

High Yield Bonds and Leveraged Loans: Strong Fundamentals and Demand Support Historically Full Valuations

Reiterate Marketweight Recommendation



March 4, 2011

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Executive Summary

Over the past two years, the global high yield bond and leveraged loan markets have rallied faster than most investors expected, and 2011 is off to a swift start; the high yield market has returned more than 3.5% through February. The latest default cycle has been the quickest on record, rising from 5% to peak and returning to 5% in less than two years, compared to prior default cycles, which have lasted more than three years. Default rates are low, and we expect them to keep falling, supported by strengthened balance sheets and healthy operating earnings. Demand for high yield bonds continues to be strong, especially for leveraged loans. Leveraged loan funds have experienced dramatic inflows year to date in anticipation of hedging inflation risks due to their floating rate structure. With yields on high yield bonds reaching their all-time lows at around 7%, it is difficult to be overly optimistic for outsized returns. We are reiterating our 7% to 8% and 6% to 7% return forecasts for global high yield and leveraged loans, respectively, in 2011. We believe that both high yield bonds and bank loans are attractive relative to investment grade fixed income alternatives. This article touches on default rates, ratings trends, profit margins, real rates and spreads, flows into leveraged loans and high yield funds and valuations. We recommend a marketweight allocation to high yield bonds and leveraged loans (see Rating Key on page 7).

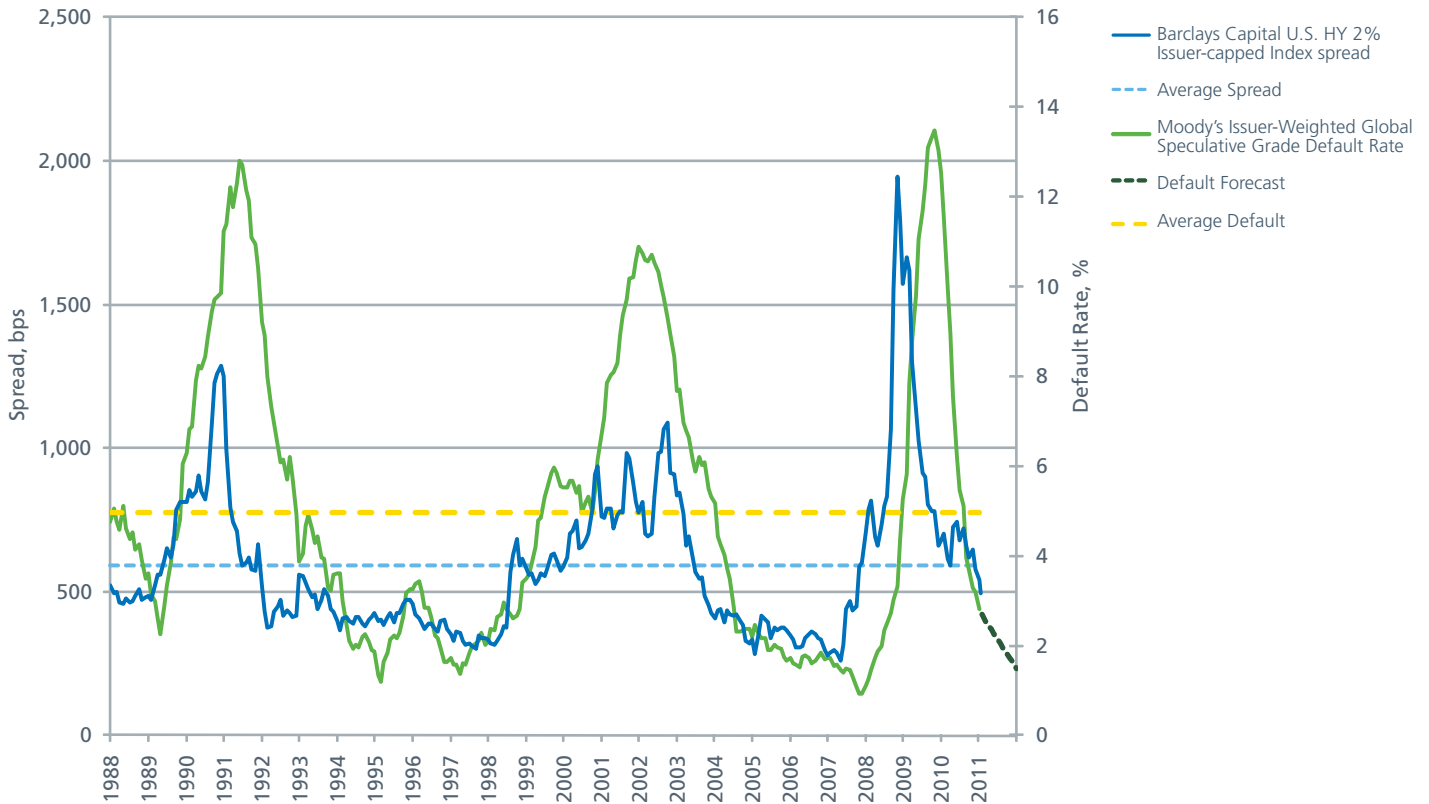
The Global Default Rate Is Low and Is Expected to Fall Further

