MERGANSER
CAPITAL MANAGEMENT

INVESTMENT MEMO

Investment Team

DOUGLAS A. KELLY, CFA
Co-Chief Investment Officer

ANDREW M. SMOCK, CFA
Co-Chief Investment Officer

PETER S. KAPLAN, CFA
Portfolio Manager

JENNIFER K. WYNN, CFA
Portfolio Manager

Prudent Exposure to Emerging Markets

The expression "emerging markets" often evokes images of faraway lands with unstable governments and boom-bust economic cycles. However, emerging markets have matured in recent years with improving sovereign creditworthiness and relative economic stability leading to expanded depth and breadth of debt offerings. As such, emerging market (EM) bonds have become a viable investment option for conservative fixed income managers. At Merganser, we believe that investments in the debt of a select group of EM corporate issuers can add diversification and yield with only marginal incremental risk to an investment-grade focused portfolio.

Defining Emerging Markets

There is no consensus on the definition of emerging markets, but they are broadly characterized by lower household income levels, higher political risks and weaker macroeconomic resilience than their developed-market peers. Barclays Indices use a ratings-based approach and include countries with a maximum average sovereign rating of Baa1/BBB+, while J.P. Morgan Indices include low- and middle-income economies as defined by the World Bank. At Merganser, we consider some 80 countries as emerging markets: all of Latin America, Africa and the Middle-East as well as most of Asia (excluding Japan, Australia and New Zealand) and emerging Europe.

This universe has about $12 trillion of bonds outstanding and is typically segmented by issuing currency, creditworthiness and type of issuer to more closely align risks with investor appetites. EM bonds are mostly domestic instruments, i.e. denominated in the home currency of the issuers, but almost $1 trillion of outstanding bonds are U.S. dollar-denominated (Yankees). Hard-currency bonds (bonds issued in more stable currencies like the U.S. dollar, Euro or British pound) offer issuers access to longer maturities, more flexible covenants and a natural hedge to foreign-denominated assets or revenues. Corporate issuers' credit ratings are generally capped by that of their sovereign, but our wide definition of emerging markets include some stronger countries. Thus, 40% of our Yankee EM investable universe lies in the BBB rating category, with 20% and 14% in the A and BB categories, respectively. Although corporate issuance has slightly outpaced sovereign issuance since 2006, sovereign issuers still represent nearly half of all outstanding Yankee EM bonds, with corporate issuers (industrials, financial institutions and utilities) accounting for about a third

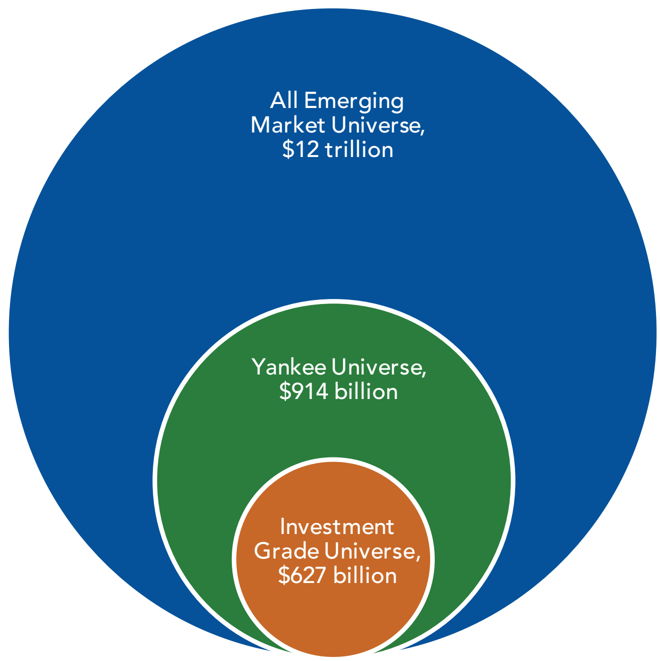
Continued on next page >

of the market and government-related entities (mostly oil and gas producers and development banks) rounding out the balance.

