	.62
DISTRIBUTIONS FROM NET INVESTMENT INCOME RELATED TO PREFERRED STOCK	(.16)	(.16)	(.17
TOTAL FROM INVESTMENT OPERATIONS	.79	.75	1.12
DISTRIBUTIONS TO COMMON SHAREHOLDERS:			
From net investment income	(.53)	(.52)	(.50
In excess of net investment income	(.01)	--	(.04
TOTAL DISTRIBUTIONS	(.54)	(.52)	(.54
Effect of rights offering and related expenses; and Auction Term Preferred Stock offering costs and sales load	(.16)	--	--
NET ASSET VALUE:			
End of period	$ 5.03	$ 4.94	$ 4.71
PER SHARE MARKET VALUE:			
End of period	$ 5.63	$ 5.13	$ 4.75
TOTAL INVESTMENT RETURN+	21.97%	19.89%	33.50
NET ASSETS, END OF PERIOD, APPLICABLE TO COMMON STOCK(a)	$ 243,625	$ 176,408	$ 164,823
NET ASSETS, END OF PERIOD, APPLICABLE TO PREFERRED STOCK(a)	$ 150,000	$ 100,000	$ 100,000
TOTAL NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK, END OF PERIOD(a)	$ 393,625	$ 276,408	$ 264,823

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	FOR THE YEARS ENDED D		
	1997(b)	1996	1995
	(FOR EACH SHARE OF COMMON STOCK OUTSTAN		
EXPENSE RATIOS:			
Ratio of interest expense to average net assets*	--	--	--
Ratio of preferred and other debt expenses to			

average net assets*	.13%	.16%	.18
Ratio of operating expenses to average net assets*	.92%	1.16%	1.39
Ratio of Litigation Settlement Expense to average net assets*	--	--	.80
RATIO OF TOTAL EXPENSES TO AVERAGE NET ASSETS*	1.05%	1.32%	2.37
RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS*	13.86%	14.36%	14.61
RATIO OF TOTAL EXPENSES TO AVERAGE NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK	.66%	.83%	1.44
RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS APPLICABLE TO COMMON AND PREFERRED STOCK	8.75%	9.05%	8.90
PORTFOLIO TURNOVER RATE	108.84%	53.45%	62.66

(a) DOLLARS IN THOUSANDS.

(b) THE FUND ISSUED SERIES A AND SERIES B ATP ON JANUARY 4, 1994, SERIES C ATP ON MAY 6, 1997 AND SERIES D ATP ON MAY 20, 1998. THE PER SHARE DATA AND RATIOS FOR THE YEARS ENDED DECEMBER 31, 1994, 1997 AND 1998 REFLECT THESE TRANSACTIONS.

(c) AS REQUIRED, EFFECTIVE JANUARY 1, 2001, THE FUND HAS ADOPTED THE PROVISIONS OF THE AICPA AUDIT AND ACCOUNTING GUIDE FOR INVESTMENT COMPANIES AND BEGAN AMORTIZING DISCOUNT AND PREMIUM ON DEBT SECURITIES. THIS HAD NO EFFECT ON NET INVESTMENT INCOME PER SHARE AND A $0.01 INCREASE TO NET REALIZED AND UNREALIZED LOSS PER SHARE FOR THE YEAR ENDED DECEMBER 31, 2001. THE EFFECT OF THIS CHANGE DID INCREASE THE RATIO OF NET INVESTMENT INCOME TO AVERAGE NET ASSETS FROM 16.29% TO 16.70%. PER SHARE, RATIOS AND SUPPLEMENTAL DATA FOR PERIODS PRIOR TO JANUARY 1, 2001 HAVE NOT BEEN RESTATED TO REFLECT THIS CHANGE IN PRESENTATION.

(d) PRIOR TO THE APPOINTMENT ON DECEMBER 2, 2002 OF T. ROWE PRICE ASSOCIATES, INC. AS THE FUND'S INVESTMENT ADVISER, THE FUND WAS ADVISED BY WELLINGTON MANAGEMENT COMPANY, LLP.

* RATIOS CALCULATED ON THE BASIS OF EXPENSES AND NET INVESTMENT INCOME APPLICABLE TO THE COMMON SHARES RELATIVE TO THE AVERAGE NET ASSETS OF THE COMMON STOCKHOLDERS ONLY. THE EXPENSE RATIO AND NET INVESTMENT INCOME RATIO DO NOT REFLECT THE EFFECT OF DIVIDEND PAYMENTS (INCLUDING NET SWAP SETTLEMENT RECEIPTS/PAYMENTS) TO PREFERRED STOCKHOLDERS.

** ANNUALIZED.

\# CALCULATION IS BASED ON AVERAGE SHARES OUTSTANDING DURING THE INDICATED PERIOD DUE TO THE PER SHARE EFFECT OF THE FUND'S JUNE 1994, MARCH 1997 AND MARCH 1998 RIGHTS OFFERINGS.

\+ TOTAL INVESTMENT RETURN IS CALCULATED ASSUMING A PURCHASE OF COMMON STOCK AT THE CURRENT MARKET VALUE ON THE FIRST DAY AND A SALE AT THE CURRENT MARKET VALUE ON THE LAST DAY OF EACH YEAR REPORTED. DIVIDENDS AND DISTRIBUTIONS ARE ASSUMED FOR PURPOSES OF THIS CALCULATION TO BE REINVESTED AT PRICES OBTAINED UNDER THE DIVIDEND REINVESTMENT PLAN. THIS CALCULATION DOES NOT REFLECT BROKERAGE COMMISSIONS.

CAPITALIZATION AND INFORMATION REGARDING SENIOR SECURITIES

CAPITALIZATION. The following table sets forth the unaudited capitalization of the Fund as of August 31, 2003.

TITLE OF CLASS	AMOUNT AUTHORIZED	AMOUNT HELD BY THE FUND OR FOR ITS ACCOUNT	AMOUNT EXCLUS HELD OR FOR
Preferred Stock, $1.00 par value	1,000,000 shares	-0- shares	4,0
Common Stock, $0.01 par value	200,000,000 shares	-0- shares	93,52

PRO FORMA CAPITALIZATION. The following table of unaudited financial information sets forth the total assets and liabilities of the Fund and the net assets of the Fund as of August 31, 2003 and as adjusted to give effect to the issuance of all of the new shares of ATP Series C, as set forth in the Prospectus.

	ACTUAL
	(IN THOUSAN
Total Assets	$ 310,914
Total Liabilities	16,662
Auction Term Preferred Stock:	
Auction Term Preferred Stock Series A, $1.00 par value, liquidation preference $25,000 per share, 2,400 shares authorized, 1,400 shares issued and outstanding	35,000
Auction Term Preferred Stock Series B, $1.00 par value, liquidation preference $25,000 per share, 1,600 shares authorized, 1,000 shares issued and outstanding	25,000
Auction Term Preferred Stock Series C, $1.00 par value, liquidation preference $25,000 per share, 3,200 shares authorized, 600 shares issued and outstanding, 1,800 shares issued and outstanding as adjusted	15,000
Auction Term Preferred Stock Series D, $1.00 par value, liquidation preference $25,000 per share, 2,400 shares authorized, 1,000 shares issued and outstanding	25,000
Net Assets attributable to Common Stock	$ 194,252
REPRESENTED BY:	
Common Stock, $0.01 par value, 200,000,000 shares authorized, 93,528,394 shares issued and outstanding	$ 935
Capital in excess of par value	382,046
Accumulated net realized loss from securities transactions	(179,933)
Net unrealized depreciation on investments and interest rate swaps	(10,173)
Accumulated undistributed net investment income	1,377
NET ASSETS:	$ 194,252
Net asset value per share of Common Stock	$ 2.08

SENIOR SECURITIES. The following table shows certain information regarding senior securities of the Fund as of the dates indicated. The information has been derived from the Fund's financial statements which have been audited by KPMG LLP, the Fund's current independent public accountants, for the fiscal year ended December 31, 2002, and by Arthur Andersen LLP, the Fund's former independent public accountants, for the fiscal years ended December 31, 2001, 2000, 1999, 1998, 1997, 1996, 1995, 1994 and 1993 as indicated in their respective reports thereto included with the Fund's audited financial statements. The information for the period commencing January 1, 2003 and concluding June 30, 2003 is unaudited. In connection with its initial public offering in February 1988, the Fund issued senior securities consisting of $105 million aggregate principal amount of 9% Senior Extendible Notes ("Notes") and $79 million (aggregate liquidation preference) of Taxable Auction Rate Preferred Stock ("TARPS"), the dividends on which were set in monthly auctions with reference to short-term interest rates. The Fund subsequently repurchased substantial amounts of these securities and by December 31, 1992 had $45.5 million aggregate principal amount of Notes and $35 million (aggregate liquidation preference) of TARPS outstanding. The Notes were refinanced in January 1993 with the proceeds of a credit facility from BankBoston, N.A. (the "Credit Facility") in the aggregate principal amount of $45 million. The Credit Facility was repaid and the outstanding TARPS were redeemed in January 1994 with the proceeds from an offering of two series of newly authorized ATP having an aggregate liquidation preference of $100 million plus accumulated and unpaid dividends. In May 1997 and in May 1998, two additional series of newly authorized ATP, with an aggregate liquidation preference of $50 and $60 million, respectively, plus accumulated and unpaid dividends were issued. See "Description of ATP" and "Financial Statements" in the Statement of Additional Information. In connection with maintaining asset coverage requirements for the ATP, the Fund repurchased $50 million, $10 million, and $50 million of the ATP in fiscal years 2002, 2001, and 2000, respectively.

	SIX MONTHS ENDED JUNE 30, 2003 UNAUDITED	AS OF DECEMBER 31, 2002	2001	2000
TOTAL AMOUNT OUTSTANDING ($'s):				
Preferred Stock	100,000,000	100,000,000	150,000,000	160,0
Short-Term Loan	--	--	--	
ASSET COVERAGE:				
Per Preferred Stock Share(1)	$ 63,307	$ 57,793	$ 54,705	$
Per $1,000 of Short-Term Loan	--	--	--	
INVOLUNTARY LIQUIDATION PREFERENCE:				
Preferred Stock Share(2)	$ 25,000	$ 25,000	$ 25,000	$
APPROXIMATE MARKET VALUE:				
Per Preferred Stock Share(2)	$ 25,000	$ 25,000	$ 25,000	$
Per $1,000 of Short-Term Loan	--	--	--	

	AS OF DECEMBER 31, 1999	1998
TOTAL AMOUNT OUTSTANDING ($'s):		
Preferred Stock	210,000,000	210,000,000
Short-Term Loan	--	--
ASSET COVERAGE:		
Per Preferred Stock Share(1)	$ 55,740	$ 57,562

Per $1,000 of Short-Term Loan	--	--
INVOLUNTARY LIQUIDATION PREFERENCE:		
Preferred Stock Share(2)	$ 25,000	$ 25,000
APPROXIMATE MARKET VALUE:		
Per Preferred Stock Share(2)	$ 25,000	$ 25,000
Per $1,000 of Short-Term Loan	--	--

	AS OF DECEMBER 31,			
	1997	1996	1995	1994
TOTAL AMOUNT OUTSTANDING ($'s):				
Preferred Stock	150,000,000	100,000,000	100,000,000	100,000,00
Short-Term Loan	--	--	--	-
ASSET COVERAGE:				
Per Preferred Stock Share(1)	$ 65,604	$ 69,102	$ 66,206	$ 60,39
Per $1,000 of Short-Term Loan	--	--	--	-
INVOLUNTARY LIQUIDATION PREFERENCE:				
Preferred Stock Share(2)	$ 25,000	$ 25,000	$ 25,000	$ 25,00
APPROXIMATE MARKET VALUE:				
Per Preferred Stock Share(2)	$ 25,000	$ 25,000	$ 25,000	$ 25,00
Per $1,000 of Short-Term Loan	--	--	--	-

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(1) CALCULATED BY SUBTRACTING THE FUND'S TOTAL LIABILITIES (NOT INCLUDING THE PREFERRED STOCK) FROM THE FUND'S TOTAL ASSETS AND DIVIDING SUCH AMOUNT BY THE NUMBER OF PREFERRED SHARES OUTSTANDING.

(2) PLUS ACCUMULATED AND UNPAID DIVIDENDS.

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PORTFOLIO COMPOSITION
(UNAUDITED)

As of September 30, 2003, the Fund's portfolio included 298 holdings issued by 230 different issuers (consolidated by affiliated companies) having an average yield to maturity of 7.85%. The weighted average maturity of the Fund's portfolio as of this date was approximately 7.16 years.

The dollar weighted average of Moody's ratings of all bonds held by the Fund for the twelve-month period ended September 30, 2003, computed on a monthly basis, is set forth below. This information reflects the average composition of the Fund's assets at September 30, 2003 and is not necessarily representative of the Fund as of the date of this Prospectus or at any other time in the future. As of September 30, 2003, the weighted average maturity of the Fund's portfolio was approximately 7.16 years. See the Statement of Additional Information for a description of the ratings system used by Moody's.

MOODY'S RATING	PERCENTAGE OF PORTFOLIO
Aa	0.13%
A	0.09%
Baa	2.26%
Ba	23.26%
B	64.49%

Caa	7.50%
Ca	0.92%
C	0.08%
NR	1.27%

Total	100.00%

THE FUND

The Fund is a diversified, closed-end management investment company with a leveraged capital structure organized as a corporation under the laws of Maryland. T. Rowe Price currently serves as the Fund's investment adviser. The Fund's investment objective is to provide high current income, while seeking to preserve stockholders' capital, through investment in a professionally managed, diversified portfolio of "high-yield" fixed-income securities, commonly known as "junk bonds."

The Fund invests primarily in "high-yield" fixed-income securities rated in the lower categories by established rating agencies, consisting principally of fixed-income securities rated BB or lower by S&P or Ba or lower by Moody's, and, subject to applicable rating agency guidelines (see "Rating Agency Guidelines"), non-rated securities deemed by the Investment Adviser to be of comparable quality. See "Investment Objective and Policies." No assurance can be given that the Fund will achieve its investment objective. See "Risk Factors and Special Considerations." The fixed-income securities in which the Fund invests are regarded by the rating agencies, on balance, as predominately speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. Such securities may also be subject to greater market price fluctuations than lower-yielding, higher-rated debt securities; credit ratings do not reflect this market risk.

On July 21, 2003, the Fund issued to the holders of its Common Stock, transferable rights (the "Rights") to purchase additional shares of Common Stock. As a result of the Rights Offering, 23,397,095 shares of Common Stock were issued on August 22, 2003, resulting in gross proceeds to the Fund of $42,348,741.95. As of September 30, 2003, the Fund had total assets of $308,898,933 and total net assets applicable to Common Stock (aggregate assets less senior securities and Fund liabilities) of $195,951,716. After giving effect to such issuance

of Common Stock, the Fund's capital structure included 93,528,394 shares of Common Stock, 1,400 shares of ATP Series A, 1,000 shares of ATP Series B, 600 shares of ATP Series C and 1,000 shares of ATP Series D.

Effective October 1, 2001, the Fund has entered into a five-year interest payment swap arrangement (the "Swap Arrangement") with Fleet National Bank ("Fleet"). Pursuant to the Swap Arrangement, the Fund makes payments to Fleet on a monthly basis at a fixed annual rate of 4.50%, computed on a notional contract amount of $100 million. In exchange for such payments, Fleet makes payments to the Fund on a monthly basis at a variable rate determined with reference to the level of short-term interest rates from time to time. The aggregate effect of this Swap Arrangement is to hedge the Fund's dividend payment obligations with respect to $100 million of the ATP, 100% of the ATP Outstanding as of September 30, 2003. See "Investment Objective and Policies" and "Description of ATP -- Dividends and Dividend Periods." After giving effect to the issuance of the new shares of ATP Series C, the Swap Arrangement will hedge the Fund's dividend obligations with respect to 77% of the ATP then Outstanding. The Fund makes dividend payments to the holders of the ATP based on the results of

periodic Auctions without regard to the Swap Arrangement. In the event that the Fund fails to satisfy certain asset coverage requirements that give rise to a mandatory redemption of the ATP, the Fund has agreed with Moody's and Fitch that it will terminate the Swap Arrangement to the extent the notional amount of the Swap Arrangement following such redemption would exceed the aggregate liquidation preference of the ATP that would remain Outstanding following such redemption, or in such greater amount as the Fund may determine, subject to deferral to the extent the value of the Swap Arrangement then exceeds a specified benchmark. In light of the proposed increase in the Fund's Outstanding ATP, the Fund will consider adjustments in the Swap Arrangement. The timing and amount of any such adjustment will depend upon market conditions.

The Fund is registered under the 1940 Act and was organized as a corporation under the laws of the State of Maryland on November 19, 1987. The Fund's address is 33 Broad Street, Boston, Massachusetts 02109, and its telephone number is (617) 263-6400. The Investment Adviser's address is 100 East Pratt Street, Baltimore, Maryland 21202, and its telephone number is (410) 345-2000.

USE OF PROCEEDS

The Fund anticipates investing substantially all of the net proceeds from the Offering in accordance with the Fund's investment objective and policies described below. See "Investment Objective and Policies." The net proceeds from the sale of the newly issued shares of ATP Series C offered hereby are estimated to be approximately $29,401,573 (after deducting sales load and estimated offering expenses of approximately $598,427). The Fund currently anticipates that investment of such net proceeds in accordance with the Fund's investment objective and policies will take up to eight weeks from their receipt by the Fund, depending on market conditions and the availability of appropriate securities, but in no event will such investment take longer than six months. Pending such investment in accordance with the Fund's investment objective and policies, the proceeds will be held in high-quality, short-term money market instruments.

DESCRIPTION OF ATP

GENERAL

The following is a brief description of the terms of the ATP. This description does not purport to be complete and is subject to qualification in its entirety by reference to the Articles which establish and fix the rights and preferences of the newly issued shares of ATP Series C. A copy of the Articles, including a form of the Articles Supplementary establishing the newly issued ATP Series C, are filed as exhibits and are incorporated by reference to the Registration Statement of which this Prospectus is a part and may be inspected and copies thereof may be obtained as described under "Additional Information."

Pursuant to the Articles, the Fund is authorized to issue 1,000,000 shares of Preferred Stock in one or more series. The Fund previously issued 1,200 shares of ATP Series A and 800 shares of ATP Series B in January 1994 (which subsequently increased to 2,400 shares of ATP Series A and 1,600 shares of ATP Series B pursuant to a stock split), 2,000 shares of ATP Series C in May 1997 and 2,400 shares of ATP Series D in May 1998. In connection with maintaining asset coverage requirements for the ATP, the Fund repurchased $50 million, $10 million, and $50 million of the ATP in fiscal years 2002, 2001, and 2000, respectively. The Fund is offering an additional 1,200 shares of ATP Series C at a price per share of $25,000 plus accumulated dividends thereon, if any. At September 30, 2003, there were 4,000 Outstanding shares of Preferred Stock of

which 1,400 are classified as ATP Series A, 1,000 are classified as ATP Series B, 600 are classified as ATP Series C and 1,000 are classified as ATP Series D.

