

Convertibles Commentary

First Quarter 2011



Market Review

The first quarter of 2011 presented several well-documented challenges to global markets. Nothing seemed to hold them back, however, not even a tsunami, a rebel uprising, government bailouts, spiking energy costs or a nuclear meltdown. Investors seemed to brush risk aside as temporary, embracing a chance to "buy the dip."

The results were positive markets across the board. Returns for the Standard & Poor's 500 Index jumped approximately 5.9%, while the Barclays U.S. Investment Grade Credit Index posted a gain of approximately 90 basis points. Convertibles once again are showing their positive skew, with a return of just over 3.7%, per the Bank of America Merrill Lynch Investment Grade Convertible Bond Index. This obviously compares very well to equity and bond returns for the period. The supply/demand environment in the convertible market remains favorable, with a diversified base of buyers and limited new supply. This situation did ease slightly during the quarter, with issuance of 40 new deals raising proceeds of nearly \$14 billion.

The Aviva Investors U.S. Investment Grade Convertible Bond portfolios performed well during the period. Convertible valuations were stable to slightly lower, with offsetting richening and cheapening positions. Notable positive contributors were EMC, Gilead Sciences and Archer Daniels Midland, which offset laggards such as Intel, Newmont Mining and Microsoft.

Our convertible philosophy remains focused on balanced convertibles, those that exhibit the most potential upside per unit of downside risk. These high-gamma bonds are the core of the strategy. It's important to highlight that this structure is quite different from that of the benchmark, which includes all bonds, regardless of profile. The overall equity sensitivity of the portfolio is an approximate 45 delta, which compares to the 52 delta of the Bank of America Merrill Lynch Index. This somewhat lower delta would have been a detractor from performance during the quarter.

Outlook and Strategy

Convertible returns are clearly being supported by a positive equity and credit environment. And while we are not strategists, we do find it remarkable that the markets continue to be as resilient as they are. The backdrop should bode well for convertible investors. The downside protection of the bond component should give some security, while the equity option clearly is providing upside. In some respects, this is the ideal environment for convertibles.

The uncertainty is clearly elevated, and the risks are numerous. The global economy appears to be on firm footing, but we do have questions. What is the impact from Japan? Will inflation erode investor confidence? How will Western governments and financial institutions deal with the continued debt burden? Is an oil price shock eminent? The list goes on.

We view the convertible market technicals as neutral. Strong demand from outright investors continues to underpin the market, while valuation is only marginally positive, and much of the investment grade space is overvalued. Issuance, as highlighted earlier, may be making a much-welcomed rebound.

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