We often refer to two of the main risks of investing in high yield: probability of default and severity of loss. The dramatic fall in default rates over the past year and the expectations of further declines to near-historical lows are providing substantial support to the market. The probability of default has been materially lessened by firms' extensions of maturities at attractive rates, large cash balances, and a combination of improved operating leverage and higher profit margins.

The Moody's trailing 12-month speculative grade (high yield) global default rate fell to 2.8% in January, down from 3.2% in December. A year ago, the default rate was 12.6%. Additionally, the U.S. leveraged loan default rate fell to 2.5% in January from 2.8% in December. A year ago, the loan default rate was 11.5%. Moody's is forecasting the global speculative grade default rate to drop to 1.5% by January of 2012. Moody's expects the hotel, gaming and leisure industries to have the highest default rates in the U.S. and the advertising and printing & publishing industries to have the highest default rates in Europe.

Exhibit 1 illustrates the historical relationship between default rates and high yield spreads. Spreads have typically led default rates by six to nine months. With current option-adjusted spreads at roughly 480 basis points and defaults forecasted to be lower in 12 months, we see fundamental support for further spread narrowing.

Exhibit 1: Spreads and Defaults



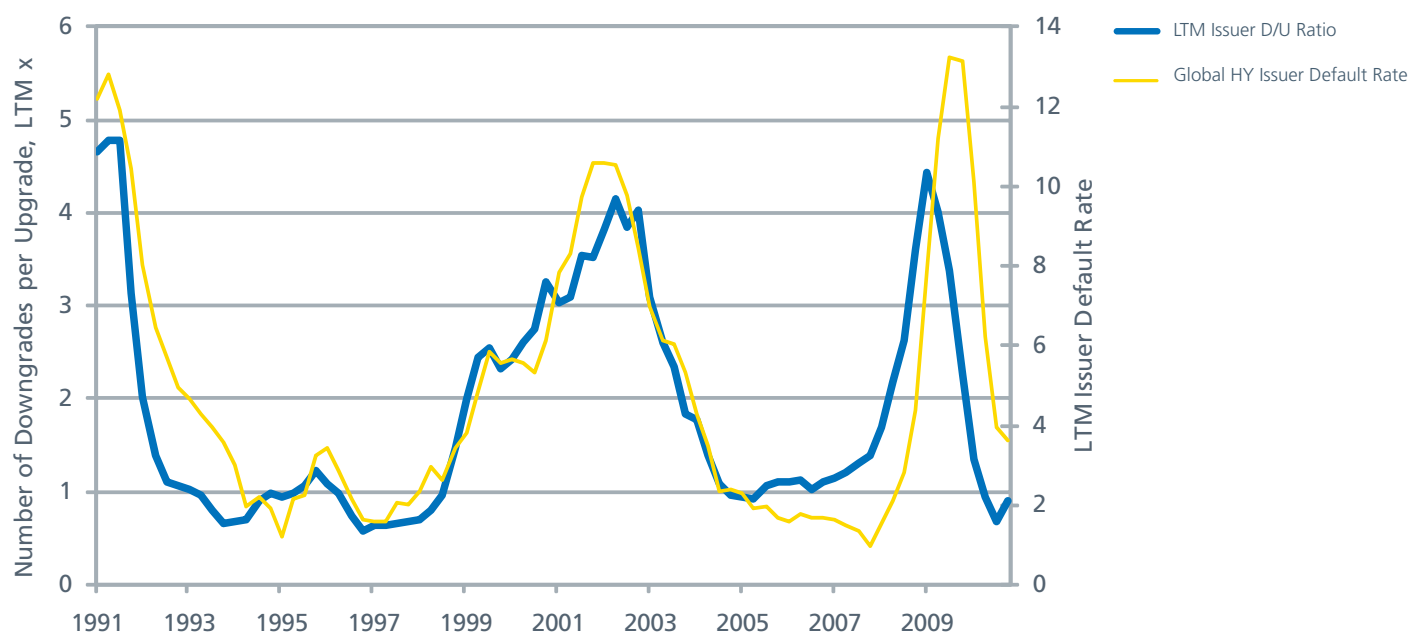
Source: Bloomberg; Barclays Capital; Moody's Investors Service; 1/31/1988 - 2/15/2011

