# Convertibles Commentary

Second Quarter 2010

## Market Review

The convertible marketplace retreated in the second quarter – down 5.8% – as underlying equities fell sharply and spreads widened out. Investor appetite for risk has curbed as growth concerns in the U.S. and China have taken center stage along with ongoing European debt problems. More defensive areas such as high-grade investments, Treasuries and gold outperformed, although speculative grades have still handily outperformed for the entire year. Overall, we saw a flight to relative safety, and large-cap and investment-grade names outperformed.

Interest rates, implied volatility and gamma all had positive pricing impacts on converts this quarter, while underlying equities, spreads and cheapening detracted from the category's performance.

June had $3.5 billion in new issuance, bringing the year-to-date total to $14.1 billion. We've experienced below-average issuance so far this year, as low interest rates have made straight debt an attractive alternative for many companies. Microsoft became the sole AAA rated convert issuer in the quarter with a $1.25 billion issue. Xilinx and PPL also were in the marketplace.

Generally, investors became more cautious in the quarter, as employment, growth, currency and debt issues occupied their attention and threatened the global growth recovery. In addition, it appears that the early growth effect from vast government intervention is starting to fade, housing is showing signs of another slowdown, and unemployment remains elevated. Implied and realized volatility both increased in the quarter.

## Outlook and Strategy

Although general consensus continues to predict strong growth for the second half of the year and into 2011, we remain cautious about the sustainability of the recovery and therefore are taking a defensive posture on credit and equity valuations. Most countries appear to be adopting export- friendly policies as central banks around the world are looking to increase liquidity and generally weaken their currencies.

We foresee substantial risks to housing in the second half of the year. In addition, early signs of renewed weakness in manufacturing have begun to surface. Debt will be an overriding theme for years to come, as households and governments – state, local and federal – contend with over leverage.

We currently like hard assets, specifically gold. We also are overweight in healthcare and defense. We remain underweight in cyclicals and financials, because slower growth and high leverage will negatively affect these sectors. Our bottom-up approach highlights security selection, which also leads to sector weightings. Both will be instrumental to performance going forward. As always, converts offer downside protection on equity valuations and exposure to a potentially increasing volatility environment.