The Liquidation Value is currently $25,000 with respect to the ATP Series A, Series B, Series C and Series D.

DIVIDENDS AND DIVIDEND PERIODS

With respect to the newly issued shares of ATP Series C, the initial Applicable Rate and the first Auction Date for the initial Dividend Period will be as set forth on the inside cover page of this Prospectus. For each subsequent Dividend Period, subject to certain exceptions, the dividend rate will be the Applicable Rate that the Auction Agent advises the Fund has resulted from an Auction. See "Description of ATP -- Dividends and Dividend Periods" in the Statement of Additional Information. During the Standard Term Period for ATP, Series A (September 30, 2003 to October 27, 2003), Series B (September 16, 2003 to October 13, 2003), Series C (September 23, 2003 to October 20, 2003), and Series D (September 9, 2003 to October 6, 2003), dividends were paid at an annual rate of 1.15%, 1.12%, 1.15% and 1.12%, respectively. The annual return on the Fund's portfolio needed to cover dividend payments on the ATP at the current rate is 0.39% calculated as of September 30, 2003. The annual return on the Fund's portfolio needed to cover total leverage related expenses is 1.62% calculated as of September 30, 2003.

The initial Dividend Period for the newly issued shares of ATP Series C shall be four days. Dividend Periods after the initial Dividend Period shall be either Standard Term Periods or, subject to certain conditions and with notice to holders, Alternate Term Periods (periods longer or shorter than 28 days and having such duration as the Board of Directors shall specify). An Alternate Term Period will not be effective unless, among other things, Sufficient Clearing Orders exist at the Auction in respect of such Alternate Term Period (that is, in general, the number of shares of ATP subject to Buy Orders by Potential Holders is at least equal to the number of shares subject to Sell Orders by Existing Holders). If Sufficient Clearing Orders do not exist at any Auction in respect of an Alternate Term Period, the Dividend Period commencing on the Business Day succeeding such Auction will be a Standard Term Period and the holders of the shares of the affected series will be required to continue to hold such shares for such Standard Term Period.

Dividends will accumulate at the Applicable Rate from the Date of Original Issue and shall be payable on each Dividend Payment Date thereafter. For Dividend Periods of one year or less, Dividend Payment Dates shall occur on the Business Day next succeeding the last day of such Dividend Period and, if any, on the 91st, 181st and 271st days thereof. For Dividend Periods of more than one year, Dividend Payment Dates shall occur on a quarterly basis on each January 1, April 1, July 1 and October 1 within such Dividend Period and on the Business Day following the last day of such Dividend Period. Dividends will be paid through the Securities Depository (the Depository Trust Company or a successor securities depository) on each Dividend Payment Date. See "Description of ATP -- Dividends and Dividend Periods" in the Statement of Additional Information. The Securities Depository's current procedures provide for it to distribute dividends in same-day funds to Agent Members who are in turn expected to distribute such dividends to the persons for whom they are acting as agents.

Except during a Default Period as described below, the Applicable Rate resulting from an Auction will not be greater than the Maximum Applicable Rate, which is equal to 150% of the applicable AA Composite Commercial Paper Rate (for a Dividend Period of fewer than 184 days) or the applicable Treasury Index Rate (for a Dividend

Period of 184 days or more, (each, a "Reference Rate")), in each case subject to upward but not downward adjustment in the discretion of the Board of Directors after consultation with the Broker-Dealers, provided that immediately following any such increase the Fund would be in compliance with the ATP Basic Maintenance Amount.

The Maximum Applicable Rate for the shares of ATP will apply automatically following an Auction for such shares in which Sufficient Clearing Orders have not been made (other than because all shares of ATP were the subject of Submitted Hold Orders) or following the failure to hold an Auction for any reason on the Auction Date scheduled to occur (except for circumstances in which the dividend rate is the Default Rate, as described below).

While any shares of ATP are Outstanding, the Fund generally may not (subject to certain exceptions) declare, pay or set apart for payment any dividend or other distribution in respect to Common Stock or any other shares of the Fund ranking junior to or on a parity with the ATP as to dividends or upon liquidation, or call for redemption, redeem, purchase or otherwise acquire for consideration any Common Stock or any other such junior shares or any such parity shares unless certain conditions have been satisfied. These conditions include the following: (i) immediately thereafter the Fund would have Eligible Assets with an aggregate Discounted Value at least equal to the ATP Basic Maintenance Amount and the 1940 Act ATP Asset Coverage would be achieved, (ii) full cumulative dividends on the ATP due on or prior to the date of the transaction have been declared and paid, and (iii) the Fund has redeemed the full number of shares of ATP required to be redeemed by any provision for mandatory redemption contained in the Articles. See "Description of ATP -- Dividends and Dividend Periods" in the Statement of Additional Information.

DEFAULT PERIOD

A Default Period will commence if the Fund fails to (i) declare in a timely manner the full amount of any dividend due on any Dividend Payment Date, (ii) pay in a timely manner to the Auction Agent the full amount of any dividends due on the ATP or the redemption price for any shares of ATP called for redemption, and such failure is not cured in a timely manner, or (iii) maintain the Aaa/AAA Credit Rating unless such failure is cured by the Dividend Payment Date next following the date of such failure. The Applicable Rate for a Default Period, including any Dividend Period commencing during a Default Period, will be the Default Rate. The Default Rate is the Reference Rate multiplied by three. Holders of two-thirds of the Outstanding shares of ATP, acting collectively, or the ATP Series C, acting as a separate series, may waive any dividend default, redemption default or rating default.

The Minimum Applicable Rate will apply automatically following an Auction in respect of a Dividend Period of 93 days or fewer in which all of the Outstanding shares are subject to (or are deemed to be subject to) Submitted Hold Orders. The Minimum Applicable Rate is 80% of the applicable AA Composite Commercial Paper Rate. No minimum rate is specified for Auctions in respect of Dividend Periods of more than 93 days.

Prior to each Auction, Broker-Dealers will notify holders of the ATP of the term of the next succeeding Dividend Period as soon as practicable after the Broker-Dealers have been so advised by the Fund. After each Auction, on the Auction Date, Broker-Dealers will notify holders of the Applicable Rate for the next succeeding Dividend Period and of the Auction Date of the next succeeding Auction.

The Fund may enter into transactions such as swaps, caps, collars and floors with the purpose of hedging its dividend payment obligations with respect to the ATP. See "The Fund" and "Investment Objective and Policies -- Certain

Investment Practices" in the Statement of Additional Information.

NOTIFICATION OF DIVIDEND PERIOD

The Fund will designate the duration of Dividend Periods of ATP Series C; provided, however, that no such designation is necessary for a Standard Term Period and such designation shall be effective only if (i) notice thereof shall have been given as provided herein, (ii) any failure to pay in a timely manner to the Auction Agent the full

amount of any dividend on, or the redemption price of, the ATP shall have been cured as set forth above, (iii) Sufficient Clearing Orders shall have existed in the Auction held on the Auction Date immediately preceding the first day of any proposed Alternate Term Period, (iv) if the Fund shall have mailed a notice of redemption with respect to any shares, as described under "Description of ATP -- Redemption" in the Statement of Additional Information, the Redemption Price with respect to such shares shall have been deposited with the Paying Agent, and (v) the Fund has confirmed that as of the Auction Date next preceding the first day of such Alternate Term Period, it has Eligible Assets with an aggregate Discounted Value at least equal to the ATP Basic Maintenance Amount, and has consulted with the Broker-Dealers and has provided notice and an ATP Basic Maintenance Certificate to Moody's (if Moody's is then rating the ATP), Fitch (if Fitch is then rating the ATP) and any Other Rating Agency which is then rating the ATP and so requires.

If the Fund proposes to designate any Alternate Term Period following the Date of Original Issue, generally not less than three Business Days nor more than 30 days prior to the first day of such Alternate Term Period, notice shall be (A) made by press release and (B) communicated by the Fund by telephonic or other means to the Auction Agent and confirmed in writing promptly thereafter. Each such notice shall state (x) that the Fund proposes to exercise its option to designate a succeeding Alternate Term Period, specifying the first and last days thereof and (y) that the Fund will by 3:00 p.m., New York City time, on the second Business Day next preceding the first day of such Alternate Term Period, notify the Auction Agent, who will promptly notify the Broker-Dealers, of either (X) its determination, subject to certain conditions, to proceed with such Alternate Term Period, subject to the terms of any Specific Redemption Provisions, or (Y) its determination not to proceed with such Alternate Term Period, in which latter event the succeeding Dividend Period shall be a Standard Term Period.

No later than 3:00 p.m., New York City time, on the second Business Day next preceding the first day of any proposed Alternate Term Period, the Fund shall deliver to the Auction Agent, who will promptly deliver to the Broker-Dealers and Existing Holders, either:

(i) a notice stating that (A) the Fund has determined to designate the next succeeding Dividend Period as an Alternate Term Period, specifying the first and last days thereof and (B) the terms of any Specific Redemption Provisions; or

(ii) a notice stating that the Fund has determined not to exercise its option to designate an Alternate Term Period.

If the Fund fails to deliver either such notice with respect to any designation of any proposed Alternate Term Period to the Auction Agent or is unable to make the confirmation pursuant to clause (v) above by 3:00 p.m., New York City time, on the second Business Day next preceding the first day of such proposed Alternate Term Period, the Fund shall be deemed to have delivered

a notice to the Auction Agent with respect to such Dividend Period to the effect set forth in clause (ii) above, thereby resulting in a Standard Term Period.

Notwithstanding the foregoing, the Fund may designate the succeeding Dividend Period as an Alternate Term Period on the second Business Day next preceding the first day of such succeeding Dividend Period by giving notice as contemplated by clause (i) above and by issuing a press release containing the information in such notice.

If the Fund is unable to make the confirmation pursuant to clause (v) above by 3:00 p.m., New York City time, on the second Business Day next preceding the first day of such Alternate Term Period, the Fund shall deliver a notice to the Auction Agent that the Fund has been unable to make such confirmation and that such Dividend Period will be a Standard Term Period.

MANDATORY REDEMPTION

If the Fund fails to maintain, as of any Valuation Date, Eligible Assets with an aggregate Discounted Value at least equal to the ATP Basic Maintenance Amount, or as of the last Business Day of any month, the 1940 Act ATP Asset Coverage, and such failure is not cured within two Business Days following such Valuation Date in the case of a failure to maintain the ATP Basic Maintenance Amount as of such Valuation Date or the last Business Day of the following month in the case of a failure to maintain 1940 Act ATP Asset Coverage as of such last Business Day, the ATP will be subject to mandatory redemption out of funds legally available therefor to the extent necessary to result in the Fund having sufficient Eligible Assets or to restore the 1940 Act ATP Asset Coverage, as the case may be. If the Fund at any time fails to maintain the Aaa/AAA Credit Rating and the Fund is unable to restore the Aaa/AAA Credit Rating within 90 calendar days thereafter, all shares of ATP will be subject to mandatory redemption out of funds legally available therefor. To maintain the Aaa/AAA Credit Rating, the Fund must maintain a rating for the ATP in the highest rating category from any two nationally recognized statistical rating organizations (as used in the rules and regulations of the Exchange Act), one of which must be Moody's or S&P. The ATP will be rated by Moody's and Fitch on the Date of Original Issue, although the Fund reserves the right to obtain a rating or ratings from additional and/or substitute rating agencies, subject to the preceding sentence.

The redemption price in the event of a mandatory redemption of a share of ATP will be the Liquidation Value of such share, plus an amount equal to accumulated but unpaid dividends thereon (whether or not earned or declared) to the date fixed for redemption plus (in the case of a Dividend Period of not less than one year only) any redemption premium specified in any Specific Redemption Provisions. In the event any mandatory redemption is required, the particular shares to be redeemed shall be selected by the Fund by lot, on a pro rata basis between each series or by such other method as the Fund shall deem fair and equitable, subject to the terms of any Specific Redemption Provisions. The Fund's ability to make a mandatory redemption may be limited by the provisions of the 1940 Act or Maryland law. See "Description of ATP -- Redemption" in the Statement of Additional Information. Shares of ATP may be subject to mandatory redemption in accordance with the foregoing mandatory redemption provisions notwithstanding the terms of any Specific Redemption Provisions.

OPTIONAL REDEMPTION

To the extent permitted under the 1940 Act and Maryland Law, the Fund at

its option may redeem shares of ATP having a Dividend Period of less than one year, in whole or in part, on the Business Day after the last day of such Dividend Period upon not less than 15 days and not more than 40 days' prior notice. The optional redemption price per share shall be the Liquidation Value, plus an amount equal to accumulated but unpaid dividends thereon (whether or not earned or declared) to the date fixed for redemption. Shares of ATP having a Dividend Period of more than one year may be redeemable at the option of the Fund prior to the end of the relevant Dividend Period, subject to any Specific Redemption Provisions, which may include the payment of redemption premiums to the extent required under any applicable Specific Redemption Provisions. The Fund shall not effect any optional redemption unless after giving effect thereto the Fund would have Eligible Assets with an aggregate Discounted Value at least equal to the ATP Basic Maintenance Amount. See "Description of ATP -- Redemption" in the Statement of Additional Information.

The Fund also reserves the right to repurchase ATP in market or other transactions from time to time in accordance with applicable law and at a price that may be more or less than the applicable Liquidation Value, but is under no obligation to do so.

RATINGS

It is a condition of the Underwriter's obligation to purchase the newly issued shares of ATP Series C offered in the Offering that the Fund obtain the Aaa/AAA Credit Rating

from Moody's and Fitch for the newly issued shares of ATP Series C on the Date of Original Issue. While there is no assurance that the Aaa/AAA Credit Rating with respect to the newly issued shares of ATP Series C will not be changed, suspended or withdrawn, the Fund will endeavor to maintain such rating and any failure to maintain such rating would, subject to cure and certain exceptions, result in mandatory redemption of the ATP. See "Mandatory Redemption" above. While the Fund does not presently intend to seek a rating from a rating agency other than Moody's and Fitch, it reserves the right to do so.

ASSET MAINTENANCE

Under the Fund's Articles, the Fund must maintain (i) as of each Valuation Date, Eligible Assets having, in the aggregate, a Discounted Value at least equal to the ATP Basic Maintenance Amount, and (ii) as of the last Business Day of each month, 1940 Act ATP Asset Coverage of at least 200%. See "Description of ATP -- Asset-Maintenance" in the Statement of Additional Information.

The Discount Factors and guidelines for calculating the Discounted Value of the Fund's portfolio for purposes of determining whether the ATP Basic Maintenance Amount has been satisfied have been established by Moody's and Fitch in connection with the Fund's receipt from Moody's and Fitch of the Aaa/AAA Credit Rating with respect to the newly issued shares of ATP Series C on their Date of Original Issue. See "Rating Agency Guidelines" in the Statement of Additional Information. Additional Discount Factors and guidelines for calculating the discounted value of investment company portfolios have been established by other rating agencies, such as S&P. Such guidelines, which are similar but not identical to those established by Moody's and Fitch, as well as various other covenants and tests such as liquidity tests, would apply in the event the Fund determined to seek (and was successful in obtaining) a rating from one or more of such agencies with respect to the ATP.

The Fund estimates that on the Date of Original Issue of the newly issued shares of ATP Series C, based on the composition of its portfolio as of September 30, 2003, the 1940 Act ATP Asset Coverage, after giving effect to the issuance of the new shares of ATP Series C ($30 million), and the deduction of sales load and estimated offering expenses for such shares ($598,427), will be 250%.

LIQUIDATION PREFERENCE

Upon a liquidation of the Fund, whether voluntary or involuntary, the holders of ATP then Outstanding will be entitled to receive and to be paid out of the assets of the Fund available for distribution to its stockholders, before any payment or distribution shall be made on the Common Stock or on any other class of shares ranking junior to the ATP upon liquidation, an amount equal to the liquidation preference with respect to the ATP. The liquidation preference shall be Liquidation Value plus an amount equal to accumulated but unpaid dividends thereon (whether or not earned or declared) to the date payment of such distribution is made in full or a sum sufficient for the payment thereof is set apart with the Paying Agent; no redemption premium shall be paid upon any liquidation even if such redemption premium would be paid upon optional or mandatory redemption of the relevant shares. After the payment to the holders of ATP of the full preferential amounts provided for as described herein, the holders of ATP as such shall have no right or claim to any of the remaining assets of the Fund. See "Description of ATP -- Liquidation" in the Statement of Additional Information.

Neither a consolidation or merger of the Fund with or into any other company or companies, nor a sale, lease or exchange of all or substantially all of the assets of the Fund in consideration for the issuance of equity securities of another company (unless there is a material adverse affect on any designation, right, preference or limitation of the ATP or any shares issuable in exchange for shares of ATP in any such consolidation or merger), will be deemed to be a liquidation, whether voluntary or involuntary, for the purposes of the foregoing paragraph.

VOTING RIGHTS

Except as otherwise indicated herein or as otherwise required by applicable law, holders of the ATP will have equal voting rights with holders of Common Stock (one vote per share) and will vote together with holders of Common Stock as a single class. The 1940 Act requires that the holders of shares of ATP, voting as a separate class, have the right to elect at least two directors at all times and to elect a majority of the directors at any time two years' dividends on any shares of ATP are unpaid. The holders of shares of ATP will vote as a separate class on certain other matters as required under the Articles or applicable law. In addition, to the extent permitted by the 1940 Act, each series of ATP may vote as a separate series in certain circumstances. See "Management of the Fund -- Board of Directors" and "Description of ATP -- Voting Rights" in the Statement of Additional Information.

AUCTION PROCEDURES

DIVIDEND RATES AND AUCTION DATES

The dividend rate for each Dividend Period will be determined on the Auction Date in respect of such Dividend Period. If Sufficient Clearing Orders exist for an Auction, the dividend rate for the ensuing Dividend Period will be the Winning Rate, or, if all shares in an Auction are the subject of Submitted

Hold Orders in respect of a Dividend Period of 93 days or fewer, the Minimum Applicable Rate. If Sufficient Clearing Orders do not exist for any Auction, the ensuing Dividend Period will be a Standard Term Period and the dividend rate for that Dividend Period will be the Maximum Applicable Rate. Except in the case of a default as described above or where all shares of the ATP are subject to Submitted Hold Orders, if there is no Auction on any Auction Date, the next Dividend Period will be a Standard Term Period, and the dividend rate will be the Maximum Applicable Rate that could have resulted from an Auction in respect of a Standard Term Period on such Auction Date. The Fund is obligated to exercise its best efforts to maintain an Auction Agent.

ORDERS BY EXISTING HOLDERS AND POTENTIAL HOLDERS

On or prior to each Auction Date and prior to the Submission Deadline (initially 1:00 p.m., New York City time), each Existing Holder, with respect to shares it then holds, may submit to a Broker-Dealer by telephone or otherwise a Hold Order, a Hold/Sell Order or a Sell Order and each Broker-Dealer will contact Potential Holders to determine the Buy Orders, if any, to be made by such Potential Holders.