Credit Rating Trends Are the Most Favorable Since 1998

Strengthened corporate balance sheets and robust earnings support a low default rate and a credit rating upgrade environment. While yields are low on a historical basis in the high yield market, we see opportunities to increase total return by finding bonds with potential to “cross-over” into the investment grade universe. Bonds that are upgraded from high yield to investment grade become open to a larger universe of buyers and typically have material price appreciation as their risk premium, or spread, narrows. For example, a Ba1/BB+ rated bond such as Macy's, the department store, trades with roughly a 5% yield. A potential total return would be closer to 9%, however, if the bond is upgraded to investment grade as its spread tightens.

The number of upgrades in the high yield bond market has outnumbered downgrades over the past 12 months, placing the trailing 12-month downgrade/upgrade ratio near an all-time low (Exhibit 2). This compares to a downgrade/upgrade ratio of nearly 4.5 at the beginning of 2009. The positive credit rating trend has increased our universe of cross-over candidates.

Exhibit 2: High Yield Credit Rating Trends Have Been Positive



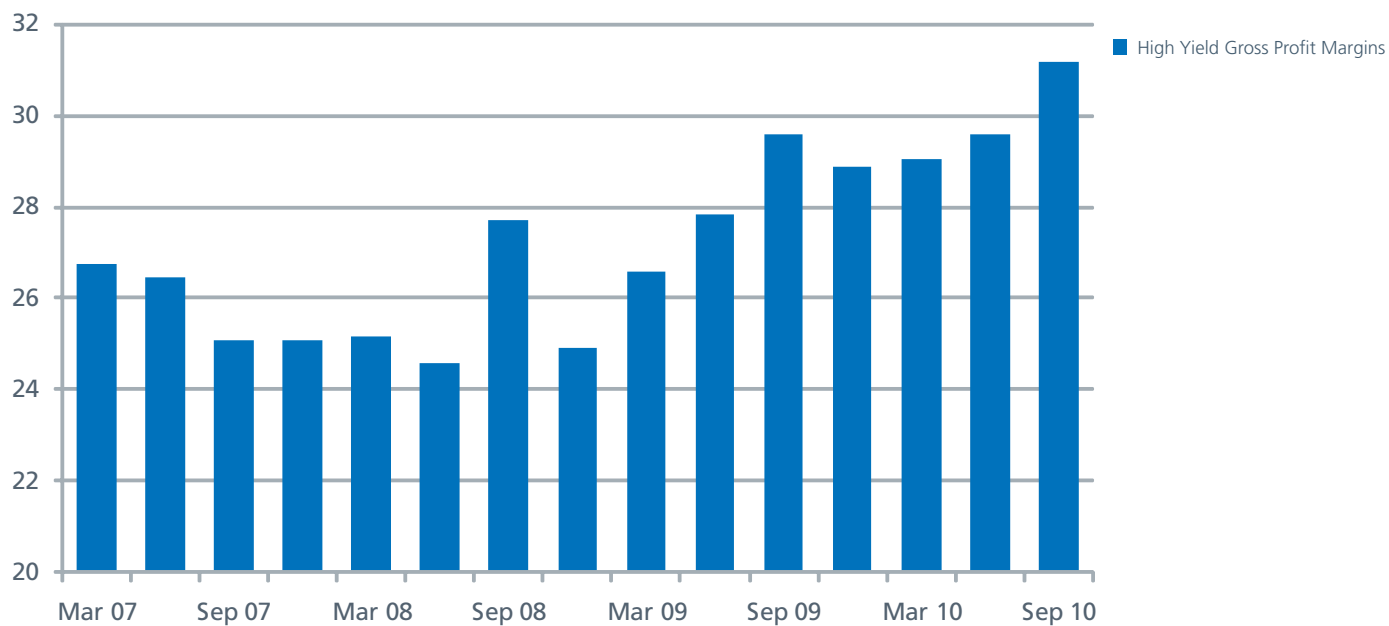
Source: B of A Merrill Lynch Global Research, Moody's; 3/31/1991 – 12/31/2010

