

# Outright Convertible Strategy

## Quarterly Review – Fourth Quarter 2009



### Performance Summary

Convertibles continued their outperformance of the equity market.

Relative Index	4Q 09 Returns	YTD 09 Returns
Merrill Lynch All Convertibles Index (VXA0)	5.97%	49.13%
Merrill Lynch Investment Grade Bonds Index (VXA1)	4.01%	25.50%
Lehman Government Credit Bond Index	-0.21%	4.52%
S&P 500 Index	6.04%	26.47%

Source: MER/Bloomberg

The Fourth Quarter offered investors another strong return in the equity market and convertibles participated in nearly all of that move. For Convertibles, the combination of a strong equity market and continuing spread tightening (from 758 down to 647) led to another good quarter.

Returns throughout the year were driven by spread tightening, with high yield spreads dropping from 1706 at the outset to 647 at the conclusion of the year. Coupling this move in spreads with the equity market upswing of over 26% for the S&P 500 and a greater than 45% gain on the Nasdaq, resulted in convertibles being the second best asset class for the year only lagging behind High Yield Corporate Bonds with a 56.3% total return.

The underlying equities in the Convertible Market were particularly spicy with a 60.5% return, led by small cap and speculative grade names. Small cap convertibles were up over 58%, while large caps were up 45%. Speculative grade convertibles returned 82% while investment grade brought up the rear with only a 25% increase. Materials (+99%) and Consumer Discretionary (+89%) led the year as investors looked towards an improving economy.

### Economic Background

The economy continued to recover in the Fourth Quarter: Fourth Quarter was the second consecutive quarter of positive GDP growth.

Investors shifted their focus from recession to the trajectory of recovery.

The capital markets responded favorably, with equity markets rising and corporate credit spreads contracting. Treasury yields also rose. The yield on Ten-Year Treasuries rose approximately 50 basis points during the Fourth Quarter, from 3.3% at the end of the Third Quarter to 3.8% at year-end.

### The Convertible Market

During the Fourth Quarter, the Convertible Market benefited from evidence that the recession is nearing an end.

Specifically, the Convertible Market profited from:

- Declining credit spreads;
- Continuing strong interest from both outright and hedged investors; and
- Convertible valuations gravitating toward fair value.

### 2010 Outlook

While 2009 was a year of exceptionally strong performance for outright convertibles, we expect more moderate returns in 2010.

Nonetheless, we believe 2010 will be a solid year, with return potential still better than average.

The equity market could be pushed higher as money on the sidelines remains high. The recovery will be likely be choppy, but as companies push towards productivity limits, they will be forced to hire more workers and as inventories are replenished, comparative revenues to a weak 2009 will cause many company's equities to look attractive.

We expect that as the economy and companies reestablish a more solid footing, we will see an increase in Convertible new issuance. There is demand for the product and the opportunity for smaller companies to restructure their balance sheets in an effective manner should be appealing.

In addition, the Convertible Market continues to offer an attractive yield, with the weighted yield-to-best for the entire market finishing 2009 at 5.3%. Short term interest rates remain close to zero, and are unlikely to move higher until later this year. In addition, longer term treasury yields remain relatively low, and have significant downside risk if interest rates rise.

Lastly, although corporate credit spreads have seen a major contraction from the distressed levels of late 2008, there is room for further, more moderate contraction as the economic recovery continues. We see contraction of corporate credit spreads as an additional source of excess return in 2010.

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Putting this all together, we believe that the next twelve to eighteen months can be a good period for Convertibles. While we do not expect the returns of 2009 to be repeated, we believe that substantial opportunity remains, and that returns going forward can be quite good versus both historic norms and competing asset classes and alternative strategies.

We thank you for your continued support and look forward to 2010 being a continued period of opportunity.

A handwritten signature in black ink, appearing to read "Andrea Revy O'Connell".