Merganser focuses its analysis on Yankee investment-grade corporate issues that we believe offer compelling expected risk-adjusted returns and are consistent with our investment strategy of providing capital preservation and liquidity. These Yankee investment-grade corporates require no currency hedging, match the U.S. dollar-denominated liabilities of our American clients and offer us an opportunity to leverage our corporate analysis expertise. We will also consider government-related and sovereign issuers when they offer significantly better liquidity than corporate issuers. Figure 1 illustrates the EM investable universe as defined by Merganser.

Figure 1 displays the emerging market investable universe. The U.S. dollar-denominated investment-grade universe, marked in orange here, represents Merganser's focus.

Figure 1: Emerging Market Investable Universe



Source: Based on Barclays Multiverse Index as of March 31, 2012.

Given broadly improving sovereign health, EM corporate bonds are increasingly comparable to domestic bonds, and, along with foreign bonds from developed markets, have become part of the investable universe for most investors. EM bonds now account for 1.6% of the Barclays U.S. Aggregate Index while foreign issuers from developed markets represent about 6.5% of the index. Further, for investors with a greater risk tolerance, there are many crossover (BB/BBB) issues with compelling risk/reward characteristics.

No Two Countries Are Alike

Although most emerging markets share the above-mentioned characteristics of weaker economic resilience and higher political risks, the particularities of each country must be understood before investing. We begin our credit work on each EM issuer with a top-down evaluation of the political, financial and economic risk level of the countries where it operates, using a mix of quantitative data points and qualitative assessments. Our analysis of the political stability of a country includes socioeconomic conditions, investment climate, strength and observance of the law as well as internal and external conflicts. The financial risk evaluation measures a

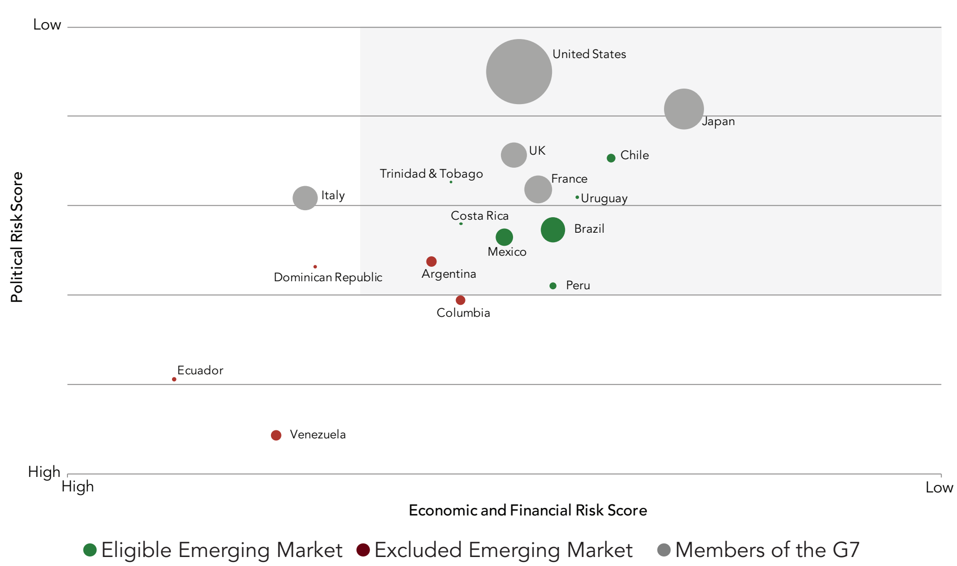
Continued on next page >

country's ability to finance its official and commercial obligations based upon its foreign debt burden, current account balance, international liquidity and exchange rate stability. Economic risk assessment factors include GDP per capita, GDP growth and inflation. We restrict our investable universe to issuers operating in countries meeting our minimum thresholds for each category, reserving judgment to consider adding solid credit stories operating in rising emerging markets or to exclude issuers facing elevated expropriation risk. About 25 emerging markets issuing Yankee bonds meet our investment criteria, including Brazil, Hong Kong, Mexico and South Korea. After completing our top-down analysis, we then conduct the same rigorous financial statement analysis and credit work that we apply to every issuer in which we invest.

