

The Decoupling of Macro and Micro Factors

June 2010



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Executive summary

Questions around European Union viability, the Gaza blockade, imminent financial reform, a China slowdown and the Gulf oil spill are completely consuming all forms of mass communication. These headlines have created a negative feedback loop in the financial markets, which has shaken investor confidence and heightened market

volatility. The macro issues have called global growth into question and led to talk of a double-dip recession. Consequently, the positive fundamentals of credit have been left far behind.

With so much global uncertainty in the market, we expect volatility to remain elevated in the near term. We do not expect short-term resolutions to many of the situations described, which will continue to cause a re-pricing of risk across the globe on a daily basis. Looking through this re-pricing of risk, we view the dip in high yield bond prices as an opportunity to invest in companies with improving fundamentals. We believe that investors will be rewarded for looking past the short-term volatility to see the corporate fundamentals. Corporate fundamental and U.S. economic news continues to be robust, even as events across the globe have dominated the headlines. In summary, our FTV analysis of the high yield market (where we focus on fundamentals, technicals and valuations) leads to a moderate overweight recommendation for investors in the high yield asset class.

The impact of European instability

Most global growth slowdown fears center around rampant speculation about the viability of the European Union (EU), as investors have become less tolerant of high levels of public/sovereign debt, especially relative to GDP. Heightened concern surrounds Portugal, Italy, Ireland, Greece and Spain (PIIGS), which are either overlevered or facing significant budget cuts, resulting in a need to significantly curb fiscal spending. Much of the worry centers on Greece and its riots last month. Unfortunately, these events have overshadowed the strong \$1 trillion financial commitment from the EU and International Monetary Fund (IMF). While these emergency funds eliminate Greece's liquidity problem in the near term, the question now turns to the country's implementation of austerity measures and, ultimately, solvency over the next several years. While many argue that Greece should never have been allowed EU membership, we feel the EU and IMF will continue to do everything they can to keep the EU members intact. One important statistic to keep in mind with respect to Greece in particular is its direct effect on the U.S. The Greek economy is about 2% of the size of the U.S. economy, and Greece takes in less than 0.1% of U.S. exports (Source: May 6, 2010, Wall Street Journal).

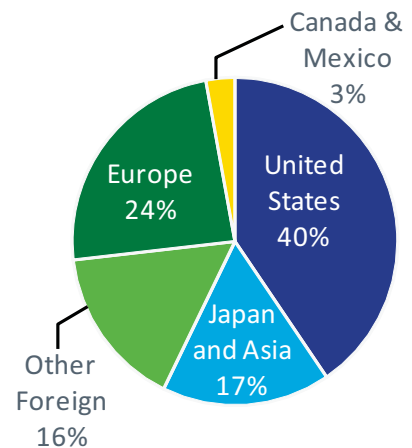
A closer look at Aviva Investors' global high yield bond strategy from a revenue perspective (Exhibit A) illustrates that 94% of the revenue generated by the top 10 constituents of our strategy is generated outside of Europe. Therefore, the impact of Greece on the U.S. economy and on our high yield strategy is muted.

The global high yield bond strategy is intentionally invested in companies domiciled in North America due to our positive outlook for the U.S. economy and corporate profitability. The strategy contains no companies domiciled in Greece. One concern for U.S. companies is that the weakening Euro and the stronger U.S. Dollar are pressuring the stocks and bonds of U.S. companies that conduct significant international business. While U.S. exports to Europe have become more expensive relative to those of European companies, investors should recognize that Europe accounts for only about 14% of U.S. exports. So, while weakness in European sovereigns and economies is a risk, the direct impact on the U.S. recovery and fundamentals of U.S. companies continues to be limited.

It is important to keep in mind the extremely strong fundamentals of corporate credit that we have experienced over the past 18 months. U.S. corporate profits have risen by more than 30% year over year as of the first quarter of 2010, something that has only happened six times over the past 60 years, according to Barclays Capital. Rising corporate profits have historically been followed by strong GDP growth and an eventual improvement in the labor market (Exhibit B).

