

Market Review

The convertible market performed very well in the fourth quarter, delivering a 6% return. December added 4.1%, driven by underlying equities advancing 6.9% for the month. This ongoing trend upward was driven by increasing risk appetites, underlying stock prices, tightening credit and associated inflows to the strategy. New issuance was restrained, but pricing should help it going forward.

Speculative grades outperformed their lower-risk counterparts, putting up an 8.2% return in the quarter. Underlying equity performance of 8.4% was the primary driver. Investment grade converts advanced 4% in the quarter, also driven by underlying stock performance of 5.6%. The fourth quarter saw a reversal in favorites, with mid- and large-cap convertibles outperforming small caps. Small caps held on to their top performance slot for the year, however.

Pricing continued to improve, given limited supply. Any dislocations in the marketplace from earlier this year have long since disappeared.

New issuance remains disappointing, at just \$8 billion for the quarter. Company expenditures will be a determining swing factor for new issuance in 2010. Mergers and acquisitions also could provide an issuance boost.

Government intervention, aimed at short-term stabilization, has provided liquidity to the financial market, but the longer-term effects remain to be seen. The underlying real health of the economy also is still a question, because this unprecedented broad support from the federal government is distorting many indicators.

Volatility continued to trend downward in the quarter from its March highs. If economic improvement trends waver or change, volatility will likely increase.

Market Outlook and Strategy

Most predictions call for growth to continue even as government support wanes. We believe, however, that the consumer is not financially capable of leading a recovery and could derail it once government support decreases. Cash-strapped states, continued housing problems, a weak commercial real estate market, a federal budget that is unsustainable and extremely loose monetary policy all present medium-term risks to the equity and credit markets. Flows into hedge funds also will affect the converts market. If the current positive trend should reverse, pricing will soften. We expect new issuance to remain consistent with or slightly below 2009 levels.

Considering these trends, we remain somewhat defensive in our approach to portfolio construction. We will take strategic positions in gold and other commodities. We expect loose monetary policy and deficit spending to continue pressuring the dollar, with deflation in the near to medium term and inflation on the horizon if money velocity suddenly reverses. We generally favor hard assets, healthcare and energy service and will remain underweight to financials, consumer discretionary and industrials.

Sector weighting will have the most influence on performance for the next few quarters, with security selection in the secondary position. Our dedication to fundamental research is critical to driving outperformance.

As always, convertibles provide balanced exposure to any equity upside while providing downside protection and an income stream – all attractive alternatives to straight debt or outright equities. Any increasing volatility in the market – along with attractive secondary pricing – will make this category appealing in 2010.

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