

CONVERTIBLES COMMENTARY

Fourth Quarter 2011



Market Review

The roller coaster continued during the final quarter of 2011. The ebb and flow of news on how the European Union will tackle its sovereign debt crisis whipsawed markets. As we enter 2012, we are seeing the same conditions. An extraordinary number of variables will affect returns in 2012, including European debt, Chinese growth and U.S. elections. Convertibles will certainly take their cue from equity and credit markets, alongside asset-class-specific factors.

During the quarter, returns for the S&P 500 rose sharply, up 11.15%, mostly on the back of an oversold bounce in October. The Barclays U.S. Investment Grade Corporate Bond Index also posted a gain of approximately 1.93% on continued government bond yield compression. Convertibles underperformed expectations, with a return of just 1.76%, per the Bank of America Merrill Lynch Investment Grade Convertible Bond Index. Equity market factors helped, but stock-specific contributions held returns back. Convertible valuations were steady during the quarter and remain at an approximate 4% discount to theoretical value.

The Aviva Investors U.S. Investment Grade Convertible Bond portfolios performed somewhat below the benchmark during the quarter, with a gain of approximately 1.28%. The funds were hard hit by a sizeable position in MF Global. We divested from the position during the quarter, but the damage was done, and it contributed to more than 100 bps of negative performance. The remainder of the portfolio performed well, and we were able to claw back a bit. Exiting the year, the funds are at benchmark delta exposure, and therefore have eliminated the defensive posture of 2011.

Outlook and Strategy

As for future convertible returns, the asset class enters 2012 at an attractive level from a valuation perspective. Convertible valuations are, outside of the beginning of 2009, at the cheapest levels since the early 1990s. At an average of 4% below fair value, the market will have a very nice tailwind. We think this will be even more dramatic because of convertible maturities and redemptions during 2012. The lack of new issuance over the past couple of years may create a real supply/demand imbalance for the market. Convertible managers reinvesting the maturing proceeds alone would create more than enough demand to richen the asset class by a couple of percentage points. This, combined with underexposed dealers and low leverage at hedge funds, has the potential to revalue the convertible market very rapidly once investors again embrace risk. All things considered, we are looking for solid upper-single-digit returns for global convertibles during the next year, with the return coming equally from four areas – coupon, asset class richening and slightly better equity and credit markets.

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.

Important information

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Performance is shown gross of fees and does not include the deduction of management fees and other expenses that may be incurred in managing an investment account. A portfolio's return will be reduced by advisory and other fees. The net compounded effect of the deduction of investment management fees over time will be affected by the amount of the fees, the time period and your account's investment performance. For example, an account with a beginning value of \$100 million, gaining an annual return of 10% per year would grow to \$259 million after 10 years, assuming no fees have been paid. If the same account paid a 1% annualized advisory fee, it would grow to only \$235 million over 10 years. The annualized returns over the 10 year time period would be 10% (gross of fees) and 8.91% (net of advisory fees). A description of Aviva Investors' fees may be found in Part II of the ADV.

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