Exhibit A

Index Top 10 Revenue Breakdown



Strategy Top 10 Revenue Breakdown

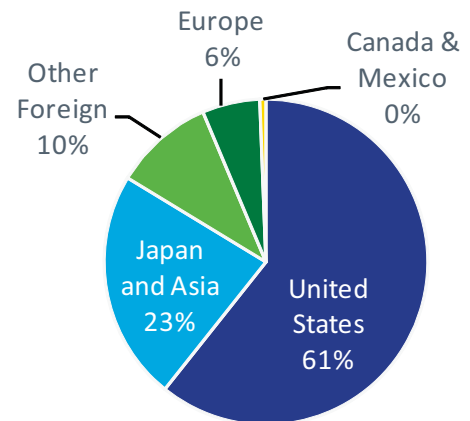


Exhibit B

First Qtr of 30%+ Profits Growth	Real GDP	Nonfarm Payrolls
	Growth over following year, %	
Q4 50	5.2	2.9
Q1 55	3.1	4.9
Q1 59	5.1	3.2
Q4 75	4.3	3.2
Q3 83	6.9	4.9
Q3 04	3.1	1.9
Q4 09	f/c: 3.6	f/c: 1.6

Source: BEA, BLS, Barclays Capital, Haver Analytics

High yield market FTV

We perform an FTV analysis on the high yield asset class, just as we do on every credit in the portfolio. We analyze fundamentals on a scale of 1 to 6 and technicals and valuations on a scale of 1 to 5. Here's our current and forward-looking assessment of the high yield market:

Fundamentals – 4 rating

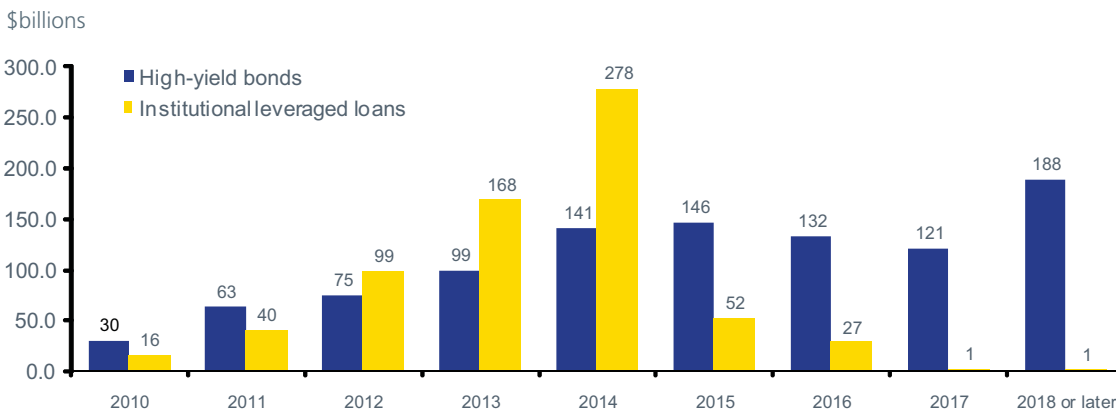
Corporate outlooks remain positive

We maintain our positive outlook for company fundamentals. Corporations are continuing the trend of pushing out debt maturities by tapping the primary bond market and/or extending bank facilities (Exhibit C). As illustrated in Exhibit D, from December 31, 2008, through March 31, 2010, issuers have extended more than \$170 billion of maturities beyond 2015.

Additionally, operating leverage is taking hold, as lean cost structures in conjunction with moderate revenue growth are generating robust earnings and cash flow. Management teams' outlooks, while cautious, maintain a positive tone, as they see general economic improvement in the U.S.. Default rates continue to decline and are forecasted by Moody's to drop to 1.9% from the current rate of 7.6% by May 31, 2011.