Andrea Revy O'Connell  
SVP, Portfolio Manager

A handwritten signature in black ink, appearing to read "Ravi Malik".

Ravi Malik  
SVP, Portfolio Manager  
Enclosure(s)

### Performance Disclosure

SSI Investment Management, Inc. acquired the assets of Frole, Revy Investment Co., Inc and its composites as of March 1st, 2009. SSI is not and does not claim to be GIPS compliant. However, from January 1, 1983 through December 31, 2008, Frole, Revy claimed GIPS compliance and was verified by Ashland Partners & Company, LLP.

The **Outright Discretionary Convertible** strategy is invested in convertible bonds and convertible preferred stocks, and do not have credit quality restrictions. This composite was created in January 1983. The composite contains fully discretionary accounts including those no longer with the firm. SSI believes a performance comparison versus the Merrill Lynch All Convertibles (VXA0) index is appropriate. However, the volatility of this strategy is expected to be greater than the volatility of the Merrill Lynch All Convertibles index as the strategy holds a smaller number of positions as the index and may hold 144A securities. The return, if any, above the Merrill Lynch All Convertibles index is dependent upon higher interest income available in the convertible market and SSI's discretionary management. The other indices shown, if any, are not necessarily comparable to SSI's strategy. These are widely recognized market indices that are shown for informational purposes only.

The **Outright Investment Grade Bonds Only** strategy is invested in convertible bonds. This composite was created in January 1999. The composite contains fully discretionary accounts including those no longer with the firm. SSI believes a performance comparison versus the Merrill Lynch Investment Grade Convertible Bonds (V0S1) index is appropriate. However, the volatility of this strategy is expected to be greater than the volatility of the Merrill Lynch Investment Grade Convertible Bonds index as the strategy holds a smaller number of positions as the index and may hold 144A securities. The return, if any, above the Merrill Lynch Investment Grade Convertible Bonds index is dependent upon higher interest income available in the convertible market and SSI's discretionary management. The other indices shown, if any, are not necessarily comparable to SSI's strategy. These are widely recognized market indices that are shown for informational purposes only.

The **Outright General Convertible** strategy is invested in convertible bonds and convertible preferred stocks. This composite was created in January 1997. The composite contains fully discretionary accounts including those no longer with the firm. SSI believes a performance comparison versus the Merrill Lynch All Convertibles excluding 144A (VXN0) index is appropriate. However, the volatility of this strategy is expected to be greater than the volatility of the Merrill Lynch All Convertibles excluding 144A index as the strategy holds a smaller number of positions as the index. The return, if any, above the Merrill Lynch All Convertibles excluding 144A index is dependent upon higher interest income available in the convertible market and SSI's discretionary management. The other indices shown, if any, are not necessarily comparable to SSI's strategy. These are widely recognized market indices that are shown for informational purposes only.

Actual results of an individual account may be materially different from the performance shown herein because of differences in inception date, transaction and related costs, restrictions, fees and other factors. The annual composite dispersion presented is an asset-weighted standard deviation calculated for accounts in the composite the entire year. All returns are based in U.S. dollars and reflect, on a percentage basis for each of the periods indicated: (a) the net increase (decrease) of all Outright General Convertible portfolios, dollar-weighted, including adjustments for unrealized gains and losses, the reinvestment of dividends and other earnings, the deduction of costs, except for SSI's management fee and any separate custodial fees, time-weighted to adjust for additions and withdrawals.

A client's actual return will be reduced by the advisory fees and any other expenses which may be incurred in the management of an investment advisory account. See SSI's Form ADV, Part II for a complete description of the investment advisory fees customarily charged by SSI. As an example, an account with an initial \$1,000,000 investment on January 1, 2003, earning a recurring 5% semi-annual gross return (10.25% annualized), and paying a .5% semi-annual management fee (1% annual fee) would have grown to \$1,340,096 on a gross of fees basis and \$1,300,392 on a net of fees basis by December 31, 2005 (3 years).

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