

Risk Control and Equity Upside:

The Merits of Convertible Bonds for an Insurance Portfolio

In a survey of insurance company Chief Investment Officers conducted by Eager, Davis & Holmes¹ in May 2009, 43% of the respondents indicated that they would likely be making a change to their equity allocation, with 90% of those respondents likely to decrease their allocation to common stocks. However, these risk reduction exercises must be weighed against long term surplus growth potential that is associated with an equity allocation. AAM believes that an investment grade convertible bond strategy offers insurance companies the unique opportunity to preserve this long term surplus growth potential while significantly reducing investment risk.

Background on the structure of a convertible security

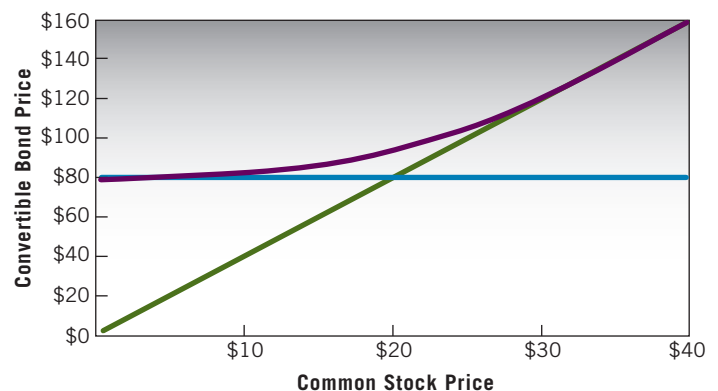
A convertible bond is a fixed income security that offers traditional characteristics of a bond such as a coupon, maturity, and credit rating. Embedded within the bond is an option that enables the investor to convert the security into a preset number of shares of the issuer's common stock. An example of a recently issued convertible is Allegheny Technologies 4.25% due 6/1/2014 ('ATI'), yielding approximately 180 basis points (bps) above Treasuries at issuance. In comparison, ATI has traditional debt outstanding carrying yield spreads of 500 bps over similar maturity Treasuries. The convertible security can be exchanged at any time into 23.9263 shares of ATI common stock at the option of the buyer. In effect, the convertible debt lowers the weighted average cost of capital for the issuer without immediately diluting existing shareholders.

This hybrid structure offers the investor in the convertible debt the downside protection of a bond with the upside potential of an equity security. The investor can analyze the aforementioned bond characteristics on a stand-alone basis to calculate the bond floor, or the theoretical value of the security without the equity option.

These bond characteristics will remain sensitive to factors that otherwise influence the valuations of traditional fixed income securities such as changes in interest rates, changes in credit spreads, and liquidity conditions.

Equally important is the equity conversion value, or the value of the security based on the predetermined conversion characteristics. By combining the bond floor and the equity conversion value as in Exhibit I, an implied valuation curve for the convertible bond can be derived. Although extremely difficult to attain in normal market conditions, the ideal price to purchase a convertible bond would be at the intersection of the bond floor and the equity conversion value; a point where the security would lack sensitivity to stock price declines, with the ability to participate one-for-one in any upward movement in the underlying common stock. Thus, the goal is to structure a well-diversified portfolio of convertible securities that are positioned as close to this intersection of the two lines as possible so that the portfolio is protected on the downside by being close to both floors, yet able to participate directly in the upside of the equity.

**EXHIBIT I:
THEORETICAL PRICE CURVE OF A CONVERTIBLE BOND**



Source: Zazove

This potential for a favorable asymmetric risk/return payoff should be intriguing to insurance companies that are focused on preserving principal and limiting portfolio volatility through fixed income investments, yet desire the long term surplus growth potential of equity securities.