Exhibit C

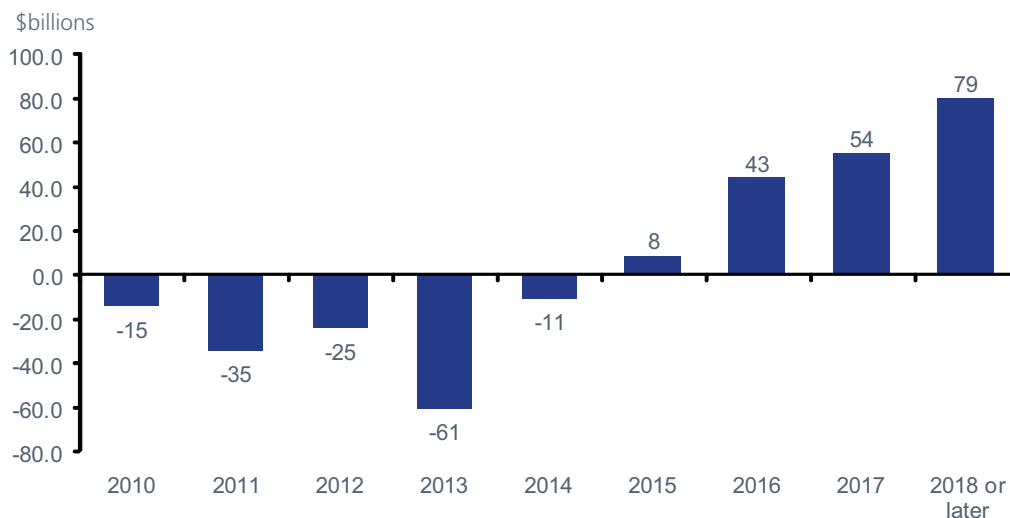
Upcoming Maturity Schedule



Source: J.P. Morgan; 2010 data is as of 03/31/2010

Exhibit D

Change in Upcoming Bond and Loan Maturities 3/31/10 vs. 12/31/08



Source: J.P. Morgan

While we certainly see signs of instability throughout the world, the focal point remains with European sovereigns and specifically the degree of impact the various austerity measures will have on global GDP. We remain comfortable with U.S. high yield companies, given the limited exposure these issuers have to the European region. Additionally, with the balance sheet repair and cost cutting that has occurred over the past year and a half, these companies, overall, are much better positioned to withstand any sales decline. As second-quarter earnings are released, we believe we will experience further investor confidence in the market. Certainly, the geopolitical risks across the globe (Europe, Korea, Middle East, etc.), revisions to China GDP estimates and the uncertainty of financial reform will weigh on investors' risk appetites at various points throughout the year. The positive trends of credit fundamentals should persist, however, and we expect them to overshadow these less powerful factors eventually.

Technicals – 2 rating

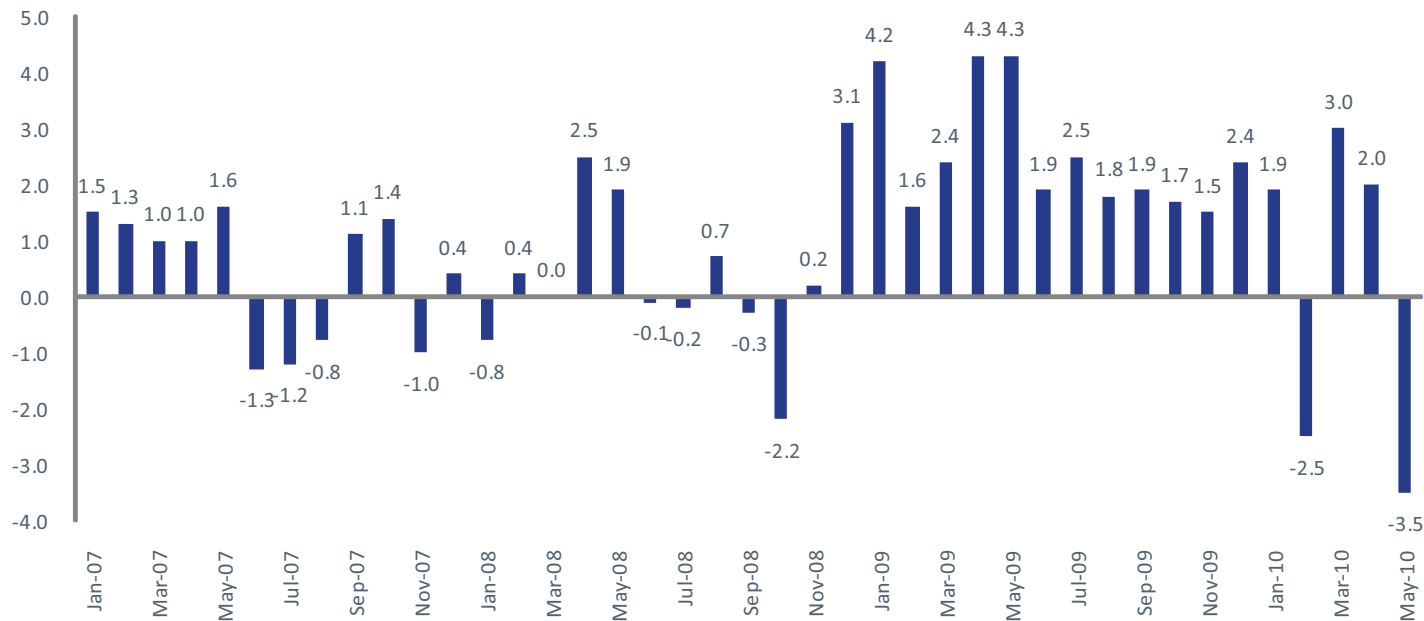
Headline risks heighten volatility and reduce investors' risk appetites