Figure 2 illustrates the application of our emerging market framework to a selection of Latin American countries, including some developed countries for comparative purposes. As expected, Chile scores favorably compared to its Latin American peers based on its low debt burden, political stability and very flexible and resilient economy. Brazil and Mexico, the two largest economies in the region, also score comfortably within our political, economic and financial risk tolerance given their recent track record of cautious fiscal and monetary policy resulting in low inflation, steady external debt levels and increasing economic resiliency. Despite acceptable scores, we exclude Argentina due to its unorthodox macroeconomic policies resulting in annual inflation in excess of 20%, and its history of expropriation of private assets (most recently that of oil and gas producer YPF SA).

Figure 2 illustrates the application of our emerging market framework to a selection of Latin American countries. The gray shaded box represents Merganser's investable universe.

Figure 2: EM Framework Applied to Latin American Region



Growing Asset Category

The Yankee EM bond market has been one of the fastest growing asset classes in global fixed income during the past few years: it is now comparable in size to the U.S. high-yield market. This expansion has been supported by a number of developments, including the stability of emerging market sovereigns and the development of deep U.S. dollar sovereign bond curves. Additionally, many companies domiciled in emerging markets, after a period of rapid growth and internationalization, have outgrown their bank credit lines and are looking to diversify funding sources by using the international bond market. This trend is especially true for Latin American companies, whose local currency debt markets are underdeveloped, as opposed to Asian companies that are able to rely on developed local currency markets with robust local demand to meet their financing needs. For example, Grupo Bimbo SAB de CV[1],

Continued on next page >

a bakery headquartered in Mexico, issued $800 million of Yankee bonds last January to finance its acquisition of Sara Lee Corp's North American fresh bakery business. Vale SA[1], an iron ore miner, and Petroleo Brasileiro SA[2], an integrated oil and gas producer, regularly tap the Yankee markets because their funding needs exceed the appetite of the Brazilian debt market. Today, they are Brazil's largest issuers of Yankee bonds, after the sovereign, with outstanding bonds in excess of $11 billion and $23 billion, respectively.

