

Market Review

The Barclays Capital Global High Yield Constrained Index turned in its fourth consecutive quarter of positive returns, at 6% for the fourth quarter of 2009, although it significantly lagged the record returns of the second (24.23%) and third (15.55%) quarters. October and November, at 1.95% and 0.87% respectively, provided the second and third lowest monthly returns of the year. December ended stronger, at 3.08%, with no negative trading days.

Since the market bottomed in March, the rest of 2009 has been beta driven. The second half of the year returned 22.49% — roughly 10% less than the first half. At 62.33%, 2009's return easily offset the -38.42% return of 2008 — the worst year since the index began in 2002. Compared with the Barclays Capital U.S. High Yield Constrained Index, which has a 17-year-history, the global high yield market of 2009 still recorded the best performance.

Global high yield corporate spreads compressed by another 143 basis points (bps) for the quarter to 682 bps, though at a much smaller magnitude. Year to date, spreads have contracted by 1,136 bps, from 1,818 bps on December 31, 2008. Current spread levels remain attractive compared to long-term averages, and we foresee another 100 bps tightening opportunity in 2010. With an option-adjusted duration of 4.2, the 100 bps of tightening alone can yield a 4% return. Combined with a current coupon yield of 8.6%, an expected default rate of 4% and a recovery rate of 35%, the global high yield market could return 10% in the next 12 months.

The primary market for high yield remained strong, with an additional \$48 billion of new issues coming into the market in the fourth quarter. That pushed the 2009 total to \$153 billion — far ahead of 2006's record \$142 billion and triple the new issuance of 2008.

As we saw in previous quarters, higher-quality bonds (BB and B) dominated the new issuance market, making up 86% in the fourth quarter and 90% for the year. The majority of the new issuance was in the form of senior notes. Refinancing was the main reason for new issuance, accounting for 75% of the total, according to Barclays Capital.

On the demand side, the high yield market absorbed more than \$2 billion in the fourth quarter, according to AMG Data Services. Mutual fund net flows reached \$32.7 billion for the year, which is in line with the previous high of \$27.3 billion in 2003.

Lower credit qualities outperformed higher qualities from March through December of 2009, as investors searched for yields. BB and B rated issues returned 4.54% and 4.87% respectively for the fourth quarter, while credits rated CCC and below returned 9.96%. For the

year, BBs and Bs each returned roughly 50%, and CCCs returned a stunning 111.5%.

Echoing the hunt for yield observed from a quality perspective, the more volatile and cyclical sectors performed best in the fourth quarter, as well. Financials came into the spotlight, as help from the government restored investor confidence and stabilized the market. The financial credits in the Global High Yield Constrained Index returned 8.77% for the fourth quarter and 121.4% for the year. Chemicals and retailers were in the same range, with returns of 9.47% and 8.62% respectively for the quarter and 81.25% and 85.25% for the year. Conversely, the lower-risk and more-defensive sectors provided moderate returns. Utilities, food and beverage and aerospace/defense performed relatively poorly, returning 5.19%, 3.28% and 4.05% respectively for the quarter and 32.73%, 38.13% and 35.17% for the year.

The Moody's Investor Service global issuer-weighted default rate finished 2009 at 12.5%, after peaking in November at 12.9%. November default rate surpassed the previous peak of 12.79% in 1991 and is significantly higher than the 4.19% default rate we saw at the end of 2008. According to J.P. Morgan, in 2009, 118 issuers defaulted with a total volume of \$184 in bonds and loans, compared with 82 issuers totaling \$49.2 billion in 2008. Despite the staggering headline numbers, many borrowers were able to negotiate with lenders for reduced liabilities. The largest default in 2009, CIT Group Inc., is one example. It filed for Chapter 11 in November with \$26 billion in bonds and loans. The company quickly reemerged from bankruptcy in December, however, with a reorganization plan. Moody's is currently forecasting global default rates to decline significantly to 3.3% by the end of 2010 due to improved liquidity. We also expect recovery rates to return back to the 40% historical level from the current level of below 30%.

Outlook and Strategy

Going into 2010, we continue to recommend a moderate overweight to high yield bonds within balanced portfolios, given our positive outlook on fundamental credit trends and historically attractive valuations. While 2009 has produced significant gains from what we feel were oversold conditions in the fourth quarter of 2008, we believe that 2010 will see a continuation of the credit rally, although by a much smaller degree. Companies have gained access to the capital markets in 2009, providing them the opportunity to extend their debt payments and reduce the likelihood of default. The combination of strengthening balance sheets and increasing operating leverage via cost cutting is putting companies in a good position to service debt when top-line growth returns.

Current valuations of around 680 bps over Treasuries and a yield-to-worst of 9.3% are still compelling, especially with the backdrop of 4% forecasted default rates. The long-term average spread over Treasuries in high yield bonds is roughly 500 bps, potentially providing further price appreciation. We also expect the hunt for yield outside of Treasuries to accelerate, as meager Treasury yields and further supply remind investors about interest rate risk. Lastly, while retail investors poured money into high yield bond funds in 2009, leaving many institutional investors in the dust, we expect that institutional investors who have been circling the wagons will pull the trigger on an allocation to high yield, continuing to keep demand high for the asset class. We believe the primary market will remain robust to absorb the money inflows, as issuers use the capital to refinance loans for bonds, extend maturities and fund operations.

An inability to sustain growth after government stimulus benefits run out, a more cautious spending pattern from consumers and tight credit conditions for small businesses remain our primary concerns for the economy, because they can cause volatility and temper growth. We think the CCC rally we saw this year is unsustainable, and we believe 2010 will be driven less by beta and more by idiosyncratic risk. We would like to reiterate our recommendation on an overweight to BB and B rated bonds due to risk/reward opportunities and a focus on credit selection.

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