Convertibles Commentary

Third Quarter 2011

AVIVA INVESTORS

Market Review

Volatility continued during the third quarter of 2011, clearly driven by the European debt crisis. Unresolved Greek debt restructuring and further pressure on peripheral Europe, including its impact on European banks, has placed downward pressure on the U.S. markets. Concern over growth in China and unscrupulous accounting practices at some Chinese firms has created further consternation for the markets. Domestically, the picture is not much better. Slowing economic signals and infighting in Washington have investors on their back foot, waiting and hoping for leadership and some certainty about a way forward.

Aside from long-term Treasury securities, results were poor across the board. Returns for the S&P 500 fell approximately 14%, while the Barclays U.S. Investment Grade Corporate Bond Index posted a gain of approximately 2.85% on the back of a significant drop in government bond yields. Convertibles slightly underperformed expectations, with a return of just -8.08%, per the Bank of America Merrill Lynch Investment Grade Convertible Bond Index. Clearly, equity market factors contributed heavily to the negative skew, but credit was a drag, as well. Convertible valuations also cheapened by about 2% during the quarter. On a year-to-date basis, convertibles are performing in line with expectations, down about 50% of the approximately 10% loss of the S&P 500.

The Aviva Investors U.S. Investment Grade Convertible Bond portfolios performed well relative to the benchmark during the quarter, with a loss of approximately 5.879%.The funds have remained a bit more defensive than the index, so they tended to outperform when the equity market was falling. This was particularly true through August. During the market turmoil of that month, we sold some of the lower-delta (less equity-sensitivity) names and reinvested in some more moderate-delta names. We would expect a bit more balanced performance in the coming months relative to the equity market direction. Notable positive contributors were Newmont Mining and National Retail Properties. Laggards during the quarter were Interpublic Group, MF Global and Prologis.

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 34 delta, which compares to the 39 delta of the Bank of America Merrill Lynch Index.

As we enter the fourth quarter, we believe the convertible market looks compelling. The market's technical factors are still positive; year to date, new issues net of maturities and redemptions have resulted in a loss of $10 billion of convertible paper outstanding. The primary calendar is nearly non-existent at this point, and fund flows have so far been benign. Furthermore, the asset class is cheap and positioned well for stabilization. The question is when this might occur. We believe the investor psyche needs significant repair, but that repair should provide fuel for returns over the long term.