LAZARD

2010 **Outlook**

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The Convertibles Market

The year 2008 clearly separated the winners from the losers by highlighting those managers who protected capital in the downturn versus those who were forced, due to losses, to gate investors' capital and suspend redemptions. The separation between strong and weak performers widened in 2009. Successful managers of convertible strategies recognized that the market was overestimating the potential for further losses, and that the market's risk/return profile was at its most attractive point in nearly a decade. Conversely, managers who struggled were positioned for further redemptions, capital flight, and extreme distress.

THE MACRO BACKDROP HEADING INTO 2010

Against this backdrop, we believe 2010 will be a defining year for many portfolio managers. There are difficult calls to make on several fronts. Equity markets have had their biggest rally since the Great Depression. Credit markets have swung from extreme despair, in the fourth quarter of 2008, back closer to longer-term averages. Many commodities have doubled in price from their 2008 lows. Is gold a crowded trade at $1,200 an ounce, up 300% from its 2002 low, or is it on its way above $2,000 due to continued global macro uncertainty? Is the bear market rally in the U.S. dollar over, or is the currency just taking a breather before furthering its role as the borrowing currency of choice for the global carry trade? Is the market concern about inflation justified, or are we likely to enter a deflationary environment, such as the one experienced by Japan in its "lost decade" (from 1992 to 2002)?

There is one certainty that we see: uncertainty is cheap. Given the wide range of possibilities, we believe that buying volatility at current levels provides investors with an investment strategy that may yield strong returns with relatively little risk. As of year-end, the VIX Index, widely regarded as a good measure of risk tendencies (thus often termed "the fear index"), had re-traced to levels seen before the Lehman collapse. In fact, at the time of writing, it is below 19%. The long-term average is in the 16% to 17% range.

THE CONVERTIBLE ARBITRAGE STRATEGY IS ATTRACTIVE ON SEVERAL FRONTS

For convertible arbitrage investors, the supply-demand picture looks more compelling than it has in a long time. Going into 2010, we are reminded of the marketplace in early 1995. At that time, many "crossover" and "outright" holders of convertibles had actually underperformed equities in the previous year—something that is not supposed to happen based on the inherent attributes of convertible securities ("upside participation with downside protection"). However, in 1994, the interest rate market suffered a ferocious bear, pushing the yield on the 10-year Treasury up from 4.5% to 7% in just six months. While the S&P 500 Index was down just over 2% for the year, unhedged convertible funds suffered losses associated with the drop in Treasurys, pushing average performance for the year down 10%. During that time, many portfolios reduced their exposure to the space by selling securities into a market where there were few buyers. The asset class cheapened to a point where it attracted the interest of a growing number of relative-value investors, who could hedge interest-rate exposure and directional moves on the underlying equities, while extracting value from the inefficiencies of the market. Over the next four years, the space continually created outsized returns for this growing investor base of convertible arbitrageurs.

Today, the number of convertible arbitrageur specialists is less than half what it was at its peak level going into 2005. Based on our conversations with fund managers, banks, and industry players, it appears that, since mid-2007, the number of portfolio managers managing convertibles-based strategies is down by almost 40%. Furthermore, the remaining players are employing approximately half the leverage they have traditionally used. Due to losses and redemptions associated with the 2008 meltdown, participants are typically running less than half the capital that had been invested in the space beforehand.

Competition for opportunities in this investment space is as low as it has been in recent history.

WHERE WE SEE THE GREATEST OPPORTUNITY

We believe short-dated convertible securities offer investors not only a safe haven for the difficult investment environment ahead, but also an opportunistic vehicle to take advantage of the myriad uncertainties that potentially lie ahead. In our view, convertible securities that mature, are puttable, or convert within 2.5 years are ideal for the current marketplace.

Why is this the case? Shorter-dated convertible securities have inherently modest levels of duration or interest-rate risk. The risk associated with inflation is likely to wreak havoc on longer-dated fixed income securities. The obvious response to this concern would be to implement an interest-rate hedging program to match exposures. However, this approach may not provide suitable protection to principal if we move into an opposing deflationary environment. A rally in interest rates will cause significant losses associated with an interest-rate hedging program, while offering little protection to the sorts of credit losses typical of a deflationary environment. These are all negative outcomes for longer-dated fixed income securities.