SUBMISSION OF ORDERS TO AUCTION AGENT

Each Order must be submitted in writing by a Broker-Dealer to the Auction Agent prior to the Submission Deadline on each Auction Date for the Auction to be conducted on such Auction Date and must specify (A) the aggregate number of shares that are the subject of such Order, (B) to the extent that such Orders are placed by an Existing Holder, the number of shares, if any, subject to any Hold Order, Hold/Sell Order or Sell Order, and (C) the rate, if any, specified in each Order.

If any rate specified in any Order contains more than three figures to the right of the decimal point, the Auction Agent will round such rate up to the next higher one thousandth of 1%.

Only in the case of an Auction preceding a Dividend Period of 93 days or fewer and following a Dividend Period of 93 days or fewer, if an Order or Orders covering all shares held by any Existing Holder are not submitted to the Auction Agent by the Submission Deadline, the Auction Agent will deem a Hold Order to have been submitted on behalf of such Existing Holder covering the number of shares held by such Existing Holder and not subject to Orders submitted to the Auction Agent. In the case of all other Auctions, if a Hold/Sell or Sell Order or Orders covering all shares held by any Existing Holder are not submitted to the Auction Agent by the Submission Deadline, the Auction Agent will deem a Sell Order to have been submitted on behalf of such

Existing Holder covering the number of shares held by such Existing Holder and not subject to Orders submitted to the Auction Agent.

If one or more Orders covering in the aggregate more than the number of shares of ATP held by an Existing Holder are submitted to the Auction Agent, such Orders will be valid in accordance with the Validity Procedures.

If more than one Order is submitted on behalf of any Existing Holder or Potential Holder, each Order submitted will be a separate Order.

In the case of any Dividend Period of 93 days or fewer, if any rate specified in any Order is lower than the Minimum Applicable Rate for the Dividend Period with respect to which such Order is made, such Order will be deemed to be an Order specifying a rate equal to such Minimum Applicable Rate.

In the case of any Dividend Period of more than 93 days, only Buy Orders, Hold/Sell Orders or Sell Orders may be submitted and Hold Orders may not be submitted.

DETERMINATION OF SUFFICIENT CLEARING ORDERS AND APPLICABLE RATE

Not earlier than the Submission Deadline, on each Auction Date, the Auction Agent will assemble all Submitted Orders and will determine whether Sufficient Clearing Orders exist and the Applicable Rate.

ACCEPTANCE OF ORDERS AND ALLOCATION OF SHARES

Based upon the results of the Auction, the Auction Agent will determine the aggregate number of shares to be held and sold by Existing Holders and to be purchased by Potential Holders, and, with respect to each Broker-Dealer, determine the extent to which such Broker-Dealer will deliver, and from which other Broker-Dealers such Broker-Dealer will receive, shares.

If Sufficient Clearing Orders exist, subject to the Rounding Procedures:

(i) all Submitted Hold Orders will be accepted;

(ii) all Submitted Sell Orders will be accepted and all Submitted Hold/Sell Orders specifying any rate higher than the Winning Rate will be accepted as Sell Orders;

(iii) all Submitted Hold/Sell Orders specifying a rate lower than the Winning Rate will be accepted as Hold Orders;

(iv) all Submitted Buy Orders specifying a rate lower than the Winning Rate will be accepted;

(v) all Submitted Hold/Sell Orders specifying a rate equal to the Winning Rate will be accepted as Hold Orders unless the number of shares subject to all such Submitted Hold/Sell Orders is greater than the number of shares remaining unaccounted for after the acceptances described in clauses (i), (iii), and (iv) above, in which event each such Submitted Hold/Sell Order will be accepted as a Hold Order and a Sell Order as to the respective number of shares determined in accordance with the Proration Procedures; and

(vi) all Submitted Buy Orders specifying a rate equal to the Winning Rate will be accepted, unless the number of shares subject to all such Submitted Buy Orders is greater than the number of shares remaining unaccounted for after the acceptances described in clauses (i), (iii), (iv) and (v) above, in

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which event each such Submitted Buy Order will be accepted only as to the number of shares determined in accordance with the Proration Procedures.

If Sufficient Clearing Orders do not exist, subject to the, Rounding Procedures:

(i) all Submitted Hold Orders will be accepted;

(ii) all Submitted Hold/Sell Orders specifying a rate equal to or lower than the Maximum Applicable Rate will be accepted as Hold Orders;

(iii) all Submitted Buy Orders specifying a rate equal to or lower than the Maximum Applicable Rate will be accepted; and

(iv) all Submitted Hold/Sell Orders specifying a rate higher than the Maximum Applicable Rate and all Submitted Sell Orders will be accepted as Hold Orders and as Sell Orders as to the respective number of shares of ATP determined in accordance with the Proration Procedures.

NOTIFICATION OF RESULTS; SETTLEMENT

The Auction Agent will advise each Broker-Dealer that submitted an Order whether such Order was accepted, and of the Applicable Rate for the next Dividend Period by telephone by approximately 3:00 p.m., New York City time, on each Auction Date. Each Broker-Dealer that submitted an Order will as soon as practicable advise each Existing Holder and Potential Holder whether its Order was accepted and will confirm in writing purchases and sales with each Existing Holder and Potential Holder purchasing or selling shares as a result of an Auction as soon as practicable on the Business Day next succeeding the Auction Date. Each Broker-Dealer that submitted a Hold Order will advise each Existing Holder on whose behalf such Hold Order was submitted of the Applicable Rate for the shares of ATP for the next Dividend Period.

In accordance with the Securities Depository's normal procedures, on the Business Day after the Auction Date, the transactions described above will be executed through the Securities Depository and the accounts of the respective Agent Members at the Securities Depository will be debited and credited and shares delivered as necessary to effect the purchases and sales as determined in the Auction. Purchasers will make payment through their Agent Members in same-day funds to the Securities Depository against delivery through their Agent Members; the Securities Depository will make payment in accordance with its normal procedures, which now provide for payment against delivery to their Agent Members in same-day funds.

If any Existing Holder selling shares in an Auction fails to deliver such shares, the Broker-Dealer of any person that was to have purchased shares in such Auction may deliver to such person a number of whole shares that is less than the number of shares that otherwise was to be purchased by such person. In such event, the number of shares to be so delivered shall be determined by such Broker-Dealer. Delivery of such lesser number of shares shall constitute good delivery.

BROKER-DEALERS; COMMISSIONS

The Fund may request the Auction Agent to terminate one or more Broker-Dealer Agreements at any time, provided that at least one Broker-Dealer Agreement is in effect after any such termination.

A Broker-Dealer may acquire shares for its own account. If a Broker-Dealer submits an Order for its own account in an Auction, it may have an advantage over others because it would have knowledge of other Orders placed through it in that Auction.

Lehman currently serves as the Broker-Dealer for the ATP Series C and intends to serve as the Broker-Dealer for the newly issued shares of ATP Series C. Other firms may serve as Broker-Dealers in connection with Auctions, although there is no assurance that they will do so.

The Auction Agent after each Auction will pay to the Broker-Dealer, from funds provided by the Fund, a service charge at an annual rate of .25 of 1% in the case of any Auction immediately preceding a Dividend Period of less than one year and, in the case of Dividend Periods of one year or more, a percentage agreed upon between the Fund and the Broker-Dealer, of the purchase price of shares placed by the Broker-Dealer at such Auction. For purposes of this paragraph, shares will be placed by a Broker-Dealer if such shares were the subject of (i) Hold Orders deemed to have been made by Existing Holders and were acquired by such Existing Holders through the Broker-Dealer or (ii) an Order submitted by the Broker-Dealer that is (A) an Order of an Existing Holder that resulted in such Existing Holder continuing to hold such shares as a result of the Auction or (B) an Order of a Potential Holder that resulted in such Potential Holder purchasing such shares as a result of the Auction or (C) a valid Hold Order. In the event an Auction scheduled to occur on an Auction Date fails to occur for any reason, a Broker-Dealer will be entitled to service charges as if the Auction had occurred and all holders of shares placed by them had submitted valid Hold Orders.

THE AUCTION AGENT

Deutsche Bank Trust Company Americas, as successor to Bankers Trust Company, serves as Auction Agent with respect to the ATP and intends to serve as the Auction Agent for the newly issued shares of ATP Series C. The Auction Agent is acting solely as agent of the Fund and is not a trustee for holders of the newly issued shares of ATP Series C. In the absence of bad faith or gross negligence on its part, the Auction Agent will not be liable to the Fund for any action taken, suffered or omitted or for any error of judgment made by it in the performance of its duties as Auction Agent.

The Auction Agent may resign upon notice to the Fund, such resignation to be effective on the earlier of (i) the 90th day after the delivery of such notice and (ii) the date on which a successor Auction Agent is appointed by the Fund. The Fund may also replace the Auction Agent.

MASTER PURCHASER'S LETTER

Each prospective purchaser of shares of ATP Series C or its Broker-Dealer will be required to sign and deliver to the Auction Agent, as a condition to such purchaser's purchasing shares of ATP in any Auction or otherwise, a Master Purchaser's Letter, the form of which is attached as Appendix A to this Prospectus, in which such prospective purchaser or its Broker-Dealer will agree, among other things:

(a) to participate in Auctions for shares of ATP in accordance with the Auction Procedures described in this Prospectus;

(b) to sell, transfer or otherwise dispose of shares of ATP only pursuant to a bid or a Sell Order in an Auction, or to or through a Broker-Dealer or to a person that has delivered a signed Master Purchaser's Letter to the Auction Agent, provided that in the case of all transfers other than those pursuant to Auctions, the Existing Holder of the shares so transferred, its Agent Member or its Broker-Dealer advises the Auction Agent of such transfer; and

(c) to have the ownership of the shares of ATP as to which such purchaser or its Broker-Dealer is the Existing Holder maintained in book entry form by the Securities Depository for the account of its Agent Member, which in turn will maintain records of such purchaser's beneficial ownership, and to authorize such Agent Member to disclose to the Auction Agent such information with respect to such purchaser's

beneficial ownership as the Auction Agent may request.

Each prospective purchaser should ask its Broker-Dealer whether such prospective purchaser should sign a Master Purchaser's Letter. If the Broker-Dealer submits Orders for such prospective purchaser listing the Broker-Dealer as the Existing Holder or the Potential Holder, a Master Purchaser's Letter signed by such prospective purchaser may not be required.

AN EXECUTION COPY OF THE MASTER PURCHASER'S LETTER IS INCLUDED WITH THIS PROSPECTUS. EXECUTION BY A PROSPECTIVE PURCHASER OR ITS BROKER-DEALER OF A MASTER PURCHASER'S LETTER IS NOT A COMMITMENT TO PURCHASE SHARES OF ATP IN THE OFFERING BEING MADE BY THIS PROSPECTUS OR IN ANY AUCTION OR OTHERWISE, BUT IS A CONDITION PRECEDENT TO SUCH PURCHASER'S PURCHASING SHARES OF ATP.

RATING AGENCY GUIDELINES

The Fund intends at all times that, so long as any shares of ATP are Outstanding and Moody's and Fitch are then rating the ATP, the composition of its portfolio will reflect guidelines established by Moody's and Fitch in connection with obtaining the Aaa/AAA Credit Rating with respect to the ATP. Should the Fund determine to seek (and be successful in obtaining) a rating from any other rating agency or issue senior securities, other than the ATP, which are rated or otherwise subject to portfolio diversification or similar requirements, the composition of its portfolio would also reflect the guidelines and requirements established by any rating agency rating such securities or by the purchaser or purchasers of such securities. Moody's and Fitch, nationally recognized statistical rating organizations, issue ratings for various securities reflecting the perceived creditworthiness of such securities. The Fund has paid certain fees to Moody's and Fitch for rating shares of the ATP. The guidelines described below, which are set forth in greater detail in the Statement of Additional Information, have been developed independently by Moody's and Fitch in connection with issuance of asset-backed and similar securities, including debt obligations and adjustable rate preferred stocks, generally on a case-by-case basis through discussions with the issuers of these securities. The guidelines are designed to ensure that assets underlying outstanding debt or preferred stock will be sufficiently varied and will be of sufficient quality and amount to justify investment-grade ratings. The guidelines do not have the force of law, but have been adopted by the Fund in order to satisfy current requirements necessary for Moody's and Fitch to issue the above-described ratings for the ATP, which ratings are generally relied upon by institutional investors in purchasing such securities. In the context of a closed-end investment company such as the Fund, therefore, the guidelines provide a set of tests for portfolio composition and asset coverage which supplement (and in some cases are more restrictive than) the applicable requirements under the 1940 Act, and which accordingly affect significantly the management of the Fund's portfolio. A rating agency's guidelines will apply to the ATP only so long as such rating agency is rating such shares and such guidelines are subject to amendment with the consent of the relevant rating agency.

The Fund intends to maintain a Discounted Value for its portfolio at least equal to the ATP Basic Maintenance Amount. Moody's and Fitch have each established separate guidelines for determining Discounted Value. To the extent any particular portfolio holding does not satisfy the applicable rating agency's guidelines, all or a portion of such holding's value will not be included in the calculation of Discounted Value (as defined by such rating agency). The Moody's and Fitch guidelines do not impose any limitations on the percentage of Fund assets that may be invested in holdings not eligible for inclusion in the

calculation of the Discounted Value of the Fund's portfolio. The amount of such assets included in the portfolio at any time may vary depending upon the rating, diversification and other characteristics of the Eligible Assets included in the portfolio.

Upon any failure to maintain the required Discounted Value, the Fund may seek to alter the composition of its portfolio to retain the ATP Basic Maintenance Amount on or prior to the Asset Coverage Cure Date, thereby incurring additional transaction costs and possible losses and/or gains on disposition of portfolio securities. To the extent any such failure is not cured within two Business Days, the ATP will be subject to mandatory redemption thereafter. The "ATP Basic Maintenance Amount" equals the sum of (i) the aggregate liquidation preference of ATP then Outstanding and (ii) certain accrued and projected payment obligations of the Fund. See "Description of ATP -- Asset Maintenance" in the Statement of Additional Information.

The Fund may, but is not required to, adopt any modifications to the guidelines that may hereafter be established by Moody's or Fitch. Failure to adopt any such modifications, however, may result in a change in the ratings described above or a withdrawal of the ratings altogether. In addition, any rating agency providing a rating for the ATP may, at any time, change or withdraw any such rating. The Board of Directors may, without stockholder approval, adopt, amend, alter or repeal any definitions, covenants or other obligations of the Fund in the Articles Supplementary, provided the Board of Directors has obtained written confirmation from any rating agency which is then rating the ATP and which so requires that any such change would not impair the respective rating then assigned to the ATP.

As described by Moody's and Fitch, a preferred stock rating is an assessment of the capacity and willingness of an issuer to pay preferred stock obligations. Fitch has stated that its rating on the ATP does not address the market liquidity of the ATP. The ratings on the ATP are not recommendations to purchase, hold or sell ATP, inasmuch as the ratings do not comment as to market price or suitability for a particular investor nor do the Rating Agency Guidelines described above address the likelihood that a holder of ATP will be able to sell such shares in an Auction. The ratings are based on current information furnished to Moody's and Fitch by the Fund and the Investment Adviser, and information obtained from other sources. The ratings may be changed, suspended or withdrawn as a result of changes in, or the unavailability of, such information. The Common Stock has not been rated by a nationally recognized statistical rating organization.

TAXATION

The following discussion offers only a brief outline of the federal income tax consequences of investing in the ATP. Investors should consult their own tax advisors for more detailed information and for information regarding the impact of state, local, foreign, and other tax consequences of such an investment and of potential changes in applicable tax laws.

The Fund has elected to be treated as a regulated investment company (a "RIC") under subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"), and intends to operate so as to meet the Code requirements for qualification as a RIC. However, no assurance can be given that such requirements will be met. If the Fund qualifies for taxation as a RIC, it generally will not be subject to federal corporate income taxes on that portion of its income that is currently distributed to its stockholders. This deduction for dividends paid to stockholders substantially eliminates the federal "double

taxation" on earnings (once at the corporate level and once again at the stockholder level) that generally results from investments in a corporation.

Under present law, the ATP will constitute stock of the Fund, and thus distributions with respect to the ATP (other than distributions in redemption of the ATP subject to section 302(b) of the Code) will constitute dividends to the extent of the Fund's current or accumulated earnings and profits, as calculated for federal income tax purposes. Such dividends generally will be taxable as ordinary income to the stockholders and will not qualify for the dividends received deduction available to corporations under section 243 of the Code. However, dividends designated by the Fund as capital gain dividends will be treated as long-term capital gains in the hands of the stockholders. In addition, under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (effective for tax years through 2008), dividends paid by the Fund to individuals may constitute qualified dividend income eligible for a maximum rate of 15%. The amount of qualified dividend income realized by the Fund is not expected to be significant, and there is no assurance that any such income will be realized by the Fund in any year. The Internal Revenue Service (the "Service") currently requires that a RIC that has two or more classes of shares allocate to each such class proportionate amounts of each type of its income (such as ordinary income and net capital gains) for each tax year. Accordingly, the Fund intends to designate distributions made with respect to the ATP as capital gain dividends in proportion to the ATP's share of the total dividends paid to both the ATP and the Common Stock during the year. The amount of net long-term capital gain realized by the Fund is not expected to be significant, and there can be no assurance that any such income will be realized by the Fund in any year. Any distribution in excess of the Fund's earnings and profits will first reduce a stockholder's adjusted basis in his shares of the

ATP and, after such adjusted basis is reduced to zero, will constitute a capital gain to a stockholder whose shares of the ATP are held as a capital asset. See "Taxation" in the Statement of Additional Information for additional information regarding the tax aspects of investing in the Fund.

INVESTMENT OBJECTIVE AND POLICIES

The investment objective of the Fund is to provide high current income, while seeking to preserve stockholders' capital, through investment in a professionally managed, diversified portfolio of "high-yield" fixed-income securities, commonly known as "junk bonds." The Fund cannot ensure that it will attain its investment objective. The Fund's investment objective and the restrictions described below under "Investment Restrictions" are fundamental policies and thus may not be changed without the affirmative vote of the holders of a majority of the outstanding shares of the Fund's Common Stock and a majority of the Outstanding shares of the ATP, voting as separate classes, which means for each class the lesser of (a) more than 50% of such class or (b) 67% or more of such class present at a meeting at which more than 50% of the outstanding shares of such class are present or represented by proxy.

INVESTMENT STRATEGY

The policies described below may be changed by the Fund without the approval of the Fund's stockholders.

The Fund seeks to achieve its investment objective by investing primarily in "high-yield" fixed-income securities rated in the lower categories by recognized rating agencies, consisting principally of fixed-income securities

rated Ba or lower by Moody's or BB or lower by S&P and, subject to applicable rating agency guidelines, (see "Rating Agency Guidelines") non-rated securities deemed by the Investment Adviser to be of comparable quality. Because non-rated securities are not eligible for inclusion in the calculation of the Discounted Value of the Fund's assets under the Rating Agency Guidelines, however, it is not presently anticipated that such securities will comprise a significant percentage of the Fund's investments, although the Fund reserves full flexibility in this regard. See "Rating Agency Guidelines." Under normal market conditions, the Fund will have at least 80% of its net assets, plus the amount of any borrowings for investment purposes, invested in securities rated BB or lower by S&P or Ba or lower by Moody's or non-rated securities deemed by the Investment Adviser to be of comparable quality. This policy may not be changed without providing stockholders with 60 days' notice. The average maturity of the Fund's portfolio is expected to be between six and ten years; however, depending upon market conditions, this range may be shortened or lengthened.

