Convertibles
Commentary

First Quarter 2009

AVIVA INVESTORS

Market Review

The first quarter of 2009 was another volatile period for the equity markets, as many concerns that plagued them in 2008 continued. The financial sector sold off significantly in the first part of the quarter. Credit remained tight, and investor concerns regarding adequate capital ratios continued. The financial sector bounced from its lows towards the latter part of the quarter, however, as a couple of larger financial institutions disclosed a profitable January and February.

Quantitative easing remained the main focus for the Federal Reserve, as it continued taking steps to bring down rates. The Federal Open Market Committee announced March 18 that it would buy up to $300 billion of the two- to 10-year Treasuries over the next six months. In addition, the Fed announced a $750 billion increase in its planned mortgage-backed securities purchases by year end and noted the launch of the Troubled Asset Loan Funding program. We also heard more details regarding the Public-Private Investment Program during the quarter.

Treasuries posted a slight loss during the quarter, as short-end yields ended up around 12 basis points, and the long-end yield was up 85 basis points. Volatility is likely to remain over the near future, as equity and debt investors digest the impact of monetary and fiscal policy, along with first-quarter corporate earnings.

The convertible marketplace improved, both in performance and issuance. Volatility measured by the CBOE Volatility Index was up 10% in the first quarter and fell below 40 for only a short period. Convertibles richened from 3.85% cheap at the start of the year to 2.53% cheap at the end of March, according to Merrill Lynch data. Speculative grade converts outperformed their Investment grade counterparts, as risk appetites increased, and investors sought relative cheapness in the below-investment grade space. High yield spreads tightened from 1,812 in the beginning of the year to 1,703 at the end of March. The convertible universe recently saw a pickup in new issuance after virtually none in the last quarter of 2008. Total new issuance during the quarter totaled $2.8 billion, and a decent number were issued by investment grade rated corporations. Companies also have been buying back their outstanding convertible debt at a good clip, giving them a cheap way to de-lever their balance sheets.

Market Outlook and Strategy

Economic activity appeared to pick up pace toward the end of the quarter, as retail sales and home sales were better than expected. Any meaningful pickup seems unsustainable, however because unemployment remains elevated, and credit markets are still in dislocation. As a result, we continue to take a defensive posture and believe that companies and the capital markets still have many issues to work through.

De-leveraging will continue to be a main focus, as companies and consumers concentrate on cleaning up their balance sheets. The Treasury and Federal Reserve are advocating highly inflationary policies, with a weak dollar policy, quantitative easing and loose discount-window standards.

We continue to favor commodities as an inflation hedge due to worldwide fundamentals, supply constraints and the potential for a weak dollar. We also like pharmaceutical companies because of their ability to fund internally due to strong cash flows. We intend to remain underweight on financials as tight capital, likely tighter regulation, poor transparency and distorted markets make the group unattractive. We expect volatility to remain elevated over the near term but trend down over the longer term if credit markets can stabilize.

Sector weighting and security selection will continue to be the most important factors in determining performance, as the effects of the housing market, higher costs, elevated inflation, job losses and tighter credit play out over the next several quarters.

Convertibles can be attractive, because they allow investors to participate in equity upside due to the option feature, while limiting the downside due to the bond component. For the remainder of the year, we believe convertibles will offer investors an opportunity to benefit from expected increases in volatility and a robust issuance calendar.