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January 27, 2010

## A Minor Correction in Riskier Assets So Far – But Watching Closely

The “riskier” sectors of the fixed income market began their own correction on 1/11/10, slightly before the S&P 500 peaked at 1150 on 1/19/10. A correction in risk assets was inevitable, in our view, after a virtually uninterrupted rally since March 2009. The chart below shows the total return and change in risk premiums for various “risky” fixed income sectors in 2009 and through 1/26/10. The correction has been relatively muted thus far, in the context of the powerful 10-month rally, and it has more negatively affected the “riskiest” sectors (high yield, convertible, and emerging market bonds) than investment grade corporate bonds. However, the prices of exchange traded funds (ETFs) that track these sectors have been more negatively affected as their premiums to their underlying net asset values (NAVs) have collapsed, or even swung to discounts. With yields and risk premiums having collapsed from record levels and the easy money having already been made, we believe that investment flows into these sectors are likely to slow. This means that future returns will be driven primarily by coupon payments and are likely to be volatile, as uncertainty about the economy and equity markets remains high.

|                                   |  | Total Returns (%) |                  |                 |          | Yield (%)          |         |         |            |
|-----------------------------------|--|-------------------|------------------|-----------------|----------|--------------------|---------|---------|------------|
|                                   |  | 2009              | 12/31/09-1/11/10 | 1/11/10-1/26/10 | YTD 2010 | 12/31/09           | 1/11/10 | 1/26/10 | YTD Change |
| S&P 500 <sup>1</sup>              |  | 26.47             | 2.92             | -4.74           | -1.97    |                    |         |         |            |
| Convertible Bonds                 |  | 47.19             | 2.83             | -2.91           | -0.16    |                    |         |         |            |
| 10-year Treasury                  |  | -9.71             | 0.27             | 1.71            | 1.98     | 3.84               | 3.82    | 3.62    | -0.22      |
|                                   |  |                   |                  |                 |          | Risk Premium (bps) |         |         |            |
|                                   |  |                   |                  |                 |          | 12/31/09           | 1/11/10 | 1/26/10 | YTD Change |
| Corporate Bonds                   |  | 19.76             | 1.03             | 0.75            | 1.79     | 190                | 176     | 182     | -8         |
| High Yield Bonds <sup>2</sup>     |  | 57.51             | 2.19             | -0.77           | 1.41     | 639                | 599     | 644     | 5          |
| Emerging Market Debt <sup>3</sup> |  | 27.24             | 1.55             | -0.71           | 0.83     | 274                | 258     | 284     | 10         |

Past performance is no guarantee of future results. Source: Merrill Lynch, Bloomberg. Basis points (bps) = 1/100<sup>th</sup> of 1%.

1. Standard & Poor's (S&P) 500 Index – measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market.
2. High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds.
3. Investments in international and emerging markets securities include exposure to risks including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

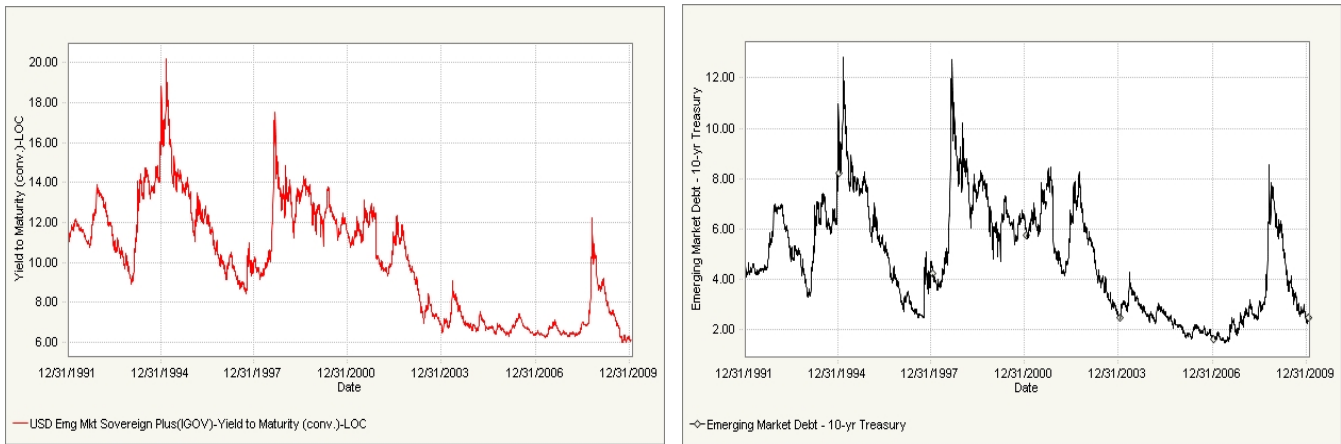
We have not lowered our portfolios' weightings to alternative fixed income and remain about neutral to our strategic benchmarks. However, we will contemplate reducing our weighting if the S&P 500 breaks key technical levels (1080) or spreads continue to widen.