Fixed-income securities which the Fund has the right to acquire include preferred stocks (limited to 20% of the Fund's total assets and subject to compliance with the Rating Agency Guidelines as described above) and all types of debt obligations having varying terms with respect to security or credit support, subordination, purchase price, interest payments and maturity. Such obligations may include, for example, bonds, debentures, notes, mortgage or other asset-backed instruments, equipment lease certificates, equipment trust certificates, conditional sales contracts, commercial paper, zero coupon securities and obligations issued or guaranteed by the United States government or any of its political subdivisions, agencies or instrumentalities (including obligations, such as repurchase agreements, secured by such instruments). The Fund may invest in U.S. dollar-denominated bonds sold in the United States by non-U.S. issuers ("Yankee bonds"). Most debt securities in which the Fund will invest will bear interest at fixed rates. However, the Fund reserves the right to invest without limitation in fixed-income securities that have variable rates of interest or involve equity features, such as contingent interest or participations based on revenues, sales or profits (i.e., interest or other payments, often in addition to a fixed rate of return, that are based on the borrower's attainment of specified levels of revenues, sales or profits and thus enable the holder of the security to share in the potential success of the venture). The Fund also has the right to acquire common stock as part of a unit in connection with the purchase of debt securities consistent with the Fund's investment policies, although such investments are not eligible for inclusion in the calculation of the Discounted Value under the Rating Agency Guidelines.

The Fund may invest up to 20% of its total assets in illiquid securities (determined as of the time of investment). Rule 144A Securities are not included in this 20% limitation. In general, the Commission defines illiquid securities as those that cannot be sold in the ordinary course of business within seven days at approximately the value assigned to them by the Fund. Illiquid securities may offer higher yields than comparable publicly traded securities, but the Fund may not be able to sell these securities when the Investment Adviser considers it desirable to do so. Illiquid securities are generally eligible for inclusion in the Discounted Value of the portfolio for purposes of the Rating Agency Guidelines of Moody's or Fitch in effect as of the date of this Prospectus only if they are Rule 144A Securities.

The Fund is permitted to invest up to 20% of its total assets in zero coupon securities, although such securities also may not be included in calculating the Discounted Value of the Fund's portfolio under the Rating Agency Guidelines. Zero coupon securities pay no cash income but are purchased at a discount from their value at maturity. When held to maturity, their entire

return comes from the difference between their purchase price and their maturity value. There may be special tax considerations associated with investing in securities structured as deferred interest, zero coupon or payment-in-kind securities. The Fund records the interest on these securities as income even though it receives no cash interest until each security's maturity date. The Fund will be required to distribute all or substantially all such amounts annually and may have to obtain the cash to do so by selling securities. Thus, to meet cash distribution obligations, the Fund may be required to liquidate a portion of its assets, which it would otherwise continue to hold, at a disadvantageous time. These distributions will be taxable to stockholders as ordinary income. In the case of securities structured as deferred interest, zero coupon or payment-in-kind securities, the market prices of such securities are affected to a greater extent by interest rate changes and, therefore, tend to be more volatile than securities which pay interest periodically and in cash.

Notwithstanding any of the foregoing, when market conditions warrant a temporary defensive investment strategy, including when it is necessary to maintain compliance with the Rating Agency Guidelines (under which the Fund's ability to invest in lower-rated securities having relatively low Discounted Values may be restricted, particularly as the market values of portfolio holdings decline), the Fund may invest without limitation in money market instruments, including rated and (subject to compliance with the Rating Agency Guidelines) unrated commercial paper of domestic and foreign corporations, certificates of deposit, bankers' acceptances and other obligations of banks, repurchase agreements and short-term obligations issued or guaranteed by the United States government or its instrumentalities or agencies. The yield on these securities will tend to be lower than the yield on other securities to be purchased by the Fund. The Fund reserves the right to invest in securities rated higher than Ba by Moody's or BB by S&P or non-rated fixed-income securities of comparable quality when the difference in yields between quality classifications is relatively narrow or for temporary defensive purposes, including maintenance of applicable asset coverage requirements when the Investment Adviser anticipates adverse market conditions. Investments in higher-rated issues may serve to lessen a decline in NAV but may also affect the amount of current income produced by the Fund, as the yields from such issues are usually lower than those from lower-rated issues.

CERTAIN INVESTMENT PRACTICES

The Fund and the Investment Adviser reserve the right to engage in certain investment practices in order to help achieve the Fund's investment objective. Such strategies include the lending of portfolio securities, the short sale of securities and the use of futures contracts and options thereon, entering into interest rate transactions, such as swaps, caps, tears or collars for the purpose of hedging the Fund's exposure to interest rates (including changes in dividend payments on the ATP), reverse repurchase agreements and repurchase agreements (other than certain repurchase agreements with qualified depository institutions having maturities no longer than one day). So long as the ATP is Outstanding, the Fund may not utilize certain investment practices, such as entering into swap agreements, the making of securities loans and buying or selling futures contracts and options thereon, unless the Fund receives written confirmation from Moody's, Fitch or any other rating agency which is then rating the ATP and which so requires, that any such action will not impair the Aaa/AAA Credit Rating. Further, the Rating Agency

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Guidelines limit or have the effect of
limiting the Fund's use of other investment practices described below, such as investments in non-U.S. securities, private placements (except Rule 144A Securities) and options, to the extent such investments are not eligible for

inclusion in the Discounted Value of the Fund's portfolio or the Rating Agency Guidelines specify terms and restrictions on such investments. See "Rating Agency Guidelines" and "Investment Objective and Policies -- Certain Investment Practices" in the Statement of Additional Information.

INVESTMENT RESTRICTIONS

The following investment restrictions are fundamental policies of the Fund, and may not be amended without the affirmative vote of the holders of a majority of the outstanding shares of Common Stock and a majority of the Outstanding shares of the ATP, voting as separate classes, which means for each class the lesser of (a) more than 50% of such class or (b) 67% or more of such class present at a meeting at which more than 50% of the outstanding shares of such class are present or represented by proxy. Under these restrictions, the Fund may not:

1. Borrow money (through reverse repurchase agreements or otherwise) or issue senior securities, except as permitted by Section 18 of the 1940 Act.

2. Pledge, hypothecate, mortgage or otherwise encumber its assets, except to secure borrowings permitted by restriction 1 above. Collateral arrangements with respect to margins for futures contracts and options are not deemed to be pledges or other encumbrances for purposes of this restriction.

3. Purchase securities on margin, except such short-term credits as may be necessary for the clearance of purchases and sales of securities and except that the Fund may make margin payments in connection with transactions in futures contracts and options.

4. Make short sales of securities or maintain a short position for the account of the Fund unless at all times when a short position is open the Fund owns an equal amount of such securities or owns securities which, without payment of any further consideration, are convertible into or exchangeable for securities of the same issue as, and in equal amount to, the securities sold short.

5. Underwrite securities issued by other persons except to the extent that, in connection with the disposition of its portfolio investments, the Fund may be deemed to be an underwriter under the federal securities laws.

6. Purchase or sell real estate (including real estate mortgage loans), although the Fund may purchase securities of issuers that deal in real estate, securities that are secured by interests in real estate and securities representing interests in real estate.

7. Purchase or sell commodities or commodity contracts, except that the Fund may purchase or sell financial futures contracts and related options.

8. Make loans, except by purchase of debt obligations in which the Fund may invest consistently with its investment policies, by entering into repurchase agreements with respect to not more than 25% of the value of its total assets, or through the lending of its portfolio securities with respect to not more than one-third of the value of its total assets.

9. Acquire more than 10% of the voting securities of any issuer.

10. Invest more than 25% of the value of its total assets in any one

industry, provided that this limitation does not apply to obligations issued or guaranteed as to interest and principal by the United States government or its agencies or instrumentalities.

11. Buy or sell oil, gas or other mineral leases, rights or royalty contracts, although the Fund may purchase securities of issuers which deal in, represent interests in or are secured by interests in such leases, rights or contracts.

12. Make investments for the purpose of exercising control or management over the issuer of any security.

The Fund also will be subject to certain investment restrictions so long as the ATP remains Outstanding, which may prohibit or limit certain practices that are otherwise authorized. See "Certain Investment Practices" above and "Rating Agency Guidelines."

RISK FACTORS AND SPECIAL CONSIDERATIONS

An investment in the Fund is subject to a number of risks and special considerations, including the following:

RISKS OF INVESTING IN ATP

AUCTION RISK. Your ability to dispose of shares of ATP may be largely dependent on the success of an Auction, which provides liquidity for the sale of the ATP. If the Auction fails; that is, if there are more ATP shares offered for sale than there are buyers for those shares, then you may not be able to sell your shares of the ATP. There is no assurance that any particular Auction will be successful. Neither the Fund nor any Broker-Dealer is obligated to ensure that an Auction will be successful or to purchase shares of ATP in an Auction or otherwise. The Fund is not required to redeem shares of ATP in the event of a failed Auction. In addition, if you place Hold Orders (Orders to retain the ATP) at an Auction only at a specified rate, and that bid rate exceeds the rate set at the Auction, you will not retain your shares of ATP. If you buy shares or elect to retain shares without specifying a rate below which you would not wish to continue to hold those shares, and the Auction sets a below-market rate, you may receive a lower rate of return on your shares than the market rate. Finally, the Dividend Period may be changed, subject to certain conditions and with notice to Holders of ATP, which could affect the liquidity of your investment. See "Description of ATP" and "Auction Procedures."

SECONDARY MARKET RISK. There is no assurance that a secondary market outside of the Auctions for the ATP will develop, whether or not such Auctions are successful, or if such a market does develop, that shares of ATP will trade at or close to the Liquidation Value. If the Fund has designated a Dividend Period for ATP which is longer than a Standard Term Period, particularly if such Dividend Period exceeds one year, any increase in interest rates will likely have an adverse affect on the secondary market price of ATP. In such case, you may have fewer opportunities to obtain liquidity if Auctions do not occur frequently. If you try to sell your ATP shares between Auctions, you may not be able to sell any or all of your shares, or you may not be able to sell them for $25,000 per share or $25,000 per share plus accumulated dividends. Thus, under certain circumstances, you may not have liquidity of investment.

The Fund does not intend to apply for listing of the newly issued shares of ATP Series C on a national securities exchange, but has been advised by Lehman that it currently intends to make a market in the ATP Series C as permitted by

applicable laws and regulations. Lehman is not obligated to make a market in the ATP Series C between Auctions and, therefore, a holder of ATP Series C may not be able to liquidate its position in the ATP Series C between Auctions at a price per share equal to its liquidation preference (i.e. Liquidation Value, plus accumulated dividends).

RATINGS AND ASSET COVERAGE RISK. While Moody's and Fitch assign ratings of Aaa and AAA, respectively, to the ATP, the ratings do not eliminate or necessarily mitigate the risks of investing in the ATP. A rating agency could downgrade its rating of the ATP or withdraw its rating of the ATP at any time, which may make your shares less liquid at an Auction or in the secondary market, though probably with higher resulting dividend rates. If a rating

agency downgrades the rating of ATP or withdraws its rating without timely replacement by a rating from a suitable successor rating agency, the Fund may alter its portfolio or redeem the ATP. If the Fund fails to satisfy the asset coverage requirements under the 1940 Act and the Rating Agency Guidelines discussed under "Description of ATP -- Asset Maintenance," the Fund may be required to redeem a sufficient number of the ATP in order to return to compliance with the asset coverage requirements, including possibly ATP having Dividend Periods of longer than one year. The Fund may be required to redeem the ATP at a time when it is not advantageous for the Fund to make such redemption or to liquidate portfolio securities in order to have available cash for such redemption. The Fund may voluntarily redeem the ATP under certain circumstances in order to meet asset maintenance tests. See "Description of ATP -- Mandatory Redemption" and "Description of ATP -- Optional Redemption." See also "Description of ATP -- Asset Maintenance" for a description of the asset maintenance tests the Fund must meet.

INFLATION RISK. Inflation is the reduction in the purchasing power of money resulting from the increase in the price of goods and services. Inflation risk is the risk that the inflation adjusted (or "real") value of your ATP investment or the income from that investment will be worth less in the future. As inflation occurs, the real value of the ATP shares and distributions declines. In an inflationary period, however, it is expected that, through the auction process, ATP dividend rates would increase, tending to offset this risk.

INDEBTEDNESS RISK. The Fund may incur indebtedness with the consent of Moody's and Fitch. To the extent that the Fund does incur any borrowings, such borrowings would typically be senior in right of payment to the ATP and the Common Stock upon liquidation of the Fund. Certain types of borrowings may result in the Fund being subject to covenants in credit agreements, including those relating to asset coverage, borrowing base and portfolio composition requirements and additional covenants that may affect the Fund's ability to pay dividends and distributions in certain instances. The Fund also may be required to pledge its assets to the lenders in connection with certain types of borrowings. Interest payments on borrowings must be made prior to the payment of dividends on Preferred Stock, including ATP.

ATP represents a perpetual equity interest in the Fund (except to the extent redeemable by the Fund) and does not give rise to a claim for payment of a principal amount at a particular date. As such, ATP effectively ranks behind all indebtedness or other non-equity claims on the Fund with respect to assets available to satisfy claims on the Fund. In addition, in the event of the dissolution, liquidation or winding up of the affairs of the Fund, after payment of the liquidation preference and all dividends accumulated to and unpaid through the date of final distribution, holders of ATP will not be entitled to any further participation in any distribution of assets of the Fund.

LEVERAGE. The Fund has had a leveraged capital structure since its organization. Assuming issuance of the new shares of ATP Series C in the Offering (after giving effect to the sales load and estimated offering expenses) at September 30, 2003, the Fund would have had total assets of approximately $338,300,506 consisting of ATP having an aggregate liquidation preference of approximately $130,000,000 and net assets attributable to Common Stock of approximately $195,353,289.

The terms of the Fund's arrangements with Moody's and Fitch, which have been agreed to in order to obtain investment grade ratings for the ATP, require that the Fund maintain (i) asset coverage with respect to the ATP at least equal, on a discounted basis, to the liquidation preference of the ATP plus certain accrued and projected payment obligations of the Fund and other amounts on an on-going basis and (ii) non-discounted asset coverage of at least 200% of the aggregate liquidation preference of the ATP as of the last Business Day of each month. See "Description of ATP -- Asset Maintenance." The 1940 Act also requires that the Fund maintain asset coverage of at least 200% on a non-discounted basis as a condition of paying dividends to the holders of the Common Stock.

As market conditions and the value of portfolio securities decline, one effect of the foregoing requirements is to cause the Fund to invest in higher-quality, lower-yielding assets and/or to maintain relatively substantial balances of highly liquid assets having low Discount Factors assigned by the rating agencies in order to remain in

compliance with asset coverage requirements, which may tend to reduce portfolio yield. In addition, the value of higher-quality assets may react with greater volatility to interest rate changes than would lower quality assets.

If the dividend rate on the ATP exceeds the net rate of return on the Fund's portfolio, the leverage will result in a lower NAV than if the Fund were not leveraged, and the Fund's ability to pay dividends and meet its asset coverage requirements on the ATP would be reduced. Any decline in the NAV of the Fund's investments also could increase the risk of the Fund failing to meet its asset coverage requirements, of losing its ratings on the ATP or, in an extreme case, of the Fund's current investment income not being sufficient, which would cause the Fund to liquidate investments in order to fund a redemption of some or all of the ATP. Under some circumstances, the Fund may be required to redeem or repurchase senior securities in order to rem"bottom" ALIGN="right">129

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Cash and cash equivalents at end of period	$ 149	$ 129

The accompanying notes are an integral part of these financial statements.

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CABOT CORPORATION

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

Three Months Ended December 31, 2008

(In millions, except shares in thousands)

UNAUDITED

	Common Stock, Net of Treasury Stock		Additional		Deferred	Notes Receivable for	Accumulated Other	Total	Total
	Shares	Cost	Paid-in Capital	Retained Earnings	Employee Benefits	Restricted Stock	Comprehensive Income	Stockholders Equity	Comprehensive Loss
Balance at September 30, 2008	65,278	$ 61	$ 21	$ 1,143	$ (30)	$ (21)	$ 75	$ 1,249	
Net income				4					$ 4
Foreign currency translation adjustment							(20)		(20)
Change in unrealized gain on derivative instruments							(3)		(3)
Other comprehensive loss									(23)
Comprehensive loss								(19)	$ (19)
Common dividends paid				(12)				(12)	
Issuance of stock under employee compensation plans, net of forfeitures	(2)								
Amortization of share-based compensation			6					6	
Purchase and retirement of common and treasury stock	(7)								
Principal payment by Employee Stock Ownership Plan under guaranteed loan					2			2	
Notes receivable for restricted stock payments and forfeitures						1		1	
Balance at December 31, 2008	65,269	$ 61	$ 27	$ 1,135	$ (28)	$ (20)	$ 52	$ 1,227	

The accompanying notes are an integral part of these financial statements.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

UNAUDITED

A. Basis of Presentation

The consolidated financial statements include the accounts of Cabot (the Company) and its wholly-owned subsidiaries and majority-owned and controlled U.S. and non-U.S. subsidiaries. Additionally, Cabot considers consolidation of entities over which control is achieved through means other than voting rights, of which there were none in the periods presented. Intercompany transactions have been eliminated in consolidation.

The unaudited consolidated financial statements have been prepared in accordance with the requirements of Form 10-Q and consequently do not include all disclosures required by Form 10-K. Additional information may be obtained by referring to Cabot s Annual Report on Form 10-K for the fiscal year ended September 30, 2008 (2008 10-K).

The financial information submitted herewith is unaudited and reflects all adjustments which are, in the opinion of management, necessary to provide a fair statement of the results for the interim periods ended December 31, 2008 and 2007. All such adjustments are of a normal recurring nature. The results for interim periods are not necessarily indicative of the results to be expected for the fiscal year.

B. Significant Accounting Policies

Revenue Recognition and Accounts Receivable

Cabot s revenue recognition policies are in compliance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, which establishes criteria that must be satisfied before revenue is realized or realizable and earned. Cabot recognizes revenue when persuasive evidence of a sales arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is probable. Cabot generally is able to ensure that products meet customer specifications prior to shipment. If the Company is unable to determine that the product has met the specified objective criteria prior to shipment, the revenue is deferred until product acceptance has occurred.

Shipping and handling charges related to sales transactions are recorded as sales revenue when billed to customers or included in the sales price in accordance with Emerging Issues Task Force (EITF) 00-10, Accounting for Shipping and Handling Fees and Costs. Shipping and handling costs are included in cost of sales.

The following table presents the percentages of total revenue recognized in each of the Company s reportable segments. Other operating revenues, which represent less than two percent of total revenues, include tolling, servicing and royalties for licensed technology.