The Impact of Raw Material Costs on Profit Margins

Recently, we have seen the cost of raw materials such as cotton, copper and corn increase at a faster pace than revenue growth. Blue chip companies such as Ford Motor and Procter & Gamble have reported lower profit margins. January's Core Producer-Price Index rose 0.5%, the largest increase in two years. Inflationary pressures are creeping back into the cost-of-goods-sold calculation and forcing companies to pass this increase along to consumers.

While some margin compression can be expected, according to Morgan Stanley, 75% of the S&P 500 companies that have reported fourth-quarter earnings have not reported lower margins. Many of the firms with declining margins are in consumer-oriented industries with more price elasticity, providing limited support to higher consumer prices. While the trend in increasing raw material costs and profit margins needs to be monitored, it is worth knowing that revenues are on the rise again. In fact, the revenue growth for S&P 500 companies has averaged 9.8% in the fourth quarter, beating estimates of around 3.8% growth. Additionally, Exhibit 3 illustrates the trend in gross margins for high yield companies. Margins are at their highest level (31.2%) in the past five years, providing some flexibility for a decline, especially when accompanied by rising revenues.

Exhibit 3: Gross Profit Margins

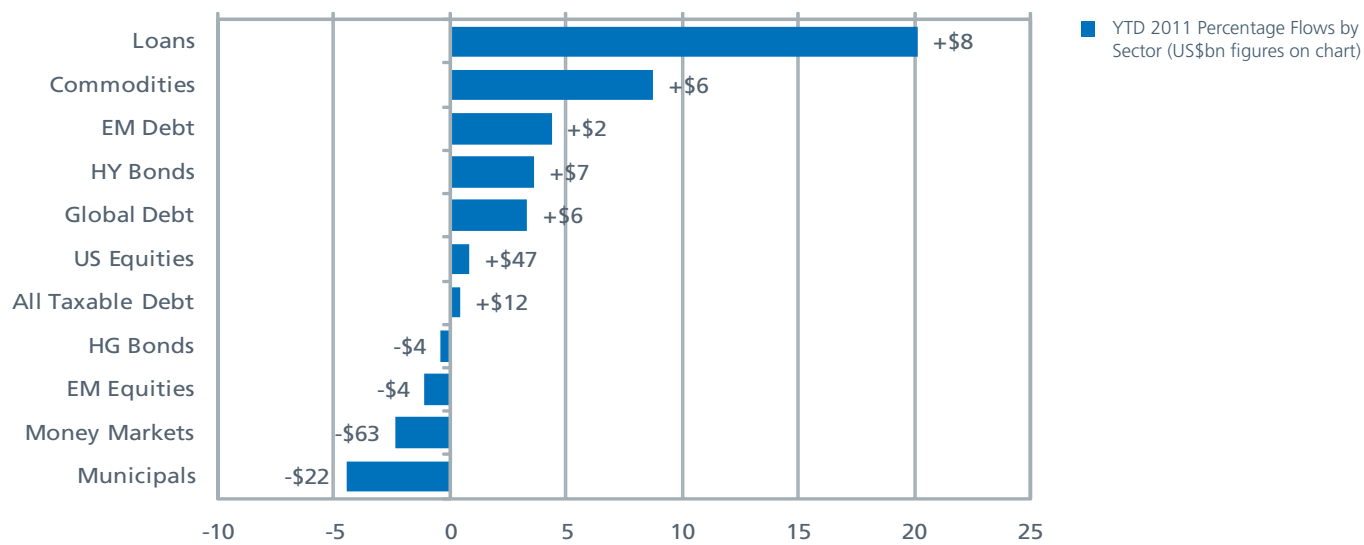


Source: B of A Merrill Lynch Global Research; 3/3/2007 – 9/30/2010

The Demand for Leveraged Loans and High Yield Bonds Is off to a Strong Start

The strong demand for both high yield bonds and leveraged loans this year is shown in Exhibit 4, which uses AMG/Lipper mutual fund data. Leveraged loan fund flows have been \$9.3 billion, or 21.9% of the leveraged loan mutual fund asset base. High yield bond funds have had roughly \$7 billion of inflows, or 3.6% of fund assets. This has been offset primarily by continued outflows in money market and municipal bond funds. The demand for loans has been driven primarily by their potential inflation hedge characteristic due to their floating rate structure. Additionally, leveraged loans, on average, are still trading at a discount to par and are typically secured, providing strong recovery values in the case of default.

