

Market Review

The convertible marketplace advanced from rising underlying equity prices and credit spread tightening. As consensus has now shifted to a second-half recovery, investors have been quick to add risk to their portfolios. The top-performing sectors were consumer discretionary and materials. This indicates that most investors see a return to normalcy later this year and a typical consumer-led recovery.

The federal government has provided unprecedented support to the financial system and is involved in an increasing percentage of the total economy. The risk of unintended consequences remains, as it does with all interventions aimed at the short term. The next several months will begin to show whether we have entered a period of asset inflation spurred by very loose economic policy or a liquidity trap where companies and individuals build savings and continue to de-lever.

The convertible marketplace continued to improve in the second quarter, both in performance and issuance. Volatility has been trending downward; The Chicago Board Options Exchange Volatility Index is now below 30. The Standard & Poor's 500 Index was up 15.93% for the quarter; the Dow Jones Industrial Average was up 11.96%; and the NASDAQ Composite outperformed, with a 20.34% rise. Convertibles cheapened, from 2.53% cheap at the start of the quarter to 3.38% cheap at the end of the quarter, according to Merrill Lynch data.

Speculative grade converts outperformed their investment grade counterparts, and small cap outperformed, as investors' appetite for risk returned. For the quarter, speculative grade converts are up an eye-popping 26.1%, while investment grade converts have returned 11.8%. This takes the year-to-date performance to 40.7% and 8.1%, respectively. New issuance continued in the quarter but was dominated by smaller deal sizes. For the quarter, we saw 45 new issues, with total proceeds of \$12.8 billion.

Market Outlook and Strategy

The rate of decline in the economy has slowed, and this has led to predictions of a V-shaped recovery in the second half, with the consumer leading the way. This seems extremely unlikely to us, because the employment situation is abysmal and likely to remain depressed through next year. In addition, deleveraging is starting to take place, where ideas about wealth are centered more on savings than borrowing.

As a result, we maintain 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, quantitative easing and loose discount window standards. This is counterbalanced by a very weak employment situation and very low utilization rates.

We continue to like gold as a safety investment in the near term and an inflation hedge for the longer term. We also like pharmaceutical companies because of their ability to fund internally, due to strong cash flows. We intend to remain underweight in financials, as tight capital, probable tighter regulation, poor transparency and distorted markets make the group unattractive.

Sector weighting and security selection will continue as the most important factors in determining performance. The effect of the housing market, higher costs, elevated inflation, job losses and tighter credit will play out over the next several quarters. We dedicate our resources to fundamental research, which should help us to outperform going forward.

Convertibles are attractive, because they allow us to participate in the equity upside with the option feature, while limiting our downside with 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.