

Market Review

The markets saw a return of volatility in the second quarter of 2011. The Greek debt restructuring and potential bailout was a significant sentiment factor during the quarter. This, coupled with continued inflationary concerns in China and a rather dismal set of economic figures from the U.S., created an equity market environment with a mostly negative trading situation. As investors began to see a short-term solution emerge to the European crisis, however, markets recovered sharply during the last week of the quarter.

The results were mixed across the board. Returns for the Standard & Poor's 500 Index fell a modest 0.39%, while the Barclays U.S. Investment Grade Corporate Bond Index posted a gain of approximately 2.28%. Convertibles underperformed expectations, with a return of just -0.62%, per the Bank of America Merrill Lynch Investment Grade Convertible Bond Index. Clearly, equity market factors contributed heavily to the negative skew. On a year-to-date basis, convertibles continue to exhibit decent positive skew, capturing a bit more than 60% of the equity market return. New issuance remains subdued, with only 26 new deals priced and proceeds of only \$5.9 billion.

The Aviva Investors U.S. Investment Grade Convertible Bond portfolios performed generally in line with the benchmark since May 1, 2011, with a loss of 1.58%. The funds have remained a bit more defensive than the index; they tended to outperform when the equity market was falling and underperform as it recovered. Convertible valuations eased a bit during the quarter as demand from outright investors appeared to ease, and dealers could be characterized as net sellers. Notable positive contributors were Boston Properties, Rayonier Inc. and National Retail Properties. Laggards during the quarter were Tech Data Corp., Xilinx Inc. and Symantec Corp.

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. The overall equity sensitivity of the portfolio is an approximate 46 delta, which compares to the 53 delta of the Bank of America Merrill Lynch Index.

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 potential. 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 imminent? 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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