Exhibit 4: Demand for High Yield and Loans

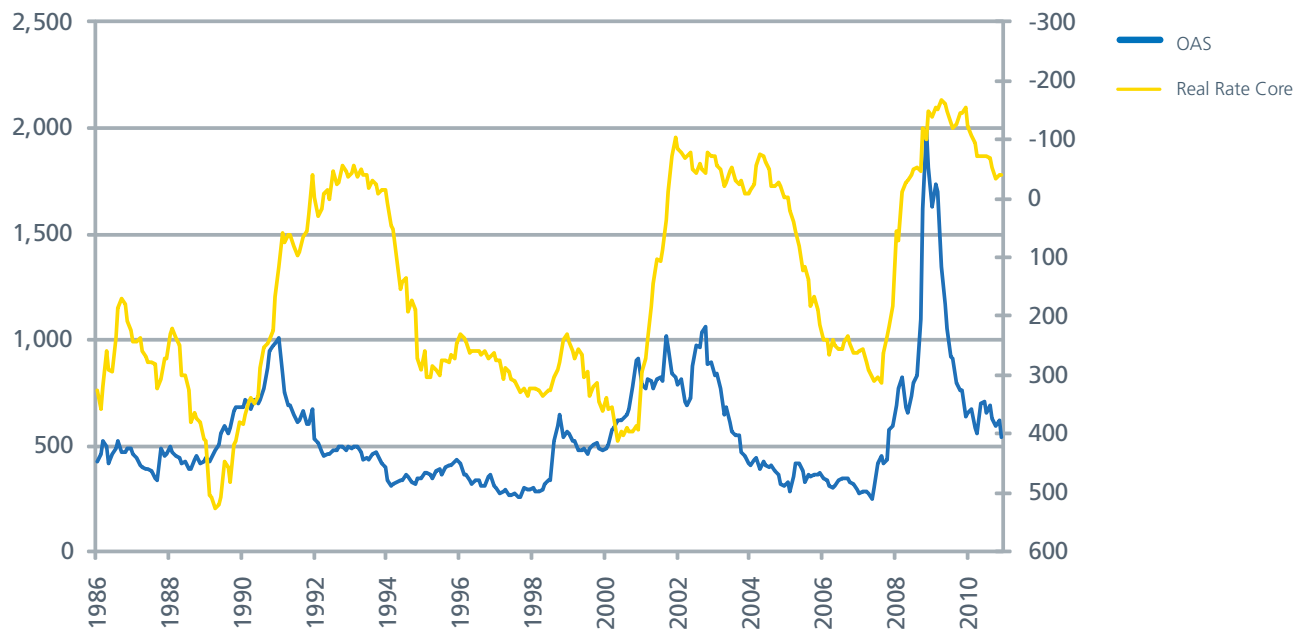


Source: B of A Merrill Lynch Global Research

Low Real Rates Support Narrowing High Yield Spreads

Having U.S. core real rates in negative territory has historically been positive for both the U.S. equity markets and high yield bonds. Exhibit 5 illustrates the historical relationship between U.S. core real rates and high yield bond spreads (OAS = option-adjusted spread). In periods of low or negative real rates, high yield spreads typically narrowed and stayed low, even when real rates started to increase. In fact, real rates would have to increase to close to 3% to cause more concern about rising spreads and higher default risk. A low real rate has been very accommodative for the high yield market, because it has helped provide a low cost of capital environment for refinancing and extending maturities. In 2010, 61% of all high yield bond issuance was used to refinance existing debt (BofA, Merrill Lynch).