We have reduced our technical assessment of the high yield market for a variety of reasons, all of which were related to the recent turmoil in Europe and concern over the global economic recovery. The Chicago Board Options Exchange Volatility Index, often referred to as the "investor fear gauge," has spiked to levels not seen since early 2009. Investor fears also are reflected in high yield mutual fund flows, which witnessed their worst single

week since AMG began tracking the data and totaled more than \$3.5 billion of outflows for the month (Exhibit E). Because of these outflows, cash balances have diminished, and the appetite for new issuance has waned, with only \$19 billion pricing in May. This was the lowest monthly new issuance since last August.

Exhibit E

Monthly HY Mutual Fund Flows



Sources: J.P. Morgan; Lipper FMI

One offset to these negative technical indicators is the number of positive idiosyncratic events the high yield market has witnessed via IPO filings and M&A activity. Several high profile credits that have submitted S-1 filings for an IPO issuance include HCA, Toys R Us, Nielsen Holdings and NXP Semiconductor. With the abundance of capital in private equity firms and on issuers' balance sheets, M&A activity has increased materially, with recent strategic purchases such as Apache buying Mariner, Tommy Hilfiger buying Phillips and Heusen and Triumph buying Vought, and private equity sponsored deals such as TPG buying IMS Health. These issue-specific events reinforce the notion that idiosyncratic events will be a key driver of performance going forward, as opposed to the general bid for market risk we witnessed over the past 15 months. While sovereign headline risk is causing market volatility, we see opportunities at the specific security level that provide attractive long-term returns.

Valuation – 4 rating

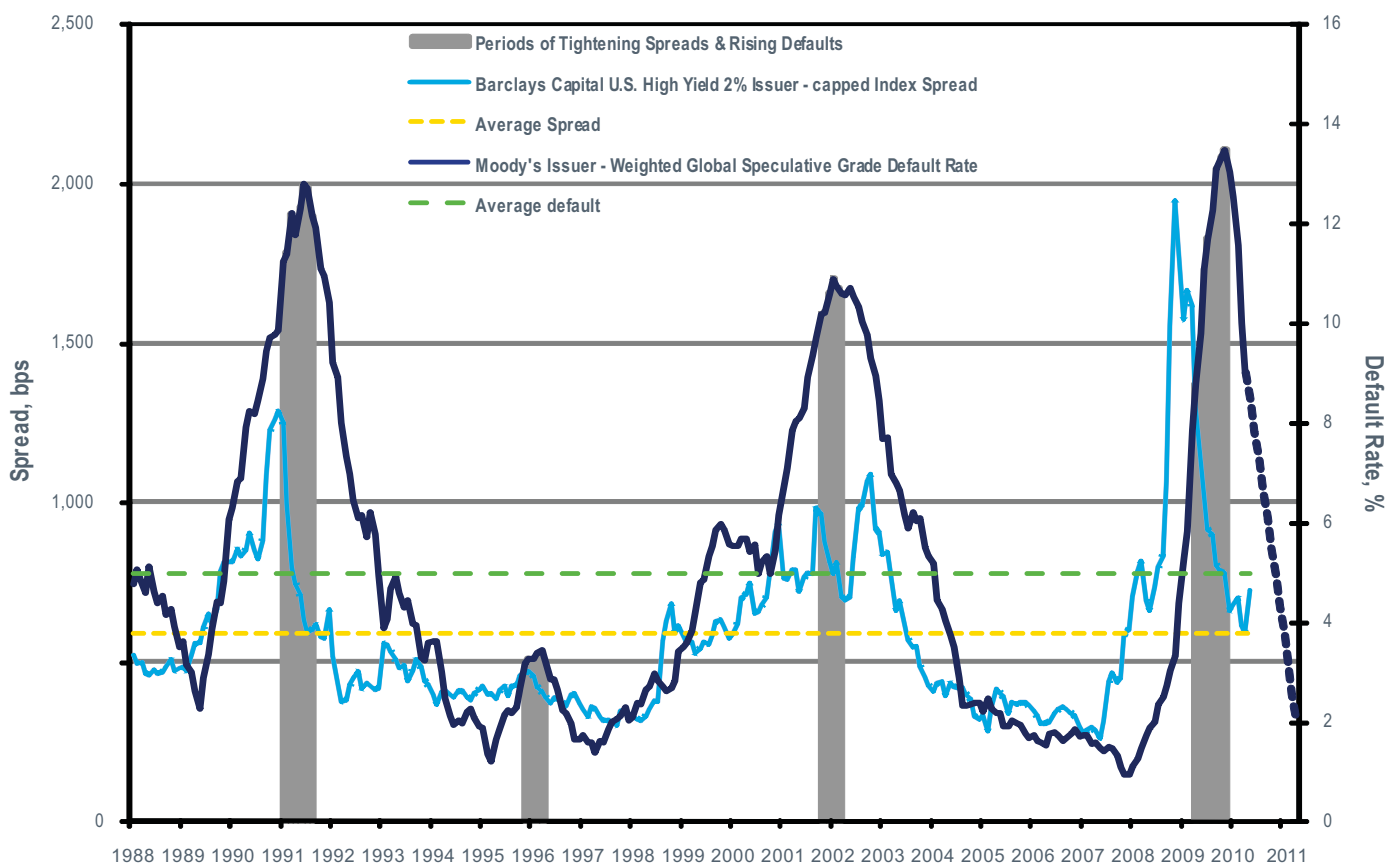
Further upside through tighter spread levels and declining default rates