The value destruction associated with higher rates should not be underestimated. Studies analyzing G10 markets from 1970 to the present show that for each increase of 100 basis points in the consumer price index ("CPI"), the index price to earnings (P/E) multiple has declined anywhere from 0.8 to 2.2, depending on which G10 market you look at. For example, based on historical data, for a 500-basis-point increase in the CPI, the index P/E multiple would be expected to collapse by 4 on the index least affected, and by 11 on the index most affected. During the 10-year inflationary period of 1973 through 1983, the impact left the S&P 500 Index trading at a P/E multiple below 8 by early 1982. An impact of this magnitude today could leave the S&P 500 Index trading at 570, down 45% from current levels.

Likewise, during this inflationary period, equity volatility remained elevated, and at significantly higher levels (with the VIX Index in the 20% to 35% range) than the muted equity volatility currently experienced. During Japan's "lost decade," equity volatility was even more significant. While the Nikkei Index dropped by more than 80%—from 38,000 to 7,000—between 1992 and 2002, the index volatility was more pronounced, with 10-day realized volatility levels above 30% for long stretches, than it has been for any 10-year period in the U.S. markets since the Great Depression. Therefore, whether one is an interest-rate bear (with the associated inflationary fears), or has a diagonally opposite perspective and holds deflationary expectations for the coming economic environment, we conclude that equity volatility is a central feature of both potential outcomes. Going long equity volatility is one of the few strategies that can set investors up for a win-win investment in either of these scenarios.

By their nature, short-dated convertible bonds, just like shorter-dated listed options, have higher gamma profiles, enabling holders to extract more value from increased equity volatility for the principal at risk. Equally, the opportunity to offset or amplify volatility exposures at the short end of the curve is dramatically increased by the availability of appropriate listed options, which are not available past the 2012 long-term equity anticipation securities (LEAPS), for longer-dated maturities.

In addition to the benefits of lower rate risk, an emphasis on holding shorter-dated bonds makes it possible to undertake credit analysis to specific corporate outcomes with a much higher level of certainty than is possible for longer-dated credit research, the outcomes of which are most closely associated with broader economic cycles.

Finally, shorter-duration securities provide the greatest exposure to event-driven trades. With close to $100 billion of convertible securities maturing or becoming puttable, callable, or redeemable over the next 10 quarters, the opportunities for special situations increase dramatically. These alpha-generating special situations include early refinancings, "sweeteners," tenders, buybacks, exchange offers, and opportunities in callable paper. More often than not, restructurings, calls, and maturities force relative-value convergence points. Therefore, in summary, short-dated securities help to mitigate exposure to interest-rate and credit risk, will likely benefit from volatility as uncertainty picks up from today's artificially low levels, and expose holders to potentially higher return opportunities available from the myriad upcoming special situations and events.

HOW WE WILL RESPOND AS THE MARKETS MOVE

We have already highlighted the uncertain market environment as a reason for making a call on interest rates and credit. As the year progresses, we will continue to question our thesis and adjust our exposures as appropriate. Based on our research on the relationship between risk aversion ("flight to quality"), equity volatility, inflation, and corresponding interest rate moves, it is clear to us that risk aversion is typically accompanied by sharp rallies in interest rates. For this reason, we believe that options on the rates curve are well designed to support hedging mark-to-market issues associated with the risk aversion impacts at the portfolio level.