The benefits of a strategic allocation

Modern portfolio theory provides a framework for how rational investors use diversification to optimize their

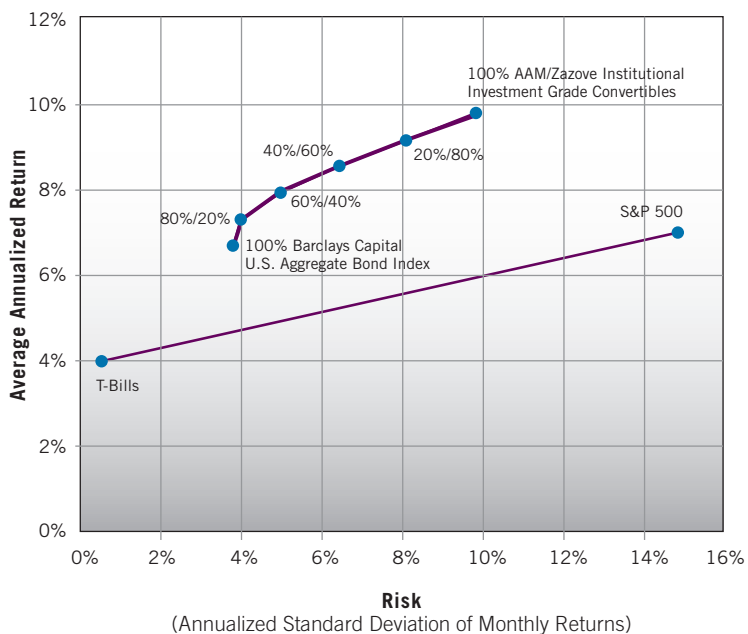
portfolios along an efficient frontier. For many insurance portfolios, efficient frontier portfolio allocations consist of only traditional fixed income securities or a modest allocation to equity securities as varying operating constraints typically inhibit the ability to incorporate other asset classes into these modeling exercises. Convertible bonds, as a defined asset class, should be added to the asset allocation framework for insurance portfolios as they offer compelling diversification benefits as evidenced in **Exhibit II**.

EXHIBIT II:
HISTORICAL MONTHLY RETURN CORRELATIONS
8/31/1991-6/30/2009

	AAM/Zazove IIG Convertibles	Barclays Capital U.S. Aggregate Bond Index	Barclays Capital U.S. Corporate Bond Index	S&P 500 Index
AAM/Zazove IIG Convertibles	1.000			
Barclays Capital U.S. Aggregate Bond Index	0.233	1.000		
Barclays Capital U.S. Corporate Bond Index	0.466	0.889	1.000	
S&P 500 Index	0.808	0.123	0.290	1.000

Source: AAM/Zazove, Barclays

EXHIBIT III:
HISTORICAL RETURN AND VOLATILITY CHARACTERISTICS
8/31/1991-6/30/2009



Source: AAM/Zazove, Barclays

These low correlations produce significant diversification benefits to a traditional fixed income portfolio (measured by the Barclays U.S. Aggregate Bond Index) as illustrated in **Exhibit III**. A 100% fixed income portfolio can increase the expected portfolio returns through a 20% allocation to convertible bonds with no meaningful change in portfolio volatility. While the surplus growth potential of traditional equities is appealing for many insurers, the higher volatility, lower income potential and higher risk-based capital charges are often deterrents for inclusion in an insurance portfolio. The distinct advantage of convertibles for an insurance portfolio is that they mitigate and/or eliminate these concerns, while their shorter durations have less interest rate sensitivity than a traditional Aggregate-based fixed income portfolio.

From a volatility perspective, convertible bond returns have historically exhibited approximately 66% of the volatility of the S&P 500. Since inception of the AAM/Zazove