	Three months ended December 31	
	2008	**2007**
Core Segment		
Rubber Blacks Business	63%	59%
Supermetals Business	7%	8%
Performance Segment	25%	30%
New Business Segment	3%	1%
Specialty Fluids Segment	2%	2%

As indicated above, Cabot derives a substantial majority of its revenues from the sale of products in the Rubber Blacks Business and Performance Segment. Revenue from these products is typically recognized when the product is shipped and title and risk of loss have passed to the customer. The Company offers certain of its customers cash discounts and volume rebates as sales incentives. The discounts and volume rebates are recorded as a reduction in sales at the time revenue is recognized and are estimated based on historical experience and contractual obligations. Cabot periodically reviews the assumptions underlying its estimates of discounts and volume rebates and adjusts its revenues

accordingly. Certain Rubber Blacks Business and Performance Segment customer contracts contain price protection clauses that provide for the potential reduction in past or future sales prices under specific circumstances. Cabot analyzes these contract provisions to determine if an obligation related to these clauses exists and records revenue net of any estimated protection commitments.

Supermetals revenues also are generally recognized when the product is shipped and title and risk of loss have passed to the customer.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

The majority of the revenue in the Specialty Fluids business arises from the rental of cesium formate. This revenue is recognized throughout the rental period based on the contracted rental terms. Customers are also billed and revenue is recognized, typically at the end of the job, for cesium formate product that is not returned.

Cabot maintains allowances for doubtful accounts based on an assessment of the collectibility of specific customer accounts, the aging of accounts receivable and other economic information on both an historical and prospective basis. Customer account balances are charged against the allowance when it is probable the receivable will not be recovered. Changes in the allowance during the first quarters of fiscal 2009 and 2008 were not material. There is no off-balance sheet credit exposure related to customer receivable balances.

Financial Instruments

Cabot s financial instruments consist primarily of cash and cash equivalents, short-term and long-term debt, and derivative instruments. The carrying values of Cabot s financial instruments approximate fair value with the exception of certain long-term debt that has not been designated with a fair value hedge. This portion of long-term debt is recorded at face value. The fair values of the Company s derivative instruments are based on quoted market prices, if such prices are available. In situations where quoted market prices are not available, the Company relies on valuation models to derive fair value. Such valuation takes into account the ability of the financial counterparty to perform. Cabot uses derivative financial instruments primarily for purposes of hedging exposures to fluctuations in interest rates and foreign currency exchange rates, which exist as part of its on-going business operations. Cabot does not enter into contracts for speculative purposes, nor does it hold or issue any financial instruments for trading purposes.

All derivatives are recognized on the consolidated balance sheets at fair value. The changes in the fair value of derivatives are recorded in either earnings or other comprehensive income, depending on whether or not the instrument is designated as part of a hedge transaction and, if designated as part of a hedge transaction, the type of hedge transaction. The gains or losses on derivative instruments reported in other comprehensive income are reclassified to earnings in the period in which earnings are affected by the underlying hedged item. The ineffective portion of all hedges is recognized in earnings.

In accordance with Cabot s risk management strategy, the Company may enter into certain derivative instruments that may not be designated as hedges for hedge accounting purposes. Although these derivatives are not designated as hedges, the Company believes that such instruments are closely correlated with the underlying exposure, thus managing the associated risk. The Company records in earnings the gains or losses from changes in the fair value of derivative instruments that are not designated as hedges.

The Company carries a variety of different cash and cash equivalents on its consolidated balance sheets. Cabot continually assesses the liquidity of cash and cash equivalents and, as of December 31, 2008, has determined that they are readily convertible to cash.

Income Tax in Interim Periods

The Company records its tax provision (benefit) on an interim basis using the estimated annual effective tax rate. This rate is applied to the current period ordinary income or loss to determine the income tax provision or benefit allocated to the interim period. Losses from jurisdictions for which no benefit can be realized and the income tax effects of unusual and infrequent items are excluded from the estimated annual effective tax rate. Valuation allowances are provided against the future tax benefits that arise from the losses in jurisdictions for which no benefit can be realized. In addition, the effects of the unusual and infrequent items are recognized in the impacted interim period as discrete items. The estimated annual effective tax rate may be significantly impacted by nondeductible expenses and the Company s projected earnings mix by tax jurisdiction. Adjustments to the estimated annual effective income tax rate are recognized in the period when such estimates are revised.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

Inventory Valuation

The cost of most raw materials, work in process and finished goods inventories in the U.S. is determined by the last-in, first-out (LIFO) method. Had the Company used the first-in, first-out (FIFO) method instead of the LIFO method for such inventories, the value of those inventories would have been $120 million and $140 million higher as of December 31, 2008 and September 30, 2008, respectively. The cost of other U.S. and all non-U.S. inventories is determined using the average cost method or the FIFO method.

Cabot reviews inventory for potential obsolescence periodically. In this review, the Company makes assumptions about the future demand for and market value of the inventory and based on these assumptions estimates the amount of any obsolete, unmarketable or slow moving inventory. Cabot writes down the value of these obsolete, unmarketable or slow moving inventories by an amount equal to the difference between the cost of the inventory and its estimated market value. During the three months ended December 31, 2008 the Company recorded a pre-tax charge of $10 million to write down the value of inventory in the Rubber Blacks Business in Asia Pacific to its market value. This write-down was due to the rapid decline in carbon black selling prices combined with high inventory levels in that region.

C. Employee Benefit Plans

Cabot provides defined benefit plans for all U.S. and some foreign employees. Due to recent global market declines, the Company s U.S. qualified defined benefit plan asset values declined by approximately 18% during the quarter, causing the plan to be in an underfunded position at December 31, 2008 as compared to a $2 million overfunded position at September 30, 2008. As a result, the Company anticipates that it will need to contribute approximately $2 million to this plan during fiscal 2009.

Net periodic defined benefit pension and other postretirement benefit costs during the first quarter of fiscal 2009 and 2008 include the following:

	Three Months Ended December 31							
	2008		2007		2008		2007	
	Pension Benefits				Postretirement Benefits			
	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
	(Dollars in millions)							
Service cost	$ 1	$ 1	$ 1	$ 1	$	$	$ 1	$
Interest cost	2	3	2	3	1		1	
Expected return on plan assets	(2)	(3)	(2)	(3)				
Amortization of actuarial loss				1				
Net periodic benefit cost	$ 1	$ 1	$ 1	$ 2	$ 1	$	$ 2	$

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

D. Commitments and Contingencies

Purchase Commitments

Cabot has entered into long-term purchase agreements primarily for the purchase of raw materials and natural gas. Under certain of these agreements the quantity of material being purchased is fixed, but the price paid changes as market prices change. The commitments in the table below are quantified on the basis of market prices at December 31, 2008.

	Payments Due by Fiscal Year (Dollars in millions)						
	2009	2010	2011	2012	2013	Thereafter	Total
Core Segment							
Rubber Blacks Business	$ 131	$ 129	$ 99	$ 81	$ 76	$ 782	$ 1,298
Supermetals Business	30	15	16	17	6	1	85
Performance Segment	96	37	18	16	17	146	330
Specialty Fluids Segment	3	4					7
Total	$ 260	$ 185	$ 133	$ 114	$ 99	$ 929	$ 1,720

Guarantee Agreements

Cabot has provided certain indemnities pursuant to which it may be required to make payments to an indemnified party in connection with certain transactions and agreements. In connection with certain acquisitions and divestitures, Cabot has provided routine indemnities with respect to such matters as environmental, tax, insurance, product and employee liabilities. In connection with various other agreements, including service and supply agreements, Cabot may provide routine indemnities for certain contingencies and routine warranties. Cabot is unable to estimate the maximum potential liability for these types of indemnities as a maximum obligation is not explicitly stated in most cases and the amounts, if any, are dependent upon the outcome of future contingent events, the nature and likelihood of which cannot be reasonably estimated. The durations of the indemnities vary, and in many cases are indefinite. Cabot has not recorded any liability for these indemnities in the consolidated financial statements, except as otherwise disclosed.

Contingencies

Cabot is a defendant, or potentially responsible party, in various lawsuits and environmental proceedings wherein substantial amounts are claimed or at issue.

Environmental Matters

As of December 31, 2008 and September 30, 2008, Cabot had $7 million on a discounted basis ($9 million on an undiscounted basis) and $9 million on a discounted basis ($10 million on an undiscounted basis), respectively, reserved for environmental matters primarily related to divested businesses. These amounts represent Cabot s best estimates of its share of costs likely to be incurred at those sites where costs are reasonably estimable based on its analysis of the extent of clean up required, alternative clean up methods available, abilities of other responsible parties to contribute and its interpretation of laws and regulations applicable to each site. Cabot reviews the adequacy of this reserve as circumstances change at individual sites. Cash payments were $1 million in each of the first quarters of fiscal 2009 and 2008 related to these

environmental matters.

Respirator Liabilities

Cabot has exposure in connection with a safety respiratory products business that a subsidiary acquired from American Optical Corporation (AO) in an April 1990 asset purchase transaction. The subsidiary manufactured respirators under the AO brand and disposed of that business in July 1995. In connection with its acquisition of the business, the subsidiary agreed, in certain circumstances, to assume a portion of AO s liabilities, including costs of legal fees together with amounts paid in settlements and judgments, allocable to AO respiratory products used prior to the 1990 purchase by the Cabot subsidiary. As more fully described in the 2008 10-K, the Company s respirator liabilities involve claims for personal injury, including asbestosis, silicosis and coal worker s pneumoconiosis, allegedly resulting from the use of AO respirators that are alleged to have been negligently designed or labeled.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

As of December 31, 2008, there were approximately 54,000 claimants in pending cases asserting claims against AO in connection with respiratory products. Cabot has a reserve to cover its expected share of liability for existing and future respirator liability claims. The book value of the reserve is being accreted up to the undiscounted liability through interest expense over the expected cash flow period, which is through 2052, and, at December 31, 2008, is approximately $14 million on a discounted basis (or $24 million on an undiscounted basis). Cash payments related to this liability were less than $1 million for the three months ended December 31, 2008.

Beryllium Claims

Cabot is a party to several pending actions in connection with its discontinued beryllium operations in Reading, Pennsylvania. Cabot entered the beryllium industry through an acquisition in 1978. The Company ceased manufacturing beryllium products at one of the acquired facilities in 1979, and the balance of its former beryllium business was sold to NGK Metals, Inc. (NGK) in 1986. As more fully described in the 2008 10-K, the actions are pending in several state and federal courts, and involve claims for personal injury and medical monitoring relating to alleged contact with beryllium in various ways. Cabot believes it has valid defenses to all of the beryllium actions against it and will assert them vigorously in the various venues in which claims have been asserted. In addition, there is a contractual indemnification obligation running from NGK to Cabot in connection with many of these matters. While the outcome of litigation is uncertain, the Company does not believe that the ultimate disposition of these matters will have a material adverse effect on the Company s consolidated financial position.

AVX Contract Dispute

On March 8, 2004, AVX Corporation (AVX) filed an action against the Company in the United States District Court for the District of Massachusetts. The complaint alleges that Cabot violated the federal antitrust laws in connection with the parties January 1, 2001 tantalum supply agreement (the Supply Agreement) by purportedly tying AVX s purchases of Cabot s flake tantalum powder to its purchases of Cabot s nodular tantalum powder. Discovery in the federal court action ended in late December 2007. No trial date has been set. The parties have filed cross-motions for summary judgment. Oral argument on those motions was heard by the court in June 2008. No decision has been issued.

On September 6, 2005, AVX filed an action in the Superior Court of Massachusetts for Suffolk County, which, in November 2005, was moved to the Business Litigation Section of the Superior Court of Massachusetts. The action alleges that Cabot improperly administered the parties Supply Agreement for the years 2003 through 2005. In particular, AVX claims that Cabot has not provided all of the price relief due to AVX under the most favored customer (MFC) provisions of the Supply Agreement. AVX seeks a judicial declaration of the rights of the parties to the Supply Agreement, an accounting of monies paid, due or owing under the MFC provisions, and an award of any sums not paid that should have been. Cabot filed an answer and counterclaims against AVX asserting that AVX actually underpaid for tantalum products in the period 2003 through 2005. On December 31, 2007, the court issued an order allowing AVX s motion for partial summary judgment on one significant legal issue involving interpretation of the Supply Agreement, but denied AVX s motion and Cabot s cross-motion in all other respects, including AVX s motion to dismiss Cabot s affirmative defenses that would negate AVX s claims. Prior to July 2008, AVX had indicated that it believed it is owed additional MFC benefits of approximately $24 million, which Cabot disputes. In July 2008, AVX attempted to assert new legal theories that increased its damage claim for additional MFC benefits to approximately $96 million. Cabot subsequently filed a motion to strike AVX s revised claim for MFC benefits and in November 2008, the court granted Cabot s motion and denied AVX s additional damage claim for MFC benefits of $72 million, thereby limiting AVX s claim to the previously stated $24 million. Cabot believes that it has valid defenses to all of AVX s claims, including the one on which partial summary judgment was granted, and will continue to assert these defenses and its counterclaims vigorously. In addition, if necessary, Cabot has the right to appeal the court s order allowing AVX s motion for partial summary judgment. While the outcome of litigation is uncertain, the Company does not believe that the ultimate disposition of these matters will have a material adverse effect on the Company s consolidated financial position.

Other

The Company has various other lawsuits, claims and contingent liabilities arising in the ordinary course of its business and in respect of the Company s divested businesses. In the opinion of the Company, although final disposition of some or all of these other suits and claims may impact the Company s financial statements in a particular period, they should not, in the aggregate, have a material adverse effect on the Company s consolidated financial position.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

E. Earnings Per Share

Basic and diluted earnings per share (EPS) were calculated as follows:

	Three Months Ended December 31	
	2008	2007
	(In millions, except per share amounts)	
Basic EPS:		
Income available to common shares (numerator)	$ 4	$ 36
Weighted average common shares outstanding	65	65
Less: contingently issuable shares[(1)]	(2)	(2)
Adjusted weighted average common shares (denominator)	63	63
Basic EPS	$ 0.07	$ 0.57
Diluted EPS:		
Income available to common shares (numerator)	$ 4	$ 36
Adjusted weighted average common shares outstanding	63	63
Effect of dilutive securities:		
Common shares issuable[(2)(3)]	1	1
Adjusted weighted average shares (denominator)	64	64
Diluted EPS	$ 0.07	$ 0.56

(1) Represents outstanding unvested restricted stock issued under Cabot s equity incentive plans.

(2) Represents incremental shares for the (i) assumed exercise of stock options; (ii) assumed issuance of shares pursuant to the Company s SERP obligation to employees; and (iii) outstanding unvested restricted stock issued under Cabot s equity incentive plans, net of assumed share repurchases.

(3) For the three months ended December 31, 2008 and 2007 options to purchase 529,100 and 120,600 shares of common stock, respectively, were not included in the calculation of diluted earnings per share because those options exercise prices were greater than the average market price of Cabot common stock for those periods.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

F. Financial Information by Segment

Cabot is organized into four business segments: the Core Segment, which is further disaggregated for financial reporting purposes into the Rubber Blacks and Supermetals Businesses, the Performance Segment, the New Business Segment and the Specialty Fluids Segment. During the first quarter of fiscal 2009, management changed the allocation method of its corporate costs to its segments. Under this new method, costs that are not controlled by the segments and which primarily benefit corporate interests are not allocated to the segments and are included under the caption Unallocated and Other in the table below. The presentation of prior period results conforms to the new allocation method.

While the Chief Operating Decision Maker uses a number of performance measures to manage the performance of the segments and allocate resources to them, income (loss) from operations before taxes is the measure that is most consistently used and is therefore the measure presented in the table below.

	Core Segment							
	Rubber Blacks Business	Supermetals Business	Performance Segment	New Business Segment	Specialty Fluids Segment	Segment Total	Unallocated and Other [1]	Consolidated Total
	(Dollars in millions)							
Three months ended December 31, 2008								
Net sales and other operating revenues[2]	$ 399	$ 45	$ 157	$ 18	$ 15	$ 634	$ 18	$ 652
Income (loss) before taxes[3]	$ 24	$ 3	$ 3	$ (3)	$ 4	$ 31	$ (30)	$ 1
Three months ended December 31, 2007								
Net sales and other operating revenues[2]	$ 410	$ 53	$ 211	$ 10	$ 16	$ 700	$ 11	$ 711
Income (loss) before taxes[3]	$ 16	$ 3	$ 31	$ (12)	$ 8	$ 46	$ (12)	$ 34

(1) Unallocated and Other includes costs that are not controlled by the segments and which primarily benefit corporate interests, certain items and eliminations that are not allocated to the operating segments. Management does not consider these items necessary for an understanding of the operating results of the segments and such amounts are excluded in the segment reporting to the Chief Operating Decision Maker.

(2) During the third quarter of fiscal 2008, the Company purchased additional shares of one of its Rubber Blacks equity affiliates which resulted in the consolidation of its operating results in the Company s consolidated financial statements beginning April 1, 2008. In the first quarter of fiscal 2008 (prior to the consolidation), segment sales included 100% of the sales of this equity affiliate at market-based prices. Unallocated and other reflects an elimination for sales of this equity affiliate for this period, offset by royalties paid by other equity affiliates, other operating revenues and external shipping and handling fees.

CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

(3) Income (loss) before taxes for Unallocated and Other includes:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Interest expense	$ (9)	$ (9)
Certain items[a]	(2)	10
Equity in net income of affiliated companies[b]	(2)	(2)
Unallocated corporate costs[c]	(7)	(7)
Foreign currency transaction losses[d]	(7)	(1)
Other expense, net [e]	(3)	(3)
Total	$ (30)	$ (12)

(a) Certain items consist of amounts that are not included in segment profit before taxes (PBT). Certain items for the three months ended December 31, 2008 include charges of $3 million for restructuring initiatives as described in Note J offset by a benefit of $1 million related to a former carbon black facility. Certain items for the three months ended December 31, 2007 include a gain of $18 million from the sale of land in Altona, Australia, offset by charges of $7 million for restructuring initiatives and $1 million for environmental and legal reserves.

(b) Equity in net income of affiliated companies is included in segment PBT and is removed from Unallocated and Other to reconcile back to income (loss) from operations before taxes.

(c) During the first quarter of fiscal 2009, management changed the allocation method of its corporate costs to its segments. The Company has recast prior periods to conform to the new allocation method. Under this new method, costs that are not controlled by the segments and which primarily benefit corporate interests are not allocated to the segments.

(d) Foreign currency transaction gains and losses are net of other foreign currency risk management activities and are not included in segment PBT.

(e) Other expense, net, consists of investment income and other expenses that are not included in segment PBT.

The Performance Segment is comprised of the Performance Products and Fumed Metal Oxides Businesses. The net sales from each of these businesses for the three months ended December 31, 2008 and 2007 are as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Performance Products	$ 105	$ 141
Fumed Metal Oxides	52	70
Total Performance Segment Sales	$ 157	$ 211

The New Business Segment is comprised of the Inkjet Colorants and the Aerogel Businesses and the business development activities of Cabot Superior MicroPowders (CSMP). The net sales from each of these businesses for the three months ended December 31, 2008 and 2007 are as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Inkjet colorants	$ 13	$ 8
Aerogel	4	1
Superior MicroPowders	1	1
Total New Business Segment Sales	$ 18	$ 10

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

G. Income Tax Uncertainties

As of December 31, 2008, the total amount of unrecognized tax benefits was $80 million. In addition, accruals of $5 million and $15 million have been recorded for penalties and interest, respectively. If the unrecognized tax benefits were recognized at a given point in time, there would be approximately a $68 million favorable impact on the Company s tax provision.

