

CORE AGGREGATE COMMENTARY

Fourth Quarter 2011



Market Review

The U.S. economy closed the year on a positive note, with fourth-quarter economic growth estimates of approximately 3.5%, following the third quarter's sluggish 1.8% annualized growth rate. The temporary factors affecting growth in the first half of 2011 continued to fade, while increased consumption provided a boost to growth during the fourth quarter. Economic data is experiencing a temporary strong patch, as increased consumption has come at the expense of a reduction in savings, and income growth remains subdued.

The European debt crisis continues to dominate the headlines, and Europe has likely entered into a recession. Growth in Asia and emerging markets also has begun to slow. While the U.S. economy has remained resilient and somewhat disconnected from the slowdown in global growth, we expect the continued global deleveraging, slowing global economy and continued U.S. political gridlock to put downward pressure on growth in 2012. The economy remains very fragile and subject to heightened political and global systemic risks, particularly from Europe, where we are getting more questions than answers regarding a credible solution to the growing sovereign fiscal problems. We expect growth to remain sluggish over the next 12 to 24 months, constrained by the stubbornly high unemployment rate, slowing global growth triggered by fiscal austerity in Europe, and subdued real income growth.

Renewed recession in the eurozone starting in the fourth quarter and continuing throughout the first half of 2012 now looks inevitable. European economies are in austerity and deleveraging mode, plagued by their continuing government- and bank-debt problems. The fear of contagion remains, as French and Italian government bond yields moved higher; the rating agencies have put France's AAA credit rating on negative watch; and Spain, Italy and other European countries are likely to face further downgrades. The latest summit may succeed in European leaders presenting a more united front and beginning the march toward a stronger fiscal union. The details of a credible plan will take a long time to work out, however. We expect financial market sentiment to continue to be driven extensively by future developments in the eurozone.

Domestically, U.S. politicians under delivered yet again, as the bipartisan super committee charged with agreeing on \$1.2 trillion of deficit reduction by November failed to reach a compromise. This will not affect the U.S. fiscal situation in 2012, but it will result in automatic spending cuts starting in January 2013. This gridlock also is affecting the Bush-era tax cuts that were set to expire at the end of 2011. The Democrats and Republicans agreed on a two-month extension to the tax cuts and will continue discussions in early 2012 to extend them through the end of the year. The sizeable U.S. budget deficit, approaching 10% of GDP, remains unsustainable. This will continue to keep the rating agencies focused on the worsening deficit picture, and we expect further risk of negative guidance from the rating agencies as we approach the sequestration effective date of 2013. We expect the current political gridlock to continue until after the 2012 election, because the parties have no incentive to concede any ground before the elections.

At its December 13 meeting, the FOMC continued to support the implementation of Operation Twist and repeated its view that economic conditions would warrant "exceptionally low levels for the federal funds rate at least through mid-2013." The Fed understands the limited ability of monetary policy action to directly improve job creation and economic growth. Chairman Ben Bernanke also continues to pressure policy makers and has communicated the need for fiscal policy to support economic growth and job creation in the near term, while also fixing the long-term deficit problem and negative drag on growth over the intermediate term. With unemployment remaining at heightened levels and inflation expectations moderating, we expect the Fed to maintain record levels of stimulus for the near future, which is consistent with its dual mandate to seek maximum sustainable employment and price stability. The Fed continues to note headwinds facing stronger economic growth; it remains disappointed with the slow recovery in unemployment; and it is concerned with the downside potential posed by heightened macro risks.

The markets improved but continued to experience heightened volatility in the fourth quarter, as risky asset classes outperformed. Demand for credit and other risky assets turned modestly positive during the fourth quarter, as investor sentiment stabilized and credit fundamentals remained solid. While the number of unresolved macro risks facing the markets stayed high, the fear of a systemic financial crisis moderated. Investors' level of risk conviction remains low, but risk appetites became more balanced following the precipitous decline in the third quarter. More positive U.S. economic fundamentals and continued solid corporate earnings helped U.S. credit markets modestly decouple from Europe.

Credit and securitized fixed income rebounded to outperform Treasuries during the fourth quarter, as the risk-off environment moderated and U.S. Treasuries remained relatively flat. Investment grade credit, high yield and CMBS outperformed Treasuries by 0.61%, 5.69% and 2.43%, respectively. Treasuries generated a 0.89% return, while the S&P 500 returned 11.15%. The 10-year Treasury yield declined 4 bps to 1.92%, while the yield curve remained relatively unchanged.

Investment Outlook

Aviva Investors expects U.S. economic growth to continue at a moderate pace of 2% to 2.5% during 2012, with downside risks resulting from the European recession and economic slowdown in Asia. We believe heightened uncertainty surrounding the resolution of the European sovereign debt crisis and domestic fiscal policies will continue to temper investors' risk appetites and favor lower levels of active risk in client portfolios. Our long-term view on longer-term investment grade and high yield credit remains constructive, given the stable credit fundamentals and relatively attractive valuations. Tactically, however, we remain patient for signs of political and macro uncertainties beginning to subside. We also expect the markets to continue pushing the ECB and Euro-area policy makers toward further coordination to avoid a systemic financial crisis and deal with the core solvency issues facing Europe.

CORE AGGREGATE COMMENTARY

Fourth Quarter 2011



We expect overall bond yields to remain relatively low, consistent with the Fed keeping rates exceptionally low through mid-2013, the continuation of Operation Twist, moderate economic growth and relatively contained inflation expectations. We expect the 10-year Treasury to range between 1.50% and 2.50% during 2012.

We believe key risks to our economic and market outlook are focused on:

1. The European sovereign debt problem and potential systemic banking and financial crisis
2. A more significant slowdown in Asia and emerging market growth
3. The U.S. economy's ability to withstand the European recession
4. The U.S. political gridlock and inability to reach agreement on extending Bush-era tax cuts

Important information

Past performance is not indicative of future results. There is potential for profit or loss with any investment.

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.

This commentary contains the current opinions of Aviva Investors and is not intended to be, and should not be interpreted as, a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This commentary is distributed for informational purposes only and is not a recommendation or investment advice. The information herein is based on sources which Aviva Investors believes to be reliable, but it is not guaranteed to be accurate or complete.

Benchmark (index) performance does not reflect the deduction of transaction costs, management fees, or other costs which would reduce returns. References to market or composite indexes, benchmarks or other measures of relative performance, over a specified period of time, are provided by your information only and do not imply that a portfolio will achieve similar returns, volatility or other results. An index is unmanaged and the composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or actual returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which may change over time. An investor cannot invest directly in an index.

Forward-looking statements, opinions and other information contained in this article are subject to change continually and without notice and may no longer be true after the date of publication. Any such statements speak only to the date they are made and Aviva Investors North America assumes no duty and does not undertake to update forward-looking statements. Such statements are subject to numerous assumptions, risks and uncertainties, which may change over time. Actual results may differ substantially from those anticipated in forward-looking statements.

No part of this commentary may be reproduced in any form, or referred to in any other publication, without the express written permission of Aviva Investors North America, Inc.