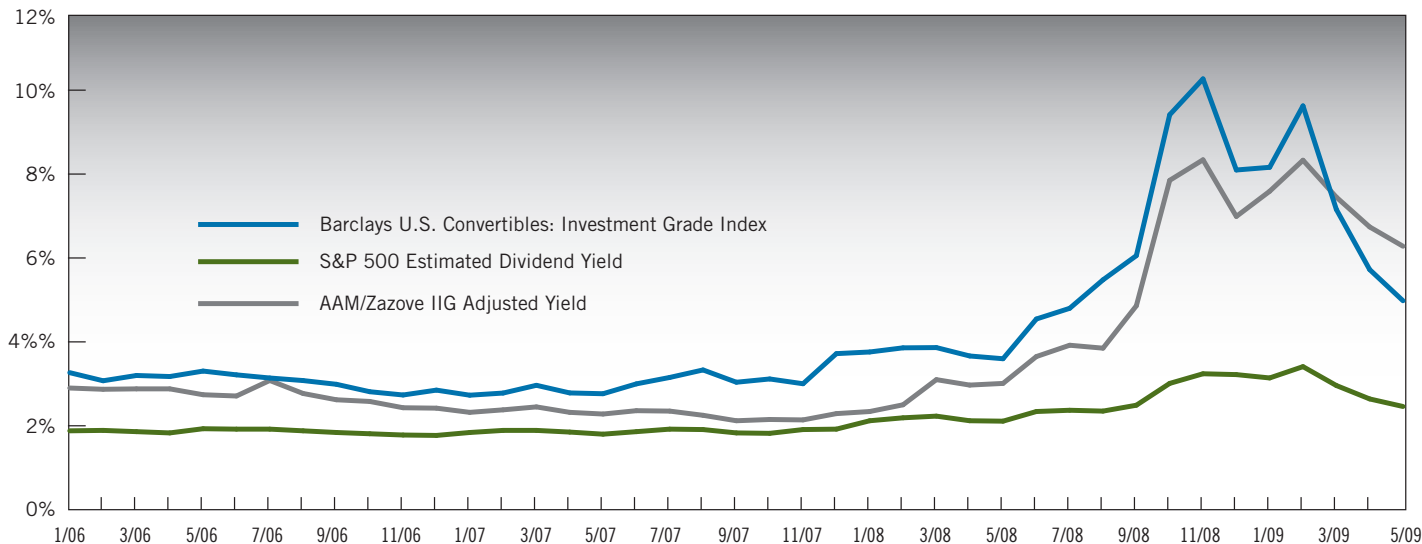
Institutional Investment Grade Convertible strategy in August 1991 through June 30, 2009, the volatility of annual returns has been 9.87% while the S&P 500 was 14.94% for the same period and the Merrill Lynch All U.S. Investment Grade Convertibles Index was 9.21%.

Consistent book income is typically one of the primary investment objectives for an insurance portfolio. Although the yields on convertibles are generally less than traditional fixed income securities, they do offer an insurance portfolio incremental income potential significantly above traditional equities as illustrated in Exhibit IV.

Perhaps one of the key advantages of convertible bonds for an insurance portfolio when compared to equities is the ability to carry the securities on Schedule D as bonds with the corresponding risk-based capital charges.

This eliminates the surplus strain of higher risk based capital charges commonly associated with equities. Moreover, because quarterly market value fluctuations for investment grade bonds generally do not affect insurance company statutory carrying values, realized balance sheet volatility is further reduced relative to a portfolio of equity securities.

**EXHIBIT IV:
HISTORICAL YIELD COMPARISON: CONVERTIBLES VS. EQUITIES²**



Source: AAM/Zazove, Barclays

What happened to convertibles in 2008?

In 2008, convertible bond valuations suffered dramatically with multiple forces pressuring the market. Among the contributing factors were:

- The collapse of credit and subsequent spread widening
- Broad equity market declines
- Restrictions on short selling
- Hedge fund deleveraging and redemptions
- Shrinking dealer desks and reluctance to commit capital
- Several investment grade defaults

The combination of these factors amid a market environment characterized by illiquidity pushed convertible bond valuations to historically attractive levels. In many cases, convertibles offered yields higher than the issuer’s pari passu straight debt, so the equity option was essentially free.

This market imbalance began to improve meaningfully in late November 2008 as crossover buyers emerged to take advantage of these anomalies. The market has since continued to benefit from a rebound in other technical factors such as a better supply/demand balance.

What is the opportunity in the current market?