Changes in the amount of unrecognized tax benefits during the fiscal quarter are as follows:

		(Dollars in millions)
Balance at September 30, 2008	$	80
Additions based on tax positions related to the current year		1
Reductions (including settlements and statute of limitation lapses) for tax positions of prior years		(1)
Balance at December 31, 2008	$	80

The balances above include uncertainties related to the Company s U.S. income tax filings for the tax years 2003 and 2004. While the U.S. Internal Revenue Service (IRS) had completed its audit of these tax years and its review of several refund claims related to these years, the results were still subject to review by the Joint Committee on Taxation (JCT) as of December 31, 2008. In late January 2009, the Company was notified by the IRS that the JCT review had concluded with no proposed changes to the IRS report. During the second quarter of fiscal 2009, this settlement is expected to provide a reduction in the amount of uncertain tax positions of approximately $9 million and a net tax benefit of approximately $5 million. In addition, the IRS is currently auditing the tax years 2005 and 2006 and certain Cabot subsidiaries are under audit in a number of jurisdictions outside of the U.S. Lastly, certain statutes of limitations are scheduled to expire in the near future. It is reasonably possible that a further change in the unrecognized tax benefits may occur within the next twelve months related to the settlement of one or more of these audits or the lapse of applicable statutes of limitations; however, an estimated range of the impact on the unrecognized tax benefits cannot be quantified at this time.

Cabot files U.S., state, and non-U.S. income tax returns in jurisdictions with varying statutes of limitations. The 2005 through 2008 tax years generally remain subject to examination by federal tax authorities and the 2003 through 2008 tax years remain subject to examination by most state tax authorities. In significant non-U.S. jurisdictions, the 2001 through 2008 tax years generally remain subject to examination by their respective tax authorities. Our significant non-U.S. jurisdictions include the United Kingdom, Germany, Japan, Canada, China, Argentina, Brazil and the Netherlands.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

H. Fair Value Measurements

Effective October 1, 2008, Cabot implemented Statement of Financial Accounting Standard (FAS) No. 157 (FAS 157) for financial assets and financial liabilities reported or disclosed at fair value. As permitted by Financial Accounting Standards Board (FASB) Staff Position No. FAS 157-2, the Company elected to defer implementation of the provisions of FAS 157 for nonfinancial assets and nonfinancial liabilities until October 1, 2009, except for nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The disclosures focus on the inputs used to measure fair value. FAS 157 establishes the following hierarchy for categorizing these inputs:

Level 1 Quoted market prices in active markets for identical assets or liabilities

Level 2 Significant other observable inputs (e.g. quoted prices for similar items in active markets, quoted prices for identical or similar items in markets that are not active, inputs other than quoted prices that are observable such as interest rate and yield curves, and market-corroborated inputs)

Level 3 Significant unobservable inputs

The following table presents information about the Company s financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008:

	December 31, 2008		
	Level 1 Inputs	Level 2 Inputs	Total
	(Dollars in Millions)		
Assets at fair value:			
Equity securities[1]	$ 1	$	$ 1
Derivatives relating to:			
Interest rates[2]		5	5
Foreign currency[2]		2	2
Commodities[2]		1	1
Total assets at fair value	$ 1	$ 8	$ 9
Liabilities at fair value:			
Derivatives relating to:			
Foreign currency[2]	$	$ 49	$ 49
Total liabilities at fair value	$	$ 49	$ 49

(1) The Company s investments in equity securities are included in Short-term marketable securities in the consolidated balance sheet.

(2) The Company s derivatives are included in Other assets and Other liabilities in the consolidated balance sheet.

For assets that are measured using quoted prices in active markets, the total fair value is the published market price per unit multiplied by the number of units held without consideration of transaction costs. Assets and liabilities that are measured using significant other observable inputs are primarily valued by reference to quoted prices of similar assets or liabilities in active markets, adjusted for any terms specific to that asset or liability. For all other assets and liabilities for which observable inputs are used, fair value is derived through the use of fair value models, such as a discounted cash flow model or other standard pricing models.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

I. Accounting Pronouncements

New and Adopted Accounting Pronouncements

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements . FAS 157 provides guidance for (i) using fair value to measure assets and liabilities; and (ii) requires additional disclosure about the use of fair value measures, the information used to measure fair value, and the effect fair-value measurements have on earnings. The primary areas in which Cabot utilizes fair value measures are in valuing pension plan assets and liabilities, valuing hedge-related derivative financial instruments, allocating purchase price to the assets and liabilities of acquired companies, and evaluating long-term assets for potential impairment. FAS 157 does not require any new fair value measurements. In February 2008, the FASB issued FASB Staff Position FAS 157-2, which defers the effective date of FAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to fiscal years beginning after November 15, 2008. Effective October 1, 2008, Cabot adopted the portion of FAS 157 that was not deferred, which includes the disclosures in Note H, and applied the provisions of the statement prospectively to assets and liabilities measured and disclosed at fair value. The adoption of the deferred portion of FAS 157 on October 1, 2009 is not expected to have a material impact on the Company s consolidated financial statements.

In February 2007, the FASB issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (FAS 159). FAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. FAS 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. Effective October 1, 2008, Cabot adopted FAS 159. The Company has not made any elections to use fair value under FAS 159; therefore, FAS 159 had no impact on the Company s consolidated financial statements at December 31, 2008.

Issued Accounting Standards Not Yet Adopted

In December 2007, the FASB issued FAS No. 141 (Revised 2007), Business Combinations (FAS 141(R)). FAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of business combinations. FAS 141(R) is effective on a prospective basis for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combination Cabot enters into after September 30, 2009 will be subject to this new standard.

In December 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51 (FAS 160). FAS 160 establishes accounting and reporting standards for the ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in the parent s ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. FAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. FAS 160 will be effective for Cabot for the first quarter of fiscal 2010, beginning October 1, 2009. The Company is evaluating the impact of FAS 160 on its consolidated financial statements.

In March 2008, the FASB issued FAS No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (FAS 161). FAS 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance and cash flows. FAS 161 is effective for Cabot beginning on January 1, 2009. FAS 161 will not affect the Company s financial position or results of operations. The new standard solely affects the disclosure of information.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

J. Restructuring

Restructuring activity for the three months ended December 31, 2008 includes the costs associated with the closure of Cabot s Waverly, West Virginia plant, Cabot s 2008 Global Restructuring plan and an approximately $1 million benefit related to the previous closure of the Company s facility in Zierbena, Spain. Restructuring activity for the three months ended December 31, 2007 includes the gain on the sale of land in Altona, Australia on which a former carbon black manufacturing facility was located. The gain was approximately $18 million, before tax and net of settlement costs, which was recorded in cost of sales in the accompanying consolidated statements of operations. As of December 31, 2008, there was no reserve for the Altona, Australia restructuring. Restructuring activity was recorded in the consolidated statements of operations as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Cost of sales	$ 1	$ (11)
Selling and administrative expenses	1	
Total	$ 2	$ (11)

As of December 31, 2008, the reserve balances for the 2008 Global Restructuring plan and the Waverly, West Virginia plant closure are included in accrued expenses in the accompanying consolidated balance sheets. Details of the restructuring activity and the reserve for these plans during the three months ended December 31, 2008 are as follows:

	Severance and Employee Benefits	Environmental Remediation	Total
		(Dollars in millions)	
Reserve at September 30, 2008	$ 2	$ 1	$ 3
Charges	2	1	3
Cash paid	(1)	(1)	(2)
Reserve at December 31, 2008	$ 3	$ 1	$ 4

Cabot expects to make cash payments of approximately $3 million in the remainder of 2009 related to these plans, comprised of $2 million for severance and employee benefits and $1 million of environmental remediation costs, and $1 million in 2010 for severance and employee benefits.

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CABOT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2008

UNAUDITED

K. Subsequent Event

On January 28, 2009, in response to a significant reduction in global demand, Cabot committed to a broad-based restructuring of its operations. Over the course of calendar year 2009, Cabot plans to: (i) close its manufacturing operations located in Berre, France, in Stanlow and Dukinfield, U.K., and its tantalum powder operations in Boyertown, Pennsylvania; (ii) close its regional office in Kuala Lumpur, Malaysia; (iii) mothball assets at its manufacturing operations in Merak, Indonesia and Sarnia, Ontario; and (iv) implement short worktime at its manufacturing operations in Rheinfelden, Germany.

The Company expects this restructuring will result in a pre-tax charge to earnings of approximately $150 million, with approximately $105 million of this amount expected to be recorded during fiscal year 2009. Estimates of the total amount the Company expects to incur for each major type of cost associated with the restructuring plan are: (i) severance and employee benefits of $70 million for approximately 500 employees, (ii) accelerated depreciation and impairment of facility assets of $50 million, (iii) demolition and site clearing costs of $20 million, and (iv) contract termination costs of $10 million. The total after-tax charge is estimated to be $130 million.

Net cash outlays related to these actions are expected to be $80 million, approximately $30 million of which is expected to be paid during fiscal 2009.

The segments impacted by this restructuring are presented in the table below.

Location	Core Segment		Performance Segment
	Rubber Blacks Business	Supermetals Business	
Berre, France	X		X
Stanlow, U.K.	X		X
Dukinfield, U.K.			X
Boyertown, PA		X	
Merak, Indonesia	X		
Sarnia, Ontario	X		X
Rheinfelden, Germany			X

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

I. Critical Accounting Policies and Estimates

The preparation of our financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosure of contingent assets and liabilities. We consider an accounting estimate to be critical to the financial statements if 1) the estimate is complex in nature or requires a high degree of judgment and 2) different estimates and assumptions were used, the results could have a material impact on the consolidated financial statements. On an ongoing basis, we evaluate our policies and estimates. We base our estimates on historical experience, current conditions and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The estimates that we believe are critical to the preparation of the Consolidated Financial Statements for the three months ended December 31, 2008 are presented below. We have other critical accounting policies that are discussed under the Critical Accounting Policies heading in management s discussion and analysis in our Fiscal 2008 Annual Report on Form 10-K (2008 10-K).

Revenue Recognition and Accounts Receivable

Our revenue recognition policies are in compliance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, which establishes criteria that must be satisfied before revenue is realized or realizable and earned. We recognize revenue when persuasive evidence of a sales arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is probable. We generally are able to ensure that products meet customer specifications prior to shipment. If we are unable to determine that the product has met the specified objective criteria prior to shipment, the revenue is deferred until product acceptance has occurred.

Shipping and handling charges related to sales transactions are recorded as sales revenue when billed to customers or included in the sales price in accordance with Emerging Issues Task Force (EITF) 00-10, Accounting for Shipping and Handling Fees and Costs. Shipping and handling costs are included in cost of sales.

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The following table presents the percentages of total revenue recognized in each of our reportable segments. Other operating revenues, which represent less than two percent of total revenues, include tolling, servicing and royalties for licensed technology:

	Three months ended December 31	
	2008	2007
Core Segment		
Rubber Blacks Business	63%	59%
Supermetals Business	7%	8%
Performance Segment	25%	30%
New Business Segment	3%	1%
Specialty Fluids Segment	2%	2%

As indicated above, we derive a substantial majority of revenues from the sale of products in our Rubber Blacks Business and Performance Segment. Revenue from these products is typically recognized when the product is shipped and title and risk of loss have passed to the customer. We offer certain customers cash discounts and volume rebates as sales incentives. The discounts and volume rebates are recorded as a reduction in sales at the time revenue is recognized and are estimated based on historical experience and contractual obligations. We periodically review the assumptions underlying the estimates of discounts and volume rebates and adjust revenues accordingly. Certain Rubber Blacks Business and Performance Segment customer contracts contain price protection clauses that provide for the potential reduction in past or future sales prices under specific circumstances. We analyze these contract provisions to determine if an obligation related to these clauses exists and record revenue net of any estimated protection commitments.

Supermetals revenues also are generally recognized when the product is shipped and title and risk of loss have passed to the customer.

The majority of the revenue in the Specialty Fluids business arises from the rental of cesium formate. This revenue is recognized throughout the rental period based on the contracted rental terms. Customers are also billed and revenue is recognized, typically at the end of the job, for cesium formate product that is not returned.

We maintain allowances for doubtful accounts based on an assessment of the collectibility of specific customer accounts, the aging of accounts receivable and other economic information on both an historical and prospective basis. Customer account balances are charged against the allowance when it is probable the receivable will not be recovered. In the current economic environment there could be significant changes in the allowance owing to events such as customer liquidity matters or customer bankruptcies. Such changes could impact our results of operations and cash flows. Changes in the allowance during the first quarters of fiscal 2009 and 2008 were not material.

Inventory Valuation

The cost of most raw materials, work in process and finished goods inventories in the U.S. is determined by the last-in, first-out (LIFO) method. Had we used the first-in, first-out (FIFO) method instead of the LIFO method for such inventories, the value of those inventories would have been $120 million and $140 million higher as of December 31, 2008 and September 30, 2008, respectively. The cost of other U.S. and all non-U.S. inventories is determined using the average cost method or the FIFO method. In periods of rapidly rising or declining raw material costs, the inventory method we employ can have a significant impact on our profitability. Under our current LIFO method, when raw material costs are rising, our most recent higher priced purchases are the first to be charged to cost of sales. If, however, we were using a FIFO method, our purchases from earlier periods, which were at lower prices, would instead be the first charged to cost of sales. The opposite result could occur during a period of rapid decline in raw material costs, as was the case during the first quarter of fiscal 2009.

At certain times, we may decrease inventory levels to the point where layers of inventory recorded under the LIFO method that were purchased in preceding years are liquidated. The inventory in these layers may be valued at an amount that is different than our current costs. If there is a liquidation of an inventory layer, there may be an impact to our cost of sales and net income for that period. If the liquidated inventory is at a cost lower than our current cost, there would be a reduction in our cost of sales and an increase to our net income during the period. Conversely, if the liquidated inventory is at a cost higher than our current cost, there would be an increase in our cost of sales and a reduction to our net income during the period.

We review inventory for potential obsolescence periodically. In this review, we make assumptions about the future demand for and market value of the inventory and based on these assumptions estimate the amount of any obsolete, unmarketable or slow moving inventory. We write down the value of these obsolete, unmarketable or slow moving inventories by an amount equal to the difference between the cost of the inventory and

its estimated market value. During the three months ended December 31, 2008 we recorded a pre-tax charge of $10 million to write down the value of inventory in the Rubber Blacks Business in Asia Pacific to its market value. This write-down was due to the

rapid decline in carbon black selling prices combined with high inventory levels in that region. This write-down may affect results in future periods when the inventory is sold since the write-down is to current market value assuming a zero profit margin going forward rather than the normal margin that is earned on this product. In addition, if actual market conditions are less favorable than those projected by management at the time of the assessment, additional inventory write-downs may be required, which could reduce our gross profit and our earnings.

Goodwill and Other Intangible Assets

We account for goodwill and other intangible assets in accordance with FAS No. 142, Goodwill and Other Intangible Assets, (FAS 142). We perform an impairment test for goodwill at least annually and when events or changes in business circumstances indicate that the carrying value may not be recoverable. To test whether an impairment exists, the fair value of the applicable reporting unit is estimated based on discounted future cash flows. The calculation of fair value is sensitive to both the estimated future cash flows and the discount rate applied to those cash flows. The assumptions used to estimate the discounted cash flows are based on management s best estimates about selling prices, production and sales volumes, costs, future growth rates, capital expenditures and market conditions over an estimate of the remaining operating period at the reporting unit. The discount rate is based on the weighted average cost of capital that is determined by evaluating the risk-free rate of return, cost of debt and expected equity premiums. If an impairment exists, a loss to write down the value of goodwill to its implied fair value is recorded. While this would have no direct impact on our cash flows, it would reduce our earnings. No impairments were recorded during the first quarters of fiscal 2009 or 2008.

Financial Instruments

Our financial instruments consist primarily of cash and cash equivalents, short-term and long-term debt, and derivative instruments. The carrying values of our financial instruments approximate fair value with the exception of certain long-term debt that has not been designated with a fair value hedge. This portion of long-term debt is recorded at face value. The fair values of our derivative instruments are based on quoted market prices, if such prices are available. In situations where quoted market prices are not available, we rely on valuation models to derive fair value. Such valuation takes into account the ability of the financial counterparties to perform. We use derivative financial instruments primarily for purposes of hedging exposures to fluctuations in interest rates and foreign currency exchange rates, which exist as part of our on-going business operations. We do not enter into contracts for speculative purposes, nor do we hold or issue any financial instruments for trading purposes.

All derivatives are recognized on the consolidated balance sheets at fair value. The changes in the fair value of derivatives are recorded in either earnings or other comprehensive income, depending on whether or not the instrument is designated as part of a hedge transaction and, if designated as part of a hedge transaction, the type of hedge transaction. The gains or losses on derivative instruments reported in other comprehensive income are reclassified to earnings in the period in which earnings are affected by the underlying hedged item. The ineffective portion of all hedges is recognized in earnings.

In accordance with our risk management strategy, we may enter into certain derivative instruments that may not be designated as hedges for hedge accounting purposes. Although these derivatives are not designated as hedges, we believe that such instruments are closely correlated with the underlying exposure, thus managing the associated risk. We record in earnings the gains or losses from changes in the fair value of derivative instruments that are not designated as hedges.

We carry a variety of different cash and cash equivalents on our consolidated balance sheets. We continually assess the liquidity of cash and cash equivalents and as of December 31, 2008, we have determined that they are readily convertible to cash.

Assets and liabilities measured at fair value are classified in the fair value hierarchy based on the inputs used for valuation. Assets that are traded on an exchange with a quoted price are classified as Level 1. Assets and liabilities that are valued based on quoted prices for similar assets or liabilities in active markets, or standard pricing models using observable inputs are classified as Level 2. We currently have no assets or liabilities that are valued using unobservable inputs and therefore no assets or liabilities that are classified as Level 3. Currently, the sensitivity of fair value estimates is immaterial relative to the assets and liabilities measured at fair value, as well as to our total equity.

Litigation and Contingencies

We are involved in litigation in the ordinary course of business, including personal injury and environmental litigation. After consultation with counsel, as appropriate, we accrue a liability for litigation when it is probable that a liability has been incurred and the amount can be reasonably estimated. The estimated reserves are recorded based on our best estimate of the liability associated with such matters or the low end of the estimated range of liability if we are unable to identify a better estimate within that range. Our best

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estimate is determined through the evaluation of various information, including claims, settlement offers, demands by government agencies, estimates performed by independent third parties, identification of other responsible parties and an assessment of their ability to contribute, and our prior experience. Litigation is highly uncertain and there is always the possibility of an unusual result in any particular case that may reduce our earnings and cash flows.