In addition, while credit hedging is no panacea, or substitute for thorough fundamental credit analysis, we look to hedge credit exposures at the portfolio level. To do this effectively, it is important to track correlations between interest rate moves, credit spread changes, equity volatility changes, and stock market direction. Although in early 2007 we embraced the use of CDSs (credit default swaps) to hedge against market risk (investment-grade index contracts for hedging investment-grade risk, and the high-yield index for hedging high-yield exposures) and idiosyncratic risk (single-name CDSs), we moved away from these instruments in 2009. In

early 2008, around the time of the Bear Stearns demise, the depth and spread in single-name CDSs had become untenable, and had reduced trading of the CDS "hedge" to an unavoidable investment distraction. By late 2008 and early 2009, however, counterparty risk associated with CDS index hedges invalidated the sought-after benefit of the hedge. Throughout 2009, the team avoided CDSs, but as we enter 2010 we are closely watching the centrally cleared Intercontinental Exchange (ICE) Index contracts as they move towards their third roll, while waiting for confirmation from the Chicago Mercantile Exchange (CME) that single-name CDS clearing is not an eventuality but a pragmatic answer to the need for a fully-functioning regulated liquid CDS market.

While we wait, we are happy to hedge credit exposures via short positions in the SPY (the S&P 500 Index ETF), which trades with a 1-cent spread, 24 hours per day, has significant market depth and almost frictionless trading costs (0.25 cents per ETF), and offers no counterparty risk concerns. We note that, since 2007, correlations between CDS index hedging instruments and the SPY run between 74% at the low end to 98% at the high, while offering the benefits of almost double the beta. To supplement this, we have been implementing additional risk offsets via VIX instruments, including futures, options, and ETFs. These allow us to benefit from a pick-up in uncertainty across the broad investment landscape as a supplement to the SPY hedge, while remaining strike-independent.

OTHER TECHNICAL FACTORS WE ARE MONITORING

Fund Flows

Rewarded by early recognition of the opportunities in the convertible securities space in early 2009, many investors are looking to increase their exposure to the space significantly in 2010. What is unusual about this? Most of the capital coming in is flowing to unhedged ("outright") convertible portfolio management teams, and not to the traditionally broader base of convertible arbitrage and convertible hedge funds. Investors recognize that convertibles offer a lower-risk vehicle for taking equity exposure in these uncertain stock markets, while additionally offering cheap credit opportunities. Despite the rally in both equity and credit markets, we believe this trend will continue.

Prime Brokers and Leverage

Prior to the third quarter of 2008, leverage in the convertible arbitrage space had averaged approximately 4x to 4.2x (LMV/NAV) over the previous ten years. By the second quarter of 2009, average leverage had dropped to about half that level. We see leverage returning to the hedged strategy, but not back to its longer-term average. Our estimate for 2010, based on discussions with prime brokers and industry research houses, as well as anecdotal discussions, is for an average settling in at the 2.5x to 3x range. Based on the "staring into the abyss" sentiment of the fall of 2008, most prime brokers are either unwilling or unlikely to provide similar levels of leverage that many participants enjoyed. When it comes to funding costs, most readers will know that several of the leading prime brokers cut credit lines completely in the third quarter of 2008. Others increased collateral and margin requirements, requested disposals, and dramatically widened finance rates. These trends showed signs of reversing by the third quarter of 2009 and we believe this will continue in 2010.

Shape of the Sell Side

The defining trend in 2009 was for small, agency-based market makers to establish businesses and compete with the larger, more established money center banks and brokerages, which have long dominated the sell-side. This can partly be attributed to career frustration (senior traders and sales professionals becoming increasingly concerned with compensation caps), the devaluation of stock awards as financials tanked, and banks' and brokers' reduced levels of capital commitments to traditional market-making. Although several of these new operations will manage to stay the course, and indeed a few will thrive, many are already finding the going tough, as the larger sell-side firms recommit capital to market-making operations and renew their efforts to recapture lost market share.

In addition, as primary capital markets reopened early in 2009, investment managers recognized the importance of directing trade flows to those banks and brokerages at the top of the new issue league tables. In this respect, JPMorgan re-took the helm at the top of the global equity-linked league table, with 11.2% of the primary market, followed closely by Citigroup (9.5%), Morgan Stanley (9.2%), Goldman Sachs (8.3%), and Credit Suisse (which rounded out the top five with 6.7%).

