

Market Review

The high yield market started the second quarter of 2010 strong with a 2.38% return in April, marking the 14th consecutive month of positive returns. The direction of the market turned swiftly during the quarter, however, as European contagion fears spread across the globe. The high yield market was down 3.58% in May, the worst month since December of 2008. With a gain of 1.23%, June was just able to return the high yield market back to where it was at the beginning of the quarter. Year to date, the high yield market returned 4.45%.

U.S. high yield corporate spreads tightened to 576 basis points (bps) on April 26, the lowest level of the year, before widening to 745 bps at the end of the second quarter. Current spreads are 83 bps wider than the year-end level of 662 bps, and they remain attractive compared to long-term averages. Most notably, BB and B spreads are 195 bps and 161 bps wider than their 17-year historical averages, while CCC spreads are roughly at their historical average of 1,040 bps.

Only \$44.5 billion of new issues were priced in the second quarter, the lowest level in a year. Most of the quarter's volume was recorded in April, when issuers raised \$30.7 billion. May and June contributed \$6.8 billion and \$7.0 billion, respectively. Despite weak issuance in recent months, 2010 is still on track to surpass 2009, with \$108.7 billion in new issues priced vs. \$152.6 billion last year.

CCC paper issuance experienced a little pickup in April, with \$7.8 billion priced, the largest number on record. The trend didn't continue in the following months, however, as only \$1.0 billion of CCCs were issued in May and June. Higher-quality bonds (BB and B) still dominated the new issuance market, making up 78% in the second quarter.

On the demand side, the second quarter, with \$2.7 billion of outflows, nearly wiped out all the progress the high yield market had made this year. According to AMG Data Services, the high yield market experienced only \$259.3 million of inflows year to date after five consecutive weeks of outflows recorded in the second quarter. If the current pace continues, 2010 will record the lowest level of inflows since 2006.

From a quality perspective, each month in the second quarter presented a unique theme. In April, a barbell-quality trade prevailed, where CCC and BB credits outperformed B credits. We believe this is due to increased risk appetite for both CCC credits and BB financial paper. The April theme was completely reversed in May, as the global

market sold off. B paper returned the best, as the risky nature of CCCs and the financial component of BBs hurt performance. The theme of June was a flight to quality, as BBs outperformed both Bs and CCCs. Year to date, BBs, Bs and CCCs returned 4.9%, 3.5% and 3.8%, respectively.

All the financial sectors in the high yield index had negative quarterly returns, down 1.7%. Life insurance, which was the best performer in the first quarter, performed worst in the second quarter, returning -8.1%. Negative news regarding the Gulf of Mexico oil spill also dragged down the prices of energy bonds, which returned -0.3%. The deep-water oil driller ATP Oil & Gas Corp. was affected the most, down 25.3% during the quarter. Airlines and railroads performed well in the second quarter, returning 2.36% and 1.95%, respectively. Year to date, the sector performance rankings haven't changed much from three months ago. Financials were still the best performer, at 10.2%, and utilities were the worst, at 0.86%.

The Moody's Investors Service U.S. issuer-weighted default rate reached 7.55% at the end of May, down from the November 2009 peak of 13.48%. According to J.P. Morgan, only six issuers defaulted in the quarter, with a volume of \$1.9 billion in bonds and loans, compared to 118 issuers at \$184 billion in all of 2009. We expect default rates to continue decreasing as liquidity improves and bond issuers are able to negotiate for maturity extensions and covenant amendments. Moody's currently forecasts that the default rate will decline to 1.9% by the end of May 2011. Recovery rates returned to around 40% in 2010, which is in line with the historical level and up from the 2009 level of under 30%.

Following a year with a record volume of fallen angels, at \$150 billion, 2010 has seen a positive credit trend. According to J.P. Morgan, rising stars outpaced fallen angels year to date at 10 to 7 on an issuer basis. On a volume basis, rising stars were roughly in line with fallen angels at \$15.1 billion to \$17.3 billion.

Outlook and Strategy

The recent market pullback has reminded investors of the double-dip recession concern. European sovereign deficits, financial regulatory reform, policy tightening in China and the Gulf coast oil spill all weighed on investor sentiment, sending the Standard & Poor's 500 Index down more than 6% for the year, while high yield still stands at a positive 4.45%. We believe the recent market movements once again validate the power of the coupon that high yield generates. The recent re-pricing of risk has made the valuations of many

high yield companies more attractive. With yields at around 9.0%, spreads above historical levels and expectations for default rates to drop below 2.0%, the high yield market sits on a comfortable cushion should investors start de-risking again. In addition, we believe the corporate fundamental outlook will remain positive, and U.S. economic news will continue to be robust. The strong primary market in high yield we have experienced since early 2009 has helped push out debt maturities. The balance sheet repair and cost cutting that occurred during the last year and a half have better positioned the high yield companies to withstand any sales declines. Thus, we continue to recommend a moderate overweight to high yield bonds.

The technicals aspect of the high yield market has deteriorated, however, as the Chicago Board Options Exchange Volatility Index, which measures equity volatility, peaked to a one-year-high of 46 on May 20, 2010. Recent high yield mutual fund outflows also negatively affected the market as new issuance activity slowed. Nevertheless, we have seen positive idiosyncratic events in the high yield market. Several high yield issuers, such as HCA, Toys R Us and NXP Semiconductor, plan on tapping the equity market through initial public offerings. Private equity buyout and merger and acquisition activities also picked up.

In all, we believe the rest of 2010 will be driven less by beta and more by idiosyncratic, security-specific risk. We would like to reiterate our recommendation of an overweight to BB and B rated bonds, due to the risk/reward opportunities, and a focus on credit selection.