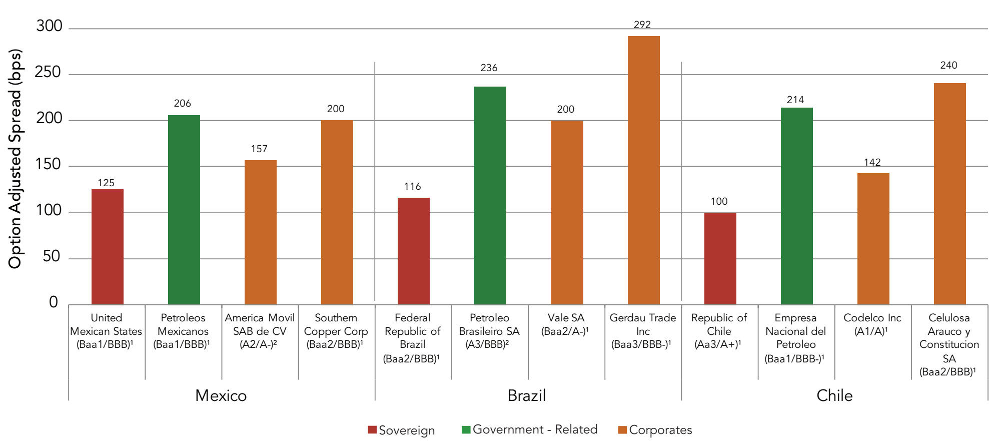
Talking Yield

Sovereign health has historically been the most important determinant of EM corporate credit risk with the spreads on sovereign issues usually setting the floor for all issuers based in that country. Although the correlation between corporate and sovereign yields is weaker in more established economies, this important relationship explains our top-down approach to selecting EM bonds. Highly rated corporate issuers can trade tight to their sovereign if they have leading business positions and maintain solid credit metrics. For example, the five-year CDS on America Movil SAB de CV[1], a Mexico-based wireless provider with operations spread across all of Latin America and A2 / A- ratings, has traded on average 15 basis points inside that of the Mexican sovereign over the past year. Spreads on EM corporate issues are generally wider than their similarly-rated U.S. peers despite usually lower financial leverage. During the past year, the average spread difference between BBB-rated Yankee EM corporate issuers and BBB-rated American issuers was about 100 basis points. Although the discount is partly justified by lower liquidity and a higher proportion of private placements, we believe that there are many opportunities to find value within the EM universe.

In the figure below, we compare the option-adjusted spread to U.S. Treasuries of sovereign, government-related, higher-rated and lower-rated investment-grade industrial Yankee bonds from three representative Latin American countries. This clearly illustrates that corporate issuers usually trade wider to their sovereign and supports our view that EM bonds can offer attractive risk/reward propositions.

Figure 3 shows that, in general, EM corporate debt offers a higher option-adjusted spread than their sovereign and can offer good value compared to domestic debt.

Figure 3: Option-Adjusted Spreads* of Sovereigns vs. Corporates



Source: Bloomberg, as of March 31, 2012. All have a duration of approximately seven years. *Option-adjusted spreads to like duration U.S. Treasuries.

Continued on next page >

Still Some Room for Improvement

Despite significant strides in the depth and breadth of the Yankee EM asset class, some weaknesses remain. While declining liquidity is a global trend in corporate bonds, it affects EM corporate bonds more than domestics due to their smaller average block trading sizes and lower turnover. The average trade size for Latin American corporate bonds was slightly less than $400,000 in April 2012, compared to $500,000 for domestic industrial bonds during that month. Turnover was about 1.5% for Latin American bonds compared to about 2.5% for domestic industrial bonds over the same period. Additionally, liquidity tends to disappear more quickly during downturns, even more than in the U.S. high-yield markets. This problem can be alleviated partly by focusing on larger issues from well-known issuers and by limiting the proportion of EM investments in portfolios with higher liquidity needs.

Transparency, either in corporate balance-sheet disclosures or bond pricing, is also weaker than that seen in developed markets. This is especially true for private placements as many EM high-grade bonds issue under Rule 144a, which does not require them to register with the SEC or provide financial statements. Corporate governance is also often weaker in emerging markets, with government influence a factor in many companies' decision-making process. This is obviously true of government-related issuers, but also significant for corporate issuers such as Vale SA. In this case, the Brazilian government has the power to veto corporate actions such as mergers and asset disposals. Finally, returns on EM bonds are more volatile than those in the domestic market: the average standard deviation of weekly excess returns on Yankee high-grade EM corporate bonds was 0.75 during the last three years, as compared to 0.60 for domestic A and BBB corporate bonds during the same period.

Conclusion

EM bonds have come a long way since the crises of the '80s and '90s. Improved legal, regulatory and economic climates within many countries have brought stability to some of the asset class. As these markets continue to develop, and global investors search for returns that are less correlated to Europe, we believe opportunities for attractive risk-adjusted returns will persist. Investing in U.S. dollar-denominated, investment-grade EM securities is a natural extension of our long history of analyzing credit risk, avoiding defaults and assessing relative value across sectors.

Contact Information

Merganser Capital Management
99 High Street
Boston, MA 02110
www.merganser.com

Consultant Relations & Client Development
P: 617-494-1000
F: 617-528-4899
info@merganser.com

1. Merganser did not hold securities for this issuer as of May 31, 2012 and will not transact in these names for the sixty days following.
2. Merganser held securities for this issuer as of May 31, 2012.