The most significant reserves that we have established are for environmental remediation and respirator litigation claims. The amount accrued for environmental matters reflects our assumptions about remediation requirements at the contaminated sites, the nature of the remedies, the outcome of discussions with regulatory agencies and other potentially responsible parties at multi-party sites, and the number and financial viability of other potentially responsible parties. A portion of the reserve for environmental matters is recognized on a discounted basis, which requires the use of an estimated discount rate and estimates of future cash flows associated with the liability. These liabilities can be affected by the availability of new information, changes in the assumptions on which the accruals are based, unanticipated government enforcement action or changes in applicable government laws and regulations, which could result in higher or lower costs.

Our current estimate of the cost of our share of existing and future respirator liability claims is based on facts and circumstances existing at this time. Developments that could affect our estimate include, but are not limited to, (i) significant changes in the number of future claims, (ii) changes in the rate of dismissals without payment of pending silica and non-malignant asbestos claims, (iii) significant changes in the average cost of resolving claims, (iv) significant changes in the legal costs of defending these claims, (v) changes in the nature of claims received, (vi) changes in the law and procedure applicable to these claims, (vii) the financial viability of other parties which contribute to the settlement of respirator claims, (viii) a change in the availability of insurance coverage maintained by the entity from which we acquired the safety respiration products business, (ix) changes in the allocation of costs among the various parties paying legal and settlement costs and (x) a determination that our interpretation of the contractual obligations on which we have estimated our share of liability is inaccurate. We cannot determine the impact of these potential developments on our current estimate of our share of liability for these existing and future claims. Accordingly, the actual amount of these liabilities for existing and future claims could be different than the reserved amount. Further, if the timing of our actual payments made for respirator claims differs significantly from our estimated payment schedule, and we could no longer reasonably predict the timing of such payments, we could then be required to record the reserve amount on an undiscounted basis on our consolidated balance sheets, causing an immediate impact to earnings.

Income Taxes

Our business operations are global in nature, and we are subject to taxes in numerous jurisdictions. Tax laws and tax rates vary substantially in these jurisdictions and are subject to change given the political and economic climate in those countries. We file our tax returns in accordance with our interpretations of each jurisdiction s tax laws.

Significant judgment is required in determining our worldwide provision for income taxes and recording the related tax assets and liabilities. In the ordinary course of our business, there are operational decisions, transactions, facts and circumstances, and calculations which make the ultimate tax determination uncertain. Furthermore, our tax positions are periodically subject to challenge by taxing authorities throughout the world. We have recorded reserves for taxes and associated interest and penalties that may become payable in future years as a result of audits by tax authorities. Any significant impact as a result of changes in underlying facts, law, tax rates, tax audit, or review could lead to adjustments to our income tax expense, our effective tax rate, or our cash flow.

We record our tax provision (benefit) on an interim basis using the estimated annual effective tax rate. This rate is applied to the current period ordinary income or loss to determine the income tax provision or benefit allocated to the interim period. Losses from jurisdictions for which no benefit can be realized and the income tax effects of unusual and infrequent items are excluded from the estimated annual effective tax rate. Valuations allowances are provided against the future tax benefits that arise from the losses in jurisdictions for which no benefit can be realized. In addition, the effects of the unusual and infrequent items are recognized in the impacted interim period as discrete items. The estimated annual effective tax rate may be significantly impacted by nondeductible expenses and our projected earnings mix by tax jurisdiction. Adjustments to the estimated annual effective income tax rate are recognized in the period that such estimates are revised.

Additionally, in accordance with FAS 109 Accounting for Income Taxes we have established valuation allowances against a variety of deferred tax assets, including net operating loss carry-forwards, foreign tax credits, and other income tax credits. Valuation allowances take into consideration our ability to use these deferred tax assets and reduce the value of such items to the amount that is deemed more likely than not to be recoverable. Our ability to utilize these deferred tax assets is dependent on achieving our forecast of future taxable operating income over an extended period of time. We review our forecast in relation to actual results and expected trends on a quarterly basis. Failure to achieve our operating income targets may change our assessment regarding the recoverability of our net deferred tax assets and such change could result in a valuation allowance being recorded against some or all of our net deferred tax assets. An increase in a valuation allowance would result in additional income tax expense, lower stockholders equity and could have a significant impact on our earnings in future periods. The release of valuation allowances in periods when these tax attributes become realizable would reduce our effective tax rate.

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Restructuring Activities

Our consolidated financial statements detail specific charges relating to restructuring activities as well as the actual spending that has occurred against the resulting accruals. Our restructuring charges are estimates based on our preliminary assessments of (i) severance benefits to be granted to employees, which are based on known benefit formulas and identified job grades, (ii) costs to vacate certain facilities and (iii) asset impairments. Because these accruals are estimates, they are subject to change as a result of deviations from initial restructuring plans or subsequent information that may come to our attention. These deviations may lead to changes in estimates, which would then be reflected in our consolidated financial statements.

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II. Results of Operations

Overview

During the first quarter of fiscal 2009, operating results declined compared to the first quarter of fiscal 2008 as weakness in the tire, automotive, construction and electronics markets, including customer de-stocking, reduced volumes.

During the first quarter of fiscal 2009, our Rubber Blacks Business PBT benefited by $22 million from higher prices in our supply contracts, reflecting contract adjustments relating to higher feedstock costs from prior periods. Rapidly falling feedstock costs during the quarter led to a $10 million positive impact from our LIFO accounting methodology. These factors more than offset lower volumes and a $10 million inventory write-down, leading to an increase in profitability when compared to the first quarter of fiscal 2008.

In the Supermetals Business, higher prices offset lower volumes leading to flat profitability when comparing the first quarter of fiscal 2009 to the same period of fiscal 2008.

The Performance Segment was affected by reduced demand and customer de-stocking in the automotive, construction and electronics markets in the first quarter of fiscal 2009, leading to lower volumes. These declines more than offset a $10 million positive LIFO impact from rapidly falling carbon black feedstock costs, leading to a decline in profitability when compared to the first quarter of fiscal 2008.

Profitability in the Specialty Fluids Segment decreased in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008 due to a slowdown of drilling activity in the North Sea and the mix of revenue generated from fluid rental versus that of fluids sold.

The New Business Segment increased its revenue and cash flow during the first quarter of fiscal 2009. This increase in revenues, combined with lower costs, led to improved profitability when compared to the first quarter of fiscal 2008.

During the first quarter of fiscal 2009, our cash flow from operations was $92 million, a portion of which was derived from a $61 million decrease in working capital.

In January 2009, we announced a restructuring of our operations, including a plan to close four of our manufacturing operations and one regional office, mothball assets at two additional sites and other significant cost cutting measures. These restructuring activities will take place over the course of calendar year 2009 and are expected to result in a minimum of $80 million of annual fixed cost savings in fiscal 2010.

First Quarter Fiscal 2009 versus First Quarter Fiscal 2008 Consolidated

Net Sales and Gross Profit

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Net sales and other operating revenues	$ 652	$ 711
Gross profit	$ 92	$ 117

The $59 million decrease in net sales from the first quarter of fiscal 2008 to the first quarter of fiscal 2009 was due primarily to lower volumes ($210 million) from weakness in the tire, automotive, construction and electronics markets and an unfavorable foreign currency impact ($8 million). These factors were only partially offset by higher selling prices ($140 million).

Gross profit declined by $25 million due principally to volume weakness, particularly in the Performance Segment. These lower volumes offset the favorable impact of higher prices in our rubber blacks supply contracts, the LIFO benefit from rapidly falling carbon black feedstock costs and an improvement in new business performance from increased revenues and lower costs.

During the first quarter of fiscal 2009 we recorded $1 million pre-tax of restructuring related charges as cost of sales in the consolidated statement of operations. This is compared to $11 million of restructuring related income recorded as cost of sales for the first quarter of fiscal 2008, which included an $18 million pre-tax benefit from the sale of land at our former carbon black facility in Altona, Australia.

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Selling and Administrative Expenses

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Selling and administrative expenses	$ 56	$ 56

Selling and administrative expenses were flat in the first quarter of fiscal 2009 when compared to the same period in fiscal 2008. Lower expenses from cost reduction efforts and a favorable foreign currency impact on our expenses offset a $3 million increase in bad debt reserves. We recorded $1 million pre-tax of restructuring related charges as selling and administrative expenses in the first quarters of both fiscal 2008 and fiscal 2009.

Research and Technical Expenses

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Research and technical expenses	$ 18	$ 17

The $1 million increase in research and technical expenses in the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008 was principally due to higher spending on process development efforts related to our Cabot Elastomer Composite technology.

Interest Expense

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Interest expense	$ (9)	$ (9)

Interest expense for the first quarter of fiscal 2009 was flat when compared to the first quarter of fiscal 2008 despite higher debt balances in the first quarter of fiscal 2009 due principally to a more favorable mix of interest rates.

Other Expense

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Other Expense	$ (9)	$ (2)

The $7 million increase in other expense in the first quarter of fiscal 2009 compared to the first quarter of fiscal 2008 was due principally to losses on foreign currency transactions, including an intercompany loan in Brazil denominated in U.S. dollars and charges related to the repatriation of a portion of our Bolivars held in Venezuela.

Effective Tax Rate

We recorded an income tax provision in the first quarter of fiscal 2009 of $1 million. This includes an unfavorable impact of $4 million relating to the effect of non-deductible losses, net tax benefits of $2 million from the renewal of U.S. research and experimentation credits and benefits of $1 million from tax settlements and releases. Without these factors, the tax rate for the first quarter of fiscal 2009 would have been

approximately 36%. This compares to an income tax benefit recorded in the first quarter of fiscal 2008 of $6 million. This included a $7 million net benefit from tax settlements as well as a $7 million benefit from tax credits approved by the Chinese tax authorities during the quarter. Without these tax benefits, the tax rate for the first quarter of fiscal 2008 would have been approximately 27%. Due to a geographic shift in the makeup of our earnings, we expect our tax rate for operations for fiscal 2009 to be between 35% and 37%, exclusive of the tax impact of restructuring charges and any tax settlements or tax reserve releases. We would anticipate this rate to return to our previously lower level with a more normalized earnings pattern.

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The IRS has recently completed its audit of tax years 2003 and 2004 and its review of several refund claims related to these years, which were still subject to review by the Joint Committee on Taxation (JCT) as of December 31, 2008. In late January 2009, we were notified by the IRS that the JCT review had concluded with no proposed changes to the IRS report. During the second quarter of fiscal 2009, this settlement is expected to provide a net tax benefit of approximately $5 million and a net cash receipt of approximately $15 million. We are also currently under audit by the IRS for tax years 2005 and 2006 and are under audit in a number of jurisdictions outside of the U.S. It is possible that some of the non-US audits will be resolved in fiscal 2009, which may impact our effective tax rate going forward.

Minority Interest in Net Loss (Income), net of tax

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Minority interest in net loss (income), net of tax	$ 2	$ (6)

Minority interest in net loss (income), net of tax is the means by which the minority shareholders portion of the income or loss in our consolidated joint ventures is removed from our consolidated statement of operations. In the first quarter of fiscal 2009, in total, these joint ventures experienced losses, primarily driven by lower volumes and inventory write-downs. This, in turn, led to our minority shareholders in these ventures absorbing a portion of these losses, resulting in a benefit to our consolidated statement of operations. In the first quarter of fiscal 2008, our consolidated joint ventures were profitable in total. Accordingly, our joint venture partners shared partially in these profits, and we removed their portion of this income from our consolidated results through minority interest.

Net Income

We reported net income for the first quarter of fiscal 2009 of $4 million ($0.07 per diluted common share after-tax) compared to net income of $36 million ($0.56 per diluted common share after-tax) in the same period of fiscal 2008.

First Quarter Fiscal 2009 versus First Quarter Fiscal 2008 By Business Segment

The following discussion of results includes information on our reportable segment sales and segment (or business) operating profit before tax (PBT). Segment PBT is a non-GAAP financial measure and is not intended to replace income (loss) from operations before taxes, the most directly comparable GAAP financial measure. In calculating segment PBT we exclude certain items, meaning items that are significant and unusual or infrequent, as these amounts are not believed to reflect the true underlying business performance. Specifically, in calculating segment PBT we include equity in net income of affiliated companies, royalties paid by equity affiliates and minority interest but exclude interest expense, foreign currency translation gains and losses, interest income and dividend income. Further, beginning in the first quarter of fiscal 2009, we exclude certain corporate costs that are not controlled by the Segments and which primarily benefit corporate interests. Our Chief Operating Decision-Maker uses segment PBT to evaluate changes in the operating results of each segment before non-operating factors and before certain items and to allocate resources to the segments. We believe that this non-GAAP measure also assists our investors in evaluating the changes in our results and performance. A reconciliation of segment PBT and income (loss) from operations is set forth below.

When explaining the changes in our PBT between periods, we use several terms. The term fixed costs means fixed manufacturing costs, including utilities. The term inventory related changes means the impact of changes related to items such as (i) inventory obsolescence and valuation reserves; (ii) utilization variances; and (iii) other increases or decreases in costs associated with the production of inventory. The term LIFO impact includes two factors: (i) the impact of current inventory costs being recognized immediately in cost of goods sold (COGS) under a last-in first-out method, compared to the older costs that would have been included in COGS under a first-in first-out method (COGS impact); and (ii) the impact of reductions in inventory quantities, causing historical inventory costs to flow through COGS (liquidation impact). The LIFO impact on PBT in the first quarter of fiscal 2009 is all COGS impact .

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Total segment PBT, certain items, other unallocated items (which includes unallocated corporate costs), and income (loss) from operations before income taxes for the three months ended December 31, 2008 and 2007 are set forth in the table below. The details of certain items and other unallocated items are shown below.

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Total segment PBT	$ 31	$ 46
Certain items	(2)	10
Other unallocated items	(28)	(22)
Income from operations before income taxes	$ 1	$ 34

Total segment PBT decreased by $15 million in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008. The decline was driven principally by lower volumes ($78 million) from weakness in the tire, automotive, construction and electronics markets. These lower volumes were partially offset by higher prices relative to raw material costs ($57 million), including pricing in our rubber blacks supply contracts reflecting higher feedstock costs from prior periods, and the LIFO benefit from rapidly falling feedstock costs, partially offset by a $10 million inventory write-down. Additionally, foreign currency translation benefited results by $6 million in the first quarter of fiscal 2009 when compared to the same period of fiscal 2008.

Certain Items:

Details of the certain items for the first quarter of fiscal 2009 and 2008 are as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Environmental reserves and legal settlements	$	$ (1)
Restructuring initiatives:		
Global	(2)	
Altona, Australia		18
North America	(1)	(6)
Europe	1	(1)
Total certain items, pre-tax	$ (2)	$ 10

In the first quarter of fiscal 2009, $2 million, pre-tax, of charges related to previously announced restructuring initiatives were recorded as certain items. In the same period of fiscal 2008, $10 million, pre-tax, of income from restructuring activities was recorded as certain items, which included $18 million from the sale of land at our former carbon black facility in Altona, Australia.

Other Unallocated Items:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Interest expense	$ (9)	$ (9)
Equity in net income of affiliated companies	(2)	(2)

Unallocated corporate costs	(7)	(7)
Foreign currency transaction losses	(7)	(1)
Other expense, net	(3)	(3)
Total	$ (28)	$ (22)

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Core Segment

Sales and PBT for the Rubber Blacks and Supermetals Businesses, which together comprise the Core Segment, for the first quarter of fiscal 2009 and 2008 are as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Rubber Blacks Business Sales	$ 399	$ 410
Supermetals Business Sales	45	53
Total Sales	$ 444	$ 463
Rubber Blacks Business PBT	$ 24	$ 16
Supermetals Business PBT	3	3
Total PBT	$ 27	$ 19

Rubber Blacks Business

Sales in the Rubber Blacks Business decreased by $11 million in the first quarter of fiscal 2009 when compared to the same period of fiscal 2008. Lower volumes ($118 million) from weakness in the tire and automotive industries combined with unfavorable foreign currency translation impacts ($6 million) to more than offset higher selling prices ($108 million).

Rubber Blacks PBT increased by $8 million in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008. This increase was driven principally by increased pricing relative to feedstock costs ($37 million), which included $22 million of benefit from our rubber blacks supply contracts and a $10 million favorable LIFO impact, partially offset by a $10 million inventory write-down to reduce inventory values to current market prices. Additionally, lower fixed costs and favorable foreign currency translation benefited results. All of these factors were partially offset by 29% lower volumes ($34 million).

Historically, our rubber blacks supply contracts provide for a price adjustment on the first day of each quarter to account for changes in feedstock costs and, in some cases, changes in other relevant costs. The feedstock adjustments are based upon the average of a relevant index over a three-month period. Because of the need to communicate these adjustments to our customers in a timely manner, the contracts typically provide for the adjustments to be calculated in the month preceding the quarter. Accordingly, the calculation has been typically based upon the average of the three months preceding the month in which the calculation is made. In periods of rapidly changing feedstock costs this time lag can have a significant impact on the results of the Rubber Blacks Business. For example, the contract price adjustment applicable to sales made in the quarter ended December 31, 2008 was calculated using the relevant index average during the months of June, July and August. Our raw material costs for the same quarter were based on actual feedstock costs in August, September and October, which were considerably lower. This resulted in a $22 million positive impact on PBT in the first quarter of fiscal 2009, compared to a $9 million unfavorable impact in the first quarter of fiscal 2008. During the first quarter of fiscal 2009 we renegotiated many of these agreements with our customers to provide for monthly pricing adjustments to account for changes in feedstock costs. While approximately 50% of the total volume of our Rubber Blacks Business continues to be sold under contract, only half of these contracted volumes is sold under agreements containing a four month lag in the time when prices are adjusted for feedstock costs.

Supermetals Business

Sales in the Supermetals Business decreased by $8 million in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008. The decrease was driven principally by lower volumes ($15 million), partially offset by higher prices ($5 million) and a foreign currency benefit ($2 million).

PBT in the Supermetals Business in the first quarter of fiscal 2009 was flat when compared to the same period of fiscal 2008 as higher prices ($5 million) and the positive impact of foreign currency translation ($1 million) offset lower volumes ($6 million).

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Performance Segment

Sales and PBT for the Performance Segment for the first quarter of fiscal 2009 and 2008 are as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Performance Products Business Sales	$ 105	$ 141
Fumed Metal Oxides Business Sales	52	70
Segment Sales	$ 157	$ 211
Segment PBT	$ 3	$ 31

Sales in the Performance Segment decreased by $54 million in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008. The decline was driven principally by lower volumes ($74 million) from weakness in the automotive, construction and electronics industries, partially offset by higher selling prices ($18 million).

PBT in the Performance Segment in the first quarter of fiscal 2009 was $28 million lower when compared to the first quarter of fiscal 2008. Volumes in the Performance Products and Fumed Metal Oxides Businesses were 37% and 30% lower than in the same period of fiscal 2008, respectively. These lower volumes, resulting from a combination of customer de-stocking and underlying demand decline in the automotive, construction and electronics markets, unfavorably affected PBT by $37 million. The impact of these lower volumes, combined with the unfavorable effects of inventory related changes ($5 million) from lower production levels, more than offset the $14 million favorable impact of higher prices relative to raw material costs, which included a $10 million LIFO benefit from rapidly falling carbon black feedstock costs.