Credit and equity market conditions have led to a rebound in convertible performance, with the Merrill Lynch All U.S. Investment Grade Convertible Index returning 7.59% year-to-date through June 30, 2009, and the AAM/Zazove Institutional Investment Grade strategy returning 15.87% for the same period. A bi-product of improving markets has been a resumption of new issuance within the fixed income markets, including convertibles, with deals priced at attractive terms. Through June 19th, year-to-date new issuance has totaled \$14.2 billion with yields averaging 4.7% and attractive conversion premiums averaging 23.3%.³ New issuance provides investors with an expanded set of options across the convertible price curve that offers balanced risk and reward characteristics. Although valuations have improved dramatically this year, we believe the current measures of the AAM/Zazove Institutional Investment Grade Convertible portfolio are compelling for new investors. Convertibles offer above average effective yields with limited interest rate risk and should continue to benefit from a normalizing market that encompasses narrowing credit spreads and higher equity valuations.

In the wake of the financial crisis, many insurers are concerned about portfolio volatility and risk based capital implications, and are either actively reducing their equity exposure and/or not rebalancing to their asset allocation targets. The AAM/Zazove Institutional Investment Grade program is a compelling strategy for these insurers to maintain their equity exposure while minimizing portfolio volatility and risk based capital requirements.

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AAM refers to Asset Allocation and Management Company, LLC, a SEC registered investment advisor specializing in insurance asset management. Zazove refers to Zazove Associates, LLC, a SEC registered investment advisor specializing in the management of convertible securities. AAM formed a sub advisory relationship with Zazove in 1991, through which Zazove manages convertible bond portfolios while AAM provides the marketing and client service to these insurance portfolios.

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¹ Eager, Davis & Holmes, Insurance Asset Outsourcing Exchange: "Insurance Companies' Investment Policies and Practices in Response to the Credit Crisis", May 2009.

² "Current Yield Proxy" equals higher of "Current Yield" and "Yield-to-Put" if a coupon paying security. If it's a zero coupon, it's the higher of "Current Yield" (Zero), "Yield-to-Put" (or "Yield-to-Maturity" if not putable). "Adjusted Yield" equals the higher of "Current Yield", "Yield-to-Put" and "Yield-to-Maturity".

³ Source: Bank of America Merrill Lynch Securities

AAM/Zazove Institutional Investment Grade Convertible Bond Strategy Composite Details

The following Schedule sets forth the number of portfolios in the Composite, total Composite assets, dispersion of Composite returns and Composite assets as a percentage of the Company's assets under management since September 30, 1991.