While we have not changed our overall allocation, we have altered the construction of our alternative fixed income bucket. We have been in the process of re-allocating funds from emerging market debt to high yield bonds, and our portfolios are currently underweight emerging market debt and overweight high yield. In our last *Fixed Income View* (1/13/10) we highlighted two reasons for this adjustment:

1. The high yield default rate has likely peaked at around 13% and market consensus is that it will fall sharply during 2010 to around 4.5–5.5%, near its long-term average. We believe that this is a reasonable assumption, as we expect corporate earnings to recover sharply and the capital markets to remain receptive to even the “junkiest” issuers, allowing them to refinance maturing debt at attractive yields.
2. In contrast to improving corporate credit metrics, sovereign/municipal balance sheets continue to deteriorate and are likely to do so as long as unemployment remains high. In general, we have a preference for corporate credit over sovereign credit and revenue bonds over state/local government bonds.

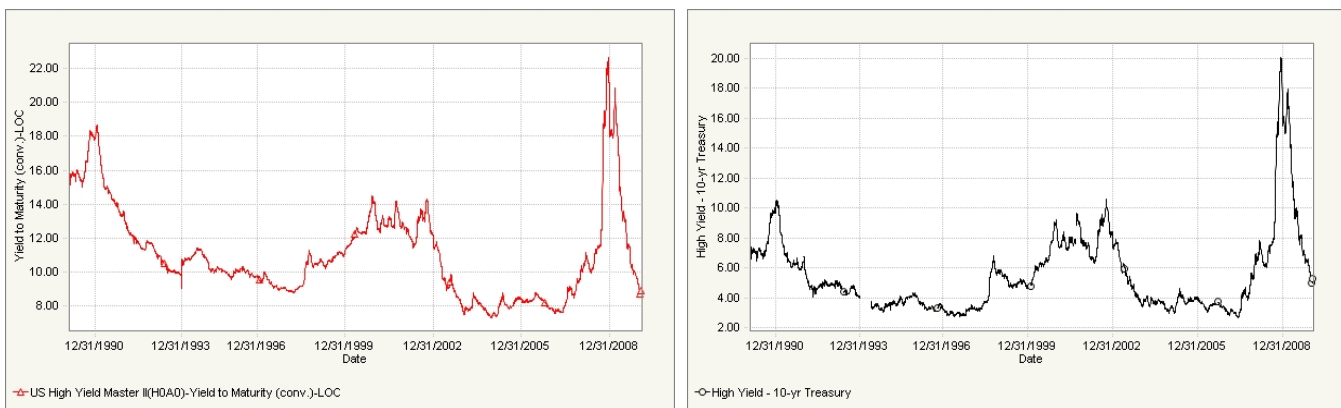
In addition to these two fundamental reasons, we also want to point out the valuation differences between these two sectors.

**Emerging Market Debt:** The chart below shows the yield and spread (risk premium) for the Merrill Lynch US Dollar Emerging Market Sovereign Plus Index, which is the benchmark we use internally. The chart shows that its current yield of 6.1% is just above its historical low of 5.99%. Investors are likely to balk at accepting much lower yields, in our view, especially when sovereign credit is generally weakening and troubled, yet remains A2/BBB<sup>1</sup> rated; Greece just sold 8 billion Euros (\$11.3 billion) of 5-year bonds at a 6.2% yield. While spreads are still slightly above their historical lows, we believe it will be difficult for spreads to tighten much further as long as sovereign credit is still weakening and supply is likely to remain high. We believe that there may be better opportunities in emerging market corporate bonds.



Source: Merrill Lynch; Past performance is no guarantee of future results.

**High Yield:** The chart below shows the yield and spread of the Merrill Lynch High Yield Master Index. While the current yield of 8.85% is not at an extreme low (unlike emerging market debt), it is within about 1.5% of its historical low. In addition, spreads are still well above their lows and are at a level consistent with past economic recoveries, which means that the high yield index may be able to absorb a moderate increase in Treasury yields without negatively affecting prices. This is why we believe that the high yield sector may be able to earn its coupon this year (i.e., total return equal to its 8.85% yield).



Source: Merrill Lynch; Past performance is no guarantee of future results.

<sup>1</sup> Obligations rated A2 by Moody's are considered upper-medium grade and are subject to low credit risk. An obligation rated BBB by Standard & Poor's exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

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