Shape of the Buy Side

In mid-2007, the convertible space was largely inhabited by convertible arbitrage and other hedged investors, including proprietary trading desks at banks and other brokers. The remaining investors were "outright" (i.e., unhedged) dedicated convertible funds. Crossover buyers—whom we define as nontraditional convertible investors "crossing over" into the convertible space—accounted for a small minority of holdings. One trend seen in 2009 was a dramatic increase in exposure by crossover buyers and, concurrently, a decrease in arbitrage exposure. These high-yield, investment-grade, equity income, and balanced funds are interested in convertibles for a variety of reasons, including the nature of the issuers (typically small- to mid-cap, capital-hungry, high-growth corporate entities), enhanced yields, equity upside, or a combination of all three.

Given the lack of more compelling opportunities in the high-yield space, the continuing attractive nature of convertible securities' risk-return characteristics for equity investors, and recent investment flows seeking defensive positioning for 2010, we expect

crossover buyers to remain active. For hedged investors, having crossover participants in the marketplace dramatically increases the opportunities to arbitrage buying and selling activity by unhedged investors. The broader range of investors improves overall market efficiency, and provides additional sources of liquidity above and beyond that traditionally provided by the sell side.

New Issuance

The primary markets created some surprises in 2009. While corporate entities fretted about their ability to tap the debt markets early in the year, by the end of the fourth quarter the high-yield market had reached record levels of issuance. Many expected convertible issuance to follow suit, but this did not materialize. Market spectators point to the willingness of investors to pour money into the strongly performing high-yield space. With interest rates low, and spreads tightening from their extremely wide levels of late 2008, many issuers were quick to take advantage of the freshly reopened high-yield markets. In addition, many did not see the need to sell convertibles on stocks that were trading at multi-year lows. With the sharp rebound in equity markets and renewed capital flows into the convertible space, we see issuance rising significantly from depressed 2009 levels.

Another interesting data point comes out of international (ex-U.S.) convertible markets. This year, issuance in the EMEA (Europe, the Middle East, and Africa) region surpassed issuance in the United States for the first time since 1999. In fact, European issuance led both the United States and Asia. The drivers of this record issuance in the 23-member block are equally interesting. With a limited high-yield market, much of the credit that "Mittelstand" (small to medium) companies in Europe require has traditionally been supplied by European banks, through revolvers, lines of credit, and bank loans. In 2009, as global credit markets suffered continued distress, European banks recorded net credit contraction for the first time since WWII. The convertible market, on the other hand, remained open, not only to the traditional investment-grade issuers in the European market, but also to the increasingly wide array of non-investment-grade companies looking to finance themselves—companies such as Evraz of Russia, Alliance Oil of Sweden, and Soitec of France.

We believe this trend will continue in 2010, and we also see issuance in Asia finally picking up after a full two-year lull. We saw the first signs of this in late 2009 with new issuance from Hong Kong, India, Malaysia, Indonesia, and Singapore. These high-growth capital-hungry issuers continue to look to finance their businesses to capitalize on the stronger growth expectations for the region.

IN CONCLUSION, AN OPPORTUNITY TO BENEFIT FROM UNCERTAINTY

On the heels of an exceptionally strong 2009, we continue to see significant value in the convertible space. Implied credit spreads remain well above historical averages. The convertible asset class continues to be relatively cheap compared to the high-yield and investment-grade universe, and to levered loans. Implied volatility is near a multi-year low, despite lingering questions about economic growth, job creation, inflation, default rates, corporate fundamentals, and the financial health of the U.S. consumer. We believe corporate defaults are poised to decline from the two-decade high of over 12% in 2009. Technicals are supportive of valuations improving, and continue to strengthen. All of these variables point to an accommodative backdrop in 2010. Special-situation opportunities are likely to remain elevated, as nearly 40% of the market matures/becomes puttable over the next 36 months. We are encouraged by what we have witnessed in January and remain confident in our ability to generate alpha in 2010.

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NOTES:

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Convertible arbitrage strategies generally involve price spreads between the convertible security and the underlying equity security. The prices of these investments can be volatile, market movements are difficult to predict. Event-driven investing requires the fund to make predictions about (i) the likelihood that an event will occur and (ii) the impact such event will have on the value of a company's financial instruments. If the event fails to occur or it does not have the effect foreseen, losses can result.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss.

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