Exhibit 5: Real Rates and High Yield Spreads



Source: B of A Merrill Lynch Global Research; 1/31/1986 – 12/31/2010

Valuations Look Relatively Full in Isolation from Fundamentals

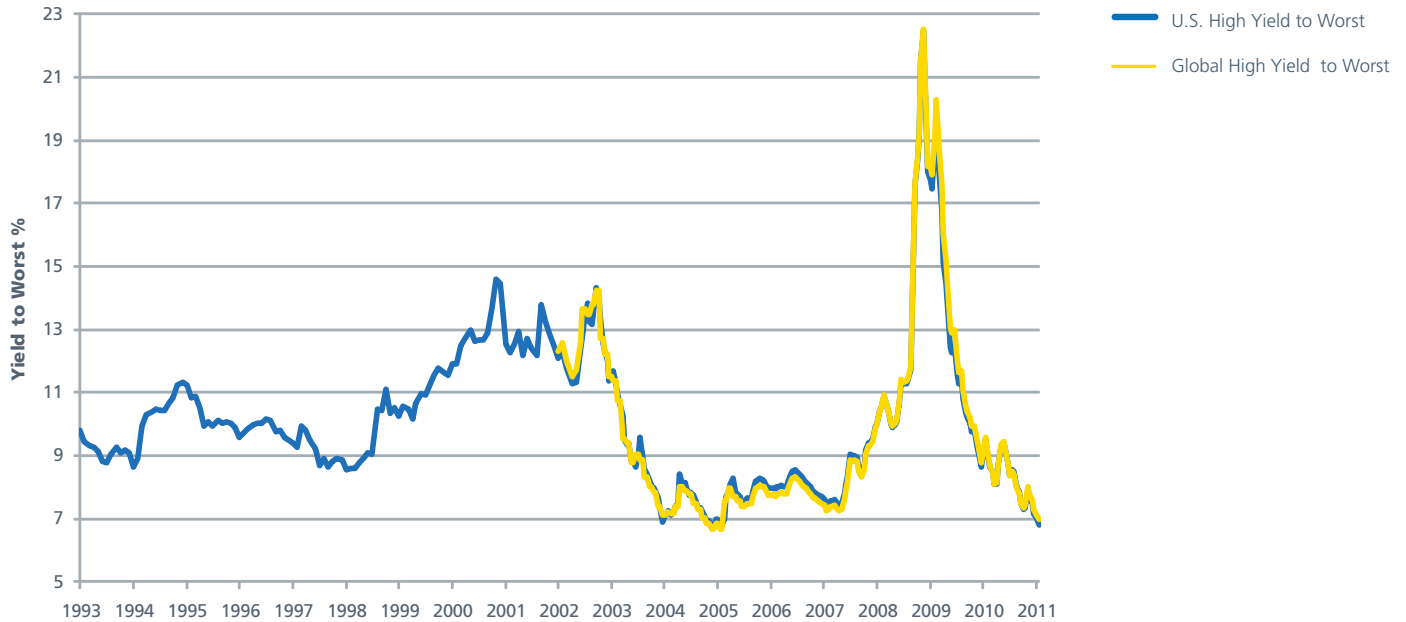
Given current valuations, it would be difficult to be positive on the high yield market without the underlying strong corporate fundamentals, which are expected to continue. Spreads do have further room to compress from the present 480 basis points, especially when the 12-month default rate forecast is 1.5% and the market has historically traded as tight as 250 basis points in 2007. Several other valuation characteristics of the market are worth noting, however: yields and prices.

The spread, or risk premium, of high yield bonds is a critical component when evaluating the attractiveness of high yield bonds relative to the risk. A more absolute measure such as yield also is critical, especially in an asset class that has historically received more than 100% of its total return from its coupon yield. Exhibit 6 illustrates the historical average yield-to-worst (a conservative estimate of yield using the worst call date) on the U.S. and global high yield markets. At just under 7%, today's yield in the high yield market represents an all-time low, which we also reached in 2005.

Exhibit 7 illustrates the historical average price of a bond in the high yield market using U.S. and global data. Today's average price for the global high yield market is roughly \$103, with the U.S. Dollar market trading at \$104 on average and Euro- and Sterling-denominated bonds trading at a slight discount. Prices can go higher. However, given that most high yield bonds have call structures in the final years leading to the maturity date, market prices will be somewhat capped.