Institutional Investment Grade													
Year	Quarter Ending	# of Portfolios	Composite Dispersion	Total Assets	% Firm Assets	Firm Assets	Year	Quarter Ending	# of Portfolios	Composite Dispersion	Total Assets	% Firm Assets	Firm Assets
09	2nd	36	1.77%	\$2,110,318,245	44%	\$4,784,587,932	00	2nd	57	0.22%	\$420,903,764	32%	\$1,261,657,245
09	1st	37	0.49%	\$1,842,620,309	44%	\$4,173,193,966	00	1st	55	0.24%	\$318,155,468	24%	\$1,292,902,564
08	4th	40	0.76%	\$1,508,985,164	40%	\$3,802,210,588	99	4th	62	0.16%	\$361,371,914	28%	\$1,310,457,223
08	3rd	41	0.25%	\$1,807,110,071	40%	\$4,469,217,584	99	3rd	59	0.17%	\$354,429,864	29%	\$1,339,728,506
08	2nd	40	0.16%	\$1,531,307,711	30%	\$5,112,848,509	99	2nd	60	0.12%	\$488,849,068	35%	\$1,408,226,771
08	1st	43	0.08%	\$2,052,736,420	43%	\$4,962,166,932	99	1st	63	0.16%	\$518,742,730	41%	\$1,293,526,801
07	4th	41	0.18%	\$2,072,705,291	43%	\$4,945,351,339	98	4th	62	0.19%	\$474,518,690	38%	\$1,256,193,828
07	3rd	45	0.10%	\$2,248,330,761	45%	\$5,047,619,189	98	3rd	62	0.22%	\$458,941,437	40%	\$1,169,351,781
07	2nd	44	0.11%	\$1,979,638,436	42%	\$4,758,779,870	98	2nd	61	0.13%	\$488,205,696	43%	\$1,173,660,528
07	1st	43	0.05%	\$1,477,240,221	33%	\$4,588,295,776	98	1st	59	0.22%	\$486,974,922	46%	\$1,045,507,403
06	4th	50	0.16%	\$1,970,379,436	44%	\$4,495,700,943	97	4th	58	0.29%	\$533,514,495	60%	\$877,992,529
06	3rd	49	0.08%	\$1,760,254,432	45%	\$3,976,438,980	97	3rd	59	0.22%	\$592,385,041	71%	\$836,799,677
06	2nd	49	0.15%	\$1,662,707,953	45%	\$3,762,293,563	97	2nd	55	0.29%	\$454,543,613	61%	\$742,056,473
06	1st	51	0.15%	\$1,637,002,679	43%	\$3,770,226,504	97	1st	48	0.25%	\$366,958,525	62%	\$591,902,951
05	4th	53	0.17%	\$1,614,911,275	44%	\$3,707,519,264	96	4th	45	0.16%	\$361,482,786	66%	\$551,318,494
05	3rd	49	0.13%	\$1,431,883,779	40%	\$3,600,500,882	96	3rd	44	0.09%	\$353,662,903	70%	\$508,589,819
05	2nd	47	0.09%	\$1,001,157,793	30%	\$3,403,625,319	96	2nd	43	0.21%	\$331,742,012	69%	\$481,249,180
05	1st	45	0.09%	\$895,653,625	30%	\$3,010,978,348	96	1st	40	0.10%	\$331,458,568	72%	\$462,135,593
04	4th	42	0.11%	\$853,621,357	29%	\$3,025,445,866	95	4th	36	0.13%	\$274,355,304	66%	\$412,800,567
04	3rd	44	0.13%	\$864,872,225	31%	\$2,781,255,140	95	3rd	34	0.17%	\$255,446,672	71%	\$357,505,216
04	2nd	75	0.10%	\$961,510,256	36%	\$2,728,413,702	95	2nd	36	0.20%	\$243,232,626	75%	\$325,613,566
04	1st	77	0.10%	\$971,994,969	36%	\$2,740,485,510	95	1st	33	0.16%	\$204,483,265	72%	\$283,510,225
03	4th	70	0.11%	\$802,023,798	32%	\$2,507,960,937	94	4th	35	0.19%	\$183,774,498	70%	\$260,877,628
03	3rd	72	0.22%	\$763,616,518	33%	\$2,311,905,876	94	3rd	35	0.13%	\$192,681,612	71%	\$269,876,859
03	2nd	72	0.29%	\$690,558,543	32%	\$2,160,079,301	94	2nd	32	0.13%	\$179,412,546	73%	\$246,503,771
03	1st	75	0.16%	\$623,549,854	33%	\$1,934,217,444	94	1st	29	0.21%	\$159,895,132	68%	\$233,975,707
02	4th	76	0.18%	\$631,064,610	37%	\$1,728,155,800	93	4th	30	0.17%	\$144,306,801	63%	\$230,282,470
02	3rd	75	0.11%	\$519,656,331	34%	\$1,546,771,247	93	3rd	26	0.16%	\$129,383,674	63%	\$203,777,196
02	2nd	75	0.24%	\$556,019,096	34%	\$1,630,958,319	93	2nd	20	0.13%	\$93,357,942	55%	\$170,814,369
02	1st	76	0.11%	\$588,067,663	36%	\$1,640,321,530	93	1st	18	0.11%	\$78,625,536	56%	\$140,871,192
01	4th	67	0.17%	\$517,182,823	34%	\$1,521,434,910	92	4th	17	0.36%	\$50,401,329	45%	\$111,977,264
01	3rd	65	0.11%	\$479,363,074	34%	\$1,402,341,862	92	3rd	8	0.15%	\$16,881,261	22%	\$75,691,295
01	2nd	63	0.13%	\$488,208,780	33%	\$1,446,317,401	92	2nd	9	0.22%	\$20,467,507	40%	\$51,296,489
01	1st	60	0.42%	\$456,030,211	33%	\$1,353,729,983	92	1st	7	0.15%	\$12,745,346	29%	\$44,563,457
00	4th	55	0.09%	\$416,103,047	33%	\$1,257,111,118	91	4th	5	0.24%	\$10,238,297	22%	\$45,681,231
00	3rd	65	0.26%	\$453,644,736	34%	\$1,320,846,460	91	3rd	1	0.00%	\$2,085,130	9%	\$23,752,927

Past performance is no guarantee of future results.