New Business Segment

Sales and PBT for the New Business Segment for the first fiscal quarter of 2009 and 2008 are as follows:

	Three Months Ended December 31	
	2008	2007
	(Dollars in millions)	
Inkjet Colorants Business Sales	$ 13	$ 8
Aerogel Business Sales	4	1
Superior MicroPowders Sales	1	1
Segment Sales	$ 18	$ 10
Segment PBT	$ (3)	$ (12)

Sales in the New Business Segment increased by $8 million in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008. The loss in the New Business Segment for the first quarter of fiscal 2009 was $3 million, which is a $9 million improvement from the first quarter of fiscal 2008. During fiscal 2008, we took steps to improve the pace and efficiency of our new business development efforts, including the elimination during the third quarter of fiscal 2008 of certain underperforming projects. These actions have led to increased revenues and lower costs in this Segment. Specifically, the increase in revenues in the Inkjet Colorants Business was due to higher volumes in both the OEM and aftermarket market segments, while an increase in orders in both the construction and oil and gas market segments led to higher revenues in the Aerogel Business.

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Specialty Fluids Segment

Sales and PBT for the Specialty Fluids Segment for the first quarter of fiscal 2009 and 2008 are as follows:

	Three Months Ended December 31	
	2008	**2007**
	(Dollars in millions)	
Segment Sales	$ 15	$ 16
Segment PBT	$ 4	$ 8

Both sales and PBT in the Specialty Fluids Segment declined in the first quarter of fiscal 2009 when compared to the first quarter of fiscal 2008. These declines were due to a slowdown in drilling activity in the North Sea. Both rental revenue and volume of fluid sold declined in the first quarter of fiscal 2009, resulting in the lower revenues. The decline in rental revenue was more significant than the decline in volume of fluid sold, leading to a larger impact on PBT than on revenue due to the higher margin associated with rental revenue.

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III. Cash Flow and Liquidity

Overview

Our liquidity position improved during the quarter primarily driven by decreasing carbon black feedstock costs which resulted in reduced working capital requirements. At December 31, 2008, we had cash or cash equivalents of $149 million, and current availability under our revolving and other credit facilities of approximately $160 million. While the availability of our credit facilities is dependent upon the financial viability of our lenders, we have no reason to believe that such liquidity will be unavailable or decreased. Our revolving credit facility contains financial covenants as to debt to total capitalization ratio and the level of subsidiary debt. At December 31, 2008 we were in compliance with these covenants and expect to remain so. All available cash is on deposit with banking institutions that we continue to believe are financially sound.

We expect cash on hand, cash from operations and present financing arrangements, including our unused lines of credit, to be sufficient to meet our cash requirements for the foreseeable future. This includes our anticipated debt repayments, capital expenditures and cash restructuring costs to be made during the next twelve months.

Cash Flows from Operating Activities

Cash generated by operating activities, which consists of net income adjusted for the various non-cash items included in income, changes in working capital and changes in certain other balance sheet accounts, totaled $92 million in the first quarter of fiscal 2009 compared to a use of cash from operating activities of $42 million during the first quarter of fiscal 2008. The principal drivers of the cash generated from operations in the first quarter of fiscal 2009 were a $99 million decrease in receivables due to lower sales volumes and receivables collections and a $49 million decrease in inventories due to reductions in inventory levels and declines in carbon black feedstock costs. These sources of cash were partially offset by the use of cash for accounts payable and accrued liabilities due to the timing of certain payments. In the first quarter of fiscal 2008 rising carbon black feedstock costs and the need for higher inventory quantities resulted in a $20 million and $50 million increase in receivables and inventories, respectively. These uses of cash were partially offset by stronger net income from operations in that quarter.

We expect to receive a net cash refund in the second quarter of fiscal 2009 of approximately $15 million from the settlement of the IRS audit of tax years 2003 and 2004 and related refund claims. This refund, however, is expected to be largely offset during the second quarter by cash tax payments scheduled to be paid in other jurisdictions.

Restructurings

As of December 31, 2008, we had $4 million of total restructuring costs in accrued expenses in the consolidated balance sheet related to the closure of our plant in Waverly, West Virginia and our 2008 global restructuring plan. We made cash payments of $2 million during the first quarter of fiscal 2009 related to restructuring costs.

On January 28, 2009, we announced a significant restructuring of our operations. Over the course of calendar year 2009, we intend to close four of our manufacturing operations and one regional office. In addition, we plan to mothball assets at two sites and implement short worktime at one site. The restructuring is expected to result, in total, in an approximate $80 million cash charge and non-cash charges of approximately $70 million. A majority of the total costs will be incurred during fiscal 2009. This restructuring plan, which will impact the Core and Performance segments, is expected to deliver in excess of $80 million of annual fixed cost savings in fiscal 2010.

Repatriation of Foreign Currency

During the first quarter of fiscal 2009, we repatriated a portion of our cash balance denominated in Bolivars. We recognized a foreign exchange loss as a result of this transaction. As of December 31, 2008, we had cash denominated in Bolivars of approximately $9 million in Venezuela, which has been translated at the official exchange rate. We continue to be concerned about the amount that we will be able to receive when we repatriate some or all of this cash as we have not received approval to exchange the Bolivars at the official rate. If we are unable to repatriate this cash at the official exchange rate or if the official exchange rate devalues, we may incur additional reductions to our earnings and translated cash balances would be reduced.

Environmental and Litigation

We have recorded a $7 million reserve on a discounted basis ($9 million on an undiscounted basis) as of December 31, 2008, for environmental remediation costs at various sites. These sites are primarily associated with businesses divested in prior years. Additionally, we have recorded a $14 million reserve on a discounted basis ($24 million on an undiscounted basis) for respirator claims as of December 31, 2008. We anticipate that these expenditures will be made over a number of years, and will not be concentrated in any one year. We also have other litigation costs associated with lawsuits arising in the ordinary course of business including claims filed against us in connection with certain discontinued operations.

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Employee Benefit Plans

We provide defined benefit plans for all U.S. and some foreign employees. Due to recent global market declines, our U.S. qualified defined benefit plan asset values declined by approximately 18% during the quarter, causing the plan to be in an underfunded position at December 31, 2008. While in the past several years we have not been required to make a contribution to the U.S. plan, the decline in the plan asset values will require us to contribute approximately $2 million to this plan during fiscal 2009.

Cash Flows from Investing Activities

Cash flows from investing activities consumed $35 million of cash in the first quarter of fiscal 2009 compared to $17 million in the first quarter of fiscal 2008. During the first quarter of fiscal 2009, capital expenditures of $32 million included an investment of $3 million in a carbon black joint venture located in China and residual spending to complete rubber blacks capacity expansion at an existing facility in China and energy centers at other rubber blacks facilities. In fiscal 2008 capital expenditures were offset by the proceeds of $18 million received from the sale of the land on which our Altona, Australia carbon black plant was located.

Cash Flows from Financing Activities

Financing activities used $38 million of cash during the first quarter of fiscal 2009 compared to $31 million of cash provided in the first quarter of fiscal 2008. In the first quarter of fiscal 2009 financing cash flows were primarily driven by the net reduction in debt of $25 million and a dividend payment of $12 million. In fiscal 2008 a total increase of $45 million in debt offset by the quarterly dividend payment of $12 million resulted in the positive cash flow from financing activities.

Contractual Obligations

Purchase Commitments

We have entered into long-term purchase agreements primarily for the purchase of raw materials and natural gas. Under certain of these agreements the quantity of material being purchased is fixed, but the price we pay changes as market prices change. The commitments in the table below are quantified on the basis of market prices at December 31, 2008.

	Payments Due by Fiscal Year (Dollars in millions)						
	2009	**2010**	**2011**	**2012**	**2013**	**Thereafter**	**Total**
Core Segment							
Rubber Blacks Business	$ 131	$ 129	$ 99	$ 81	$ 76	$ 782	$ 1,298
Supermetals Business	30	15	16	17	6	1	85
Performance Segment	96	37	18	16	17	146	330
Specialty Fluids Segment	3	4					7
Total	$ 260	$ 185	$ 133	$ 114	$ 99	$ 929	$ 1,720

Off-balance sheet arrangements

Cabot has no material transactions that meet the definition of an off-balance sheet arrangement.

Forward-Looking Information

This report on Form 10-Q contains forward-looking statements under the Federal securities laws. These forward-looking statements address expectations or projections about the future, including our expectations concerning the amount and timing of the charge to earnings we will record in connection with, and the annualized fixed cost savings we expect to realize from, the restructuring initiative we announced in January 2009; the benefits we expect to receive from recent tax settlements; our expected tax rate for fiscal 2009; the amount and timing of charges and payments associated with restructurings and cost reduction initiatives we have previously undertaken; the amount and timing of payments associated with environmental remediation and respirator claims; the amount and timing of cash contributions we may make to our U.S.

qualified defined benefit plan; the outcome of pending litigation; capital expenditures for fiscal 2009; cash requirements and uses of available cash; and our ability to meet cash requirements for the foreseeable future.

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Forward-looking statements are based on our current expectations, assumptions, estimates and projections about Cabot s businesses and strategies, market trends and conditions, economic conditions and other factors. These statements are not guarantees of future performance and are subject to risks, uncertainties, potentially inaccurate assumptions, and other factors, some of which are beyond our control or difficult to predict. If known or unknown risks materialize, or should underlying assumptions prove inaccurate, our actual results could differ materially from those expressed in the forward-looking statements.

In addition to factors described elsewhere in this report, the following are some of the factors that could cause our actual results to differ materially from those expressed in the forward-looking statements: changes in raw material costs; lower than expected demand for our products; fluctuations in currency exchange rates; patent rights of others; stock and credit market conditions; the timely commercialization of products under development (which may be disrupted or delayed by technical difficulties, market acceptance, competitors new products, as well as difficulties in moving from the experimental stage to the production stage); our ability to successfully implement our cost reduction initiatives and organizational restructurings; demand for our customers products; competitors reactions to market conditions; the accuracy of the assumptions we used in establishing a reserve for our share of liability for respirator claims; and the outcome of pending litigation. Other factors and risks are discussed in our 2008 10-K.

We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Investors are advised, however, to consult any further disclosures we make on related subjects in future 10-K, 10-Q and 8-K reports filed with the Securities and Exchange Commission.

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IV. Recently Issued Accounting Pronouncements

Issued Accounting Standards Not Yet Adopted

In December 2007, the FASB issued FAS No. 141 (Revised 2007), Business Combinations (FAS 141(R)). FAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of business combinations. FAS 141(R) is effective on a prospective basis for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combination we enter into after September 30, 2009 will be subject to this new standard.

In December 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51 (FAS 160). FAS 160 establishes accounting and reporting standards for the ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in the parent s ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. FAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. FAS 160 will be effective for us for the first quarter of fiscal 2010, beginning October 1, 2009. We are evaluating the impact of FAS 160 on our consolidated financial statements.

In March 2008, the FASB issued FAS No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (FAS 161). FAS 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance and cash flows. FAS 161 is effective for us beginning on January 1, 2009. FAS 161 will not affect our financial position or results of operations. The new standard solely affects the disclosure of information.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Information about market risks for the period ended December 31, 2008 does not differ materially from that discussed under Item 7A of our fiscal 2008 Annual Report on Form 10-K.

Item 4. Controls and Procedures

As of December 31, 2008, we carried out an evaluation, under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Executive Vice President and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon that evaluation, our President and Chief Executive Officer and our Executive Vice President and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of that date.

There were no changes in our internal control over financial reporting that occurred during our fiscal quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

Item 1. Legal Proceedings

Respirator Liabilities

We have exposure in connection with a safety respiratory products business that a subsidiary acquired from American Optical Corporation (AO) in an April 1990 asset purchase transaction. The subsidiary manufactured respirators under the AO brand and disposed of that business in July 1995. In connection with its acquisition of the business, the subsidiary agreed, in certain circumstances, to assume a portion of AO s liabilities, including costs of legal fees together with amounts paid in settlements and judgments, allocable to AO respiratory products used prior to the 1990 purchase by the Cabot subsidiary. As more fully described in our 2008 10-K, our respirator liabilities involve claims for personal injury, including asbestosis, silicosis and coal worker s pneumoconiosis, allegedly resulting from the use of AO respirators that are alleged to have been negligently designed or labeled. As of December 31, 2008, there were approximately 54,000 claimants in pending cases asserting claims against AO in connection with respiratory products. We have a reserve to cover our expected share of liability for existing and future respirator liability claims. The book value of the reserve is being accreted up to the undiscounted liability through interest expense over the expected cash flow period, which is through 2052, and, at December 31, 2008, is approximately $14 million on a discounted basis (or $24 million on an undiscounted basis).

Beryllium Claims

We are a party to several pending actions in connection with our discontinued beryllium operations in Reading, Pennsylvania. We entered the beryllium industry through an acquisition in 1978. We ceased manufacturing beryllium products at one of the acquired facilities in 1979, and the balance of our former beryllium business was sold to NGK Metals, Inc. (NGK) in 1986. As more fully described in the 2008 10-K, the actions are pending in several state and federal courts and involve claims for personal injury and medical monitoring relating to alleged contact with beryllium in various ways. During the first quarter of fiscal 2009, one of the personal injury claims pending against us in state court in Pennsylvania was settled, leaving two personal injury claims pending against us in that court as of December 31, 2008.

We believe we have valid defenses to all of the beryllium actions and will assert them vigorously in the various venues in which claims have been asserted. In addition, there is a contractual indemnification obligation running from NGK to Cabot in connection with many of these matters.

AVX

In September 2005, AVX filed an action in the Superior Court of Massachusetts for Suffolk County, which, in November 2005, was moved to the Business Litigation Section of the Superior Court of Massachusetts. The action alleges that Cabot improperly administered the parties Supply Agreement for the years 2003 through 2005. In particular, AVX claims that we have not provided all of the price relief due to AVX under the most favored customer (MFC) provisions of the Supply Agreement. AVX seeks a judicial declaration of the rights of the parties to the Supply Agreement, an accounting of monies paid, due or owing under the MFC provisions, and an award of any sums not paid that should have been. We filed an answer and counterclaims against AVX asserting that AVX actually underpaid for tantalum products in the period 2003 through 2005. On December 31, 2007, the court issued an order allowing AVX s motion for partial summary judgment on one significant legal issue involving interpretation of the Supply Agreement, but denied AVX s motion and our cross-motion in all other respects, including AVX s motion to dismiss Cabot s affirmative defenses that would negate AVX s claims. Prior to July 2008, AVX had indicated that it believed it is owed additional MFC benefits of approximately $24 million, which we dispute. In July 2008, AVX attempted to assert new legal theories that increased its damage claim for additional MFC benefits to approximately $96 million. We subsequently filed a motion to strike AVX s revised claim for MFC benefits and in November 2008, the court granted our motion and denied AVX s additional damage claim for MFC benefits of $72 million, thereby limiting AVX s claim to the previously stated $24 million. AVX subsequently filed a motion requesting the court to reconsider or clarify this ruling, which was denied in its entirety.

We believe that we have valid defenses to all of AVX s claims, including the one on which partial summary judgment was granted, and will continue to assert these defenses and our counterclaims vigorously. In addition, if necessary, we have the right to appeal the court s order allowing AVX s motion for partial summary judgment.

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Other Matters

We have various other lawsuits, claims and contingent liabilities arising in the ordinary course of our business, including a number of claims asserting premises liability for asbestos exposure, and in respect of our divested businesses. In our opinion, although final disposition of some or all of these other suits and claims may impact our financial statements in a particular period, they should not, in the aggregate, have a material adverse effect on our consolidated financial position.

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Item 1A. Risk Factors

There have been no material changes from the risk factors disclosed in the Risk Factors section of our Annual Report on Form 10-K for the year ended September 30, 2008.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The table below sets forth information regarding the Company s purchases of its equity securities during the first quarter ended December 31, 2008.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2008 October 31, 2008	13,159	$ 13.54	1,759	4,312,837
November 1, 2008 November 30, 2008	3,470	$ 12.19	470	4,312,367
December 1, 2008 December 31, 2008	30,660	$ 11.47	810	4,311,557
Total	47,289		3,039	

(1) On May 11, 2007, we announced publicly that our Board of Directors authorized us to repurchase five million shares of our common stock in the open market or in privately negotiated transactions. On September 14, 2007, our Board of Directors increased the share repurchase authorization to 10 million shares. This authority does not have a set expiration date.

Included in the shares repurchased from time to time by Cabot under the Board s authorization are shares of common stock repurchased from employees at fair market value to satisfy tax withholding obligations that arise on the vesting of shares of restricted stock and the exercise of stock options. During the first quarter of fiscal 2009, of the 3,039 shares repurchased pursuant to the Board s authorization, 2,229 were repurchased from employees in private transactions and 810 were repurchased from employees to satisfy tax withholding obligations. The average price paid for the 3,039 shares was $24.09.

From time to time, we also repurchase shares of unvested restricted stock from employees whose employment is terminated before such shares vest. These shares are repurchased pursuant to the terms of our equity incentive plans and are not included in the shares repurchased under the Board s authorization. During the first quarter of fiscal 2009, we repurchased 44,250 forfeited shares pursuant to the terms of our equity incentive plans. The purchase price for these repurchased shares was the employee s original purchase price for the stock, which under the terms of the Company s long term incentive compensation program since 1999 has been an amount equal to 30% of the fair market value of such shares on the date of grant. The average price per share paid for these forfeited shares was $11.28.

Item 6. Exhibits

The following Exhibits are filed herewith:

Exhibit 3.1	Restated Certificate of Incorporation of Cabot Corporation effective January 9, 2009.
Exhibit 10.1*	Cabot Corporation Amended and Restated Supplemental Cash Balance Plan dated December 31, 2008.
Exhibit 10.2*	Cabot Corporation Amended and Restated Supplemental Retirement Savings Plan dated December 31, 2008.
Exhibit 10.3*	Amendment to Cabot Corporation Senior Management Severance Protection Plan dated December 31, 2008.
Exhibit 10.4*	Amendment to Cabot Corporation Short-Term Incentive Compensation Plan dated December 31, 2008.
Exhibit 10.5*	Amendment No. 2 to Cabot Corporation Amended and Restated Deferred Compensation Plan dated December 31, 2008.
Exhibit 31.1	Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act.
Exhibit 31.2	Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act.
Exhibit 32	Certifications of the Principal Executive Officer and the Principal Financial Officer pursuant to 18 U.S.C. Section 1350.

* Management contract or compensatory plan or arrangement.

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SIGNATURES

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

Cabot Corporation

Date: February 9, 2009

By: /s/ Jonathan P. Mason
Jonathan P. Mason
Executive Vice President and Chief Financial Officer

(Duly Authorized Officer)

Date: February 9, 2009

By: /s/ James P. Kelly
James P. Kelly
Vice President and Controller

(Chief Accounting Officer)

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Exhibit Index

Exhibit No.	Description
Exhibit 3.1	Restated Certificate of Incorporation of Cabot Corporation effective January 9, 2009.
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Exhibit 32	Certifications of the Principal Executive Officer and the Principal Financial Officer pursuant to 18 U.S.C. Section 1350.

* Management contract or compensatory plan or arrangement.