

## Market Review

The convertibles market performed well in the quarter, with a return of 5.6%. Underlying equity performance and spread tightening drove the returns. The market has continued the trend of the last several quarters, as risk appetite continues to increase and investors search for returns in an ultralow interest rate environment. Sovereign debt issues briefly quelled the rally but turned out to be a short-term influence.

Investors' appetite for risk also is fueled by small- and midcaps outperforming large caps, growth outperforming value, and speculative-grade investments outperforming investment grades. Convertibles have continued to richen on strong underlying demand, as investment capital and the return of hedge fund leverage bring fresh money to the space.

New issuance showed signs of life, particularly in March. We saw 14 new deals with net proceeds of \$4.3 billion. Amid strong demand, pricing was close to fair value. Priceline and Hartford were among the notable new issues.

Investors continue to search for returns in an environment of 0% short-term interest rates and low yields. We have seen this behavior before, when the Federal Reserve (Fed) boosts risk assets by making savings and income-producing instruments unattractive from a return perspective. We are seeing distorted demand in some investment sectors and would expect a reversal when the Fed is forced to raise interest rates and tighten its extremely loose monetary policy.

Government intervention has succeeded in inflating investment and risk assets. It has provided unprecedented liquidity to the banks and financial institutions, which has prevented a larger swath of banks from being seized. It has been unsuccessful in spurring lending; demand for new credit is as tepid as the willingness to lend. This has resulted in a collapse of the velocity of the money supply, as banks build excess reserves. As with all government intervention, the unintended consequence and long-term effects – both moral and monetary – remain to be seen.

Volatility has remained subdued after a brief uptick during the initial Greek debt issues. We expect it to increase in the future.

## Outlook and Strategy

We foresee slow, below-trend economic growth for the remainder of the year and acceleration into 2011. Profit expectations remain robust. We believe the economy still has significant structural issues, and much-needed fixes have not been implemented, which will lead to unforeseen events and result in jolts to the economy. The overall trend of U.S. consumers – whether they reduce savings to historical levels or increase household leverage – remains at the heart of the potential for near- and medium-term growth.

We remain somewhat defensive and look for companies that don't require significant U.S. or worldwide growth to be successful. We believe that the economic recovery has significant headwind and is vulnerable to more shocks. In addition, costs associated with the sovereign intervention will have to be addressed in the near future. We like healthcare, defense, gold and some energy sectors. We are underweight to cyclical and financials.

In the future, performance will be driven by our bottom-up approach to both security selection and sector weighting. Converts are attractive, because they offer exposure to equity markets and provide downside protection. A rising-volume environment also should benefit convertible valuations.