Notes to performance summaries

1. The Zazove Institutional Grade Composite (the “Composite”) represents a composite of discretionary accounts managed under the Zazove Institutional Investment Grade Strategy. Zazove Associates, LLC (the “Company”) has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). The Company is the successor to Zazove Associates, Inc., an Illinois corporation that transferred its investment advisory business on January 1, 1995 to Zazove Associates, L.L.C., a Delaware limited liability company. Zazove Associates, Inc. is the managing member and majority equity-holder of the Company.

2. The Composite was created on September 30, 1991. All returns are based in U.S. Dollars and are computed using dollar weighted/time weighted returns calculated on a monthly basis. A schedule of the number of portfolios in the Composite, total Composite assets, dispersion of the Composite returns and Composite assets as a percentage of the Company’s assets is attached. Additional information regarding policies and procedures for calculating and reporting returns is available upon request.

3. The Composite is defined to include all fee paying, discretionary accounts over \$200,000 that are managed under Zazove Institutional Investment Grade Strategy (leverage is not utilized). Portfolios that have significant additions of capital are excluded from the calculations for a month on the following basis: (i) if the cash balance at the beginning of a month is greater than 15% of the portfolio’s market value and is the result of an addition of capital by investor, (ii) if, as the result of an intra-month addition of capital by investor, average capital for a month is greater than 25% of the portfolio’s market value at the close of the prior month, or (iii) if, as a result of an intra-month addition of capital by investor, average capital for a month is greater than 15% of the portfolio’s market value at the close of the prior month and if the ending cash balance is greater than 15% of the portfolio’s market value. A portfolio is excluded from the calculations for a month in which the account is considered non-discretionary as a result of specific instructions by investor (e.g., account liquidation, trading freezing, sell instructions).

4. Returns are presented before management fees (i.e., gross returns). Management fees and other expenses (including applicable withholding taxes, if any) incurred in managing the account will reduce returns. The Company’s basis fee schedule for a separately managed account is 1% of assets under management. Advisory fees are described in Part II of the Company’s Form ADV. Under certain circumstances management fees are negotiable.

5. The dispersion of quarterly Composite returns in the accompanying schedule is measured by the standard deviation of asset-weighted portfolio returns represented in the Composite for the quarter.

6. Returns of stock and bond indices include the reinvestment of dividends and interest, respectively.

7. A complete list of Company composites and performance results is available upon request. Historical performance data reflects actual past performance and is not a guarantee of future performance.

Impact of management fees on investment return

The following Schedule illustrates the effect of management fees on a portfolio that obtains consistent returns at the specified annual rate, while incurring management fees at the beginning of each quarter equal to one-fourth of the annual fee.

Annual Return	Annual Fee	Portfolio Value		
		in 1 yr	in 5 yrs	in 10 yrs
	0.00%	\$10,800	\$14,693	\$21,589
	0.50%	\$10,747	\$14,337	\$20,555
8.00%	1.00%	\$10,694	\$13,989	\$19,570
	1.50%	\$10,642	\$13,649	\$18,630
	2.00%	\$10,590	\$13,317	\$17,735
	0.00%	\$11,000	\$16,105	\$25,937
	0.50%	\$10,946	\$15,706	\$24,669
10.00%	1.00%	\$10,983	\$15,315	\$23,457
	1.50%	\$10,840	\$14,932	\$22,299
	2.00%	\$10,787	\$14,557	\$21,192
	0.00%	\$11,200	\$17,623	\$31,058
	0.50%	\$11,146	\$17,200	\$29,584
12.00%	1.00%	\$11,092	\$16,786	\$28,187
	1.50%	\$11,038	\$16,382	\$26,837
	2.00%	\$10,984	\$15,987	\$25,559