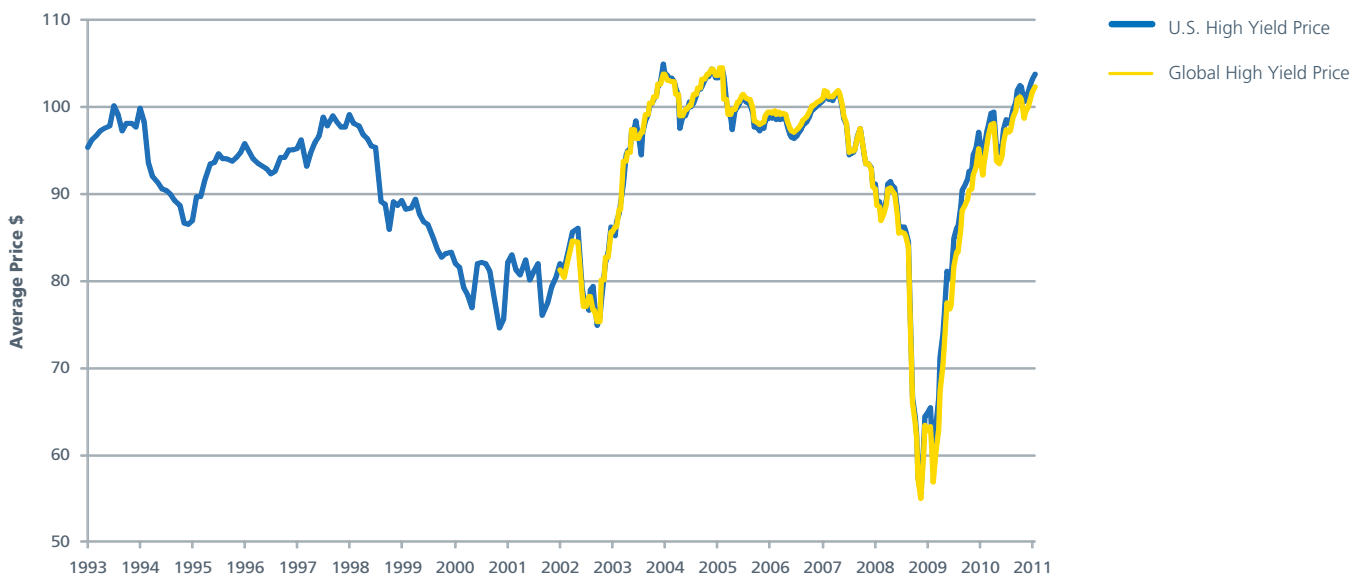
We believe this will result in close to a coupon-clip return for the market this year. With a very low number of defaults in the forecast, a coupon-clip of around 7%, with a 1% price return net of defaults due to moderate spread tightening, provides for a 7% to 8% total return forecast for the year. This is relatively attractive, especially when compared to fixed income alternatives, and it warrants an average allocation within the clients' range, or a marketweight recommendation.

Exhibit 6: Yields in High Yield Bonds Are at Their All-Time Low



Source: Barclays Capital; U.S. HY is represented by the Barclays Capital U.S. High Yield 2% Capped Index; Data from 1/29/1993 - 2/15/2011. Global HY is represented by the Barclays Capital Global High Yield xCMBS xEMG 2% Capped Index; Data from 1/31/2002 to 2/15/2011

Exhibit 7: Prices in High Yield Bonds Are Near Their All-Time High



Source: Barclays Capital; U.S. HY is represented by the Barclays Capital U.S. High Yield 2% Capped Index; Data from 1/29/1993 - 2/15/2011. Global HY is represented by the Barclays Capital Global High Yield xCMBS xEMG 2% Capped Index; Data from 1/31/2002 to 2/15/2011

Rating Key:

For example, a client may have an allocation range to high yield bonds of 5% to 15% as a percentage of assets. The following provides a possible percentage allocation in parentheses and a definition of the rating.

Overweight (15%):

Maximum exposure to high yield bonds. Recommendation reflects a high level of conviction for returns higher than the historical average.

Moderate Overweight (12.5%):

Exposure to high yield bonds is recommended at the higher end of the allocation range. Return expectations are higher than the historical average.

Marketweight (10%):

Exposure to high yield bonds is recommended in the middle of the allocation range. Return expectations are roughly in line with the historical average.

Moderate Underweight (7.5%):

Exposure to high yield bonds is recommended at the lower end of the allocation range. Return expectations are lower than the historical average.

Underweight (5%):

Minimum exposure to high yield bonds. Recommendation reflects a high level of conviction for returns lower than the historical average.

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