We believe valuations are attractive and that the return for the high yield asset class should exceed its 10-year average of 7.5% (Barclays Capital) over the next 12 months. With today's valuation, the coupon return alone is 9%, which does not account for any capital appreciation. Despite expected continued choppiness, as the global economy attempts to self-sustain without the assistance of massive government stimulus, the high yield market is poised to generate returns above the long-run average.

As reflected in Exhibit C, the debt maturity extension will support the trend of lower defaults. High yield spreads typically lead defaults by six to nine months, as illustrated in Exhibit F. With default rates expected to materially decline below long-term averages, spreads should contract meaningfully as they are trading significantly above long-term averages, if history proves prescient.

Exhibit F

Spreads vs. Default Rates



Source: Bloomberg; Barclays Capital; 1/31/1988 -5/31/2010

Investment recommendation

In summary, our FTV analysis of the high yield market leads to a moderate overweight recommendation for investors. Following the financial crisis in 2008, companies have reduced debt, improved earnings and extended their debt maturities, providing for very little debt coming due over the next few years. We believe that default rates will continue to decline dramatically and strong fundamentals will outweigh the global headwinds currently in the market.

We view the dip in high yield bond prices as a buying opportunity to invest in companies with improving fundamentals. We believe that investors will be rewarded by looking past the short-term volatility to see corporate fundamentals. Corporate fundamental and economic news continues to exceed expectations, even as events across the globe have dominated the headlines. Further, business leaders in the U.S. continue to be more confident that the U.S. will see sustained growth beyond 2010. "The health of companies, both large and small, seems to be getting stronger all the time," Jamie Dimon, CEO, J.P. Morgan Chase. (Source: May 6, 2010, Wall Street Journal)

Careful credit selection remains our key to principal preservation, and we will continue to select bonds that we consider to have very little default risk. This is why we believe our fundamentally driven bottom-up focused strategy should provide investors with solid risk-adjusted returns throughout these volatile times. Lastly, investors often profit when valuations and fundamentals diverge. We believe this is one of those times. As valuations are becoming more attractive, U.S. corporate fundamentals continue to improve, and we believe this represents a buying opportunity that will reward investors who have a long-term investment horizon.



Todd J. Youngberg, CFA

Head of High Yield

The high yield portfolio management team is lead by Senior Vice President Todd Youngberg. Todd has over 20 years of investment management industry experience. Todd is responsible for the overall strategy and approach of the high yield practice at Aviva Investors.

High Yield Portfolio Managers

The team manages a variety of high yield strategies including US high yield, Global high yield, BB HY, and high yield bank loans. Combined, the team has over 45 years of direct experience investing in the high yield marketplace. The high yield portfolio management team emphasizes a team based approach.



Josh Rank, CFA; Jeremy Hughes, CFA; Chris Langs, CFA

The three high yield portfolio managers each have sector trading responsibilities. This allows for focus within areas of trading responsibilities and keeps the portfolio managers in the market on a day to day basis. This approach emphasizes consistent alpha drivers across high yield strategies, modeling analysis and optimal relative value decisions across industries and within company capital structures.

Important information

Past performance is not indicative of future results.

Investing in bonds, equities, commodities or other securities is subject to certain risks, including market, interest-rate, issuer, credit, equity, commodity, and inflation risk; all or a portion of the investment is at risk and may be lost.

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