Convertibles Commentary

Third Quarter 2009

AVIVA INVESTORS

Market Review

The convertible marketplace performed very well in the third quarter. Whereas credit spread tightening drove performance in the first two quarters, equity returns were the primary driver this quarter. The return of investors' appetite for risk has resulted in lower-grade credits outperforming their higher-grade counterparts and small cap outperforming large cap. Speculative grade converts were up 19.7% for the quarter and 68.5% year to date, while investment-grade converts returned 11.6% for the quarter and 20.7% year to date.

Throughout the quarter, convertibles were better bid as investors put incoming cash to work, chasing higher-yielding, lower-quality convertibles. Convertibles richened, from 2.22% cheap at the start of the quarter to 1.42% cheap at the end, according to Merrill Lynch data.

Despite government intervention in providing unprecedented funding and liquidity to the market, deflation is taking hold as banks choose to keep excess reserves at the Fed rather than increase lending. This is due in part to tightened lending standards, low demand for new loans and caution by banks based on their weakening balance sheets. Inflation is the longer-term risk. If banks begin lending excess reserves, the money multiplier could cause tremendous inflationary pressure. This could force the Federal Reserve to rapidly raise rates and potentially derail a recovery or allow inflation to flare up in both assets and prices and continue to pressure the dollar.

Volatility was subdued over the quarter, with the Chicago Board Options Exchange Volatility Index falling to 25.61 as of September 30. New issuance, meanwhile, continued its muted pace. It rallied in September with 10 new deals valued at $2.7 billion, after a quiet July and August. We have seen just $25 billion in new issuance year-to-date, compared to $58 billion for 2008.

Market Outlook and Strategy

We believe the market is priced for a return of a normalized growth and improving credit fundamentals. This includes mid-level price/earnings ratios and spreads that are consistent with a sustained economic recovery. In our view, however, the headwinds created by a federal budget deficit of more than 40%, chronic unemployment, cautious consumers and deteriorating housing market make this scenario very unlikely. We are cautious on spreads and equity valuations but see opportunities in single-name convertibles and are positive on volatility-sensitive convertibles.

Our cautious stance on credit and equity valuations as a whole is reflected in our portfolio biases. As a result, we favor defensive sectors, such as gold, healthcare and other hard assets that can benefit from a weaker dollar. We will remain underweight in financials and consumer cyclicals.

The most important factors in determining performance over the next few quarters are sector weighting and security selection. We are dedicated to fundamental research, which should help us outperform the market.

Convertibles allow investors to participate in both the upside of equities and the downside of credits. We expect increased volatility in late October or early November, which will benefit the valuation of convertibles.

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