EDMOND DE ROTHSCHILD ASSET MANAGEMENT
GROUPE LCF ROTHSCHILD

INTERVIEW | Saint-Honoré Convertibles

Interview with Kris Deblander

Head of Convertible Bond Management
February 2009

2005 2006 2007 2008

Saint–Honoré Convertibles – Best fund over 10 years in the convertible bonds Europe category for the 4th year running[1].
LIPPER FUND AWARDS FRANCE, FEBRUARY 7 2008

How do you explain the performance of the convertible bond asset class in 2008?

In 2008, European convertible bonds lost more than 30% (-31.7% for the UBS European Focus Hedged CB Index) following sharp declines in equity markets (-46% for the DJ Stoxx 600). It is important to understand the reasons behind this fall to get a better grasp on the potential of a future revaluation.

During previous crises, and especially in 2002, the convex[2] nature of convertible bonds helped cushion the fall but **this protection was less efficient in 2008**. This was not due to a technical difference in deltas[2] as the pool had similar characteristics in both 2002 and 2008. The very disappointing performance in 2008 can be partly attributed to equity falls but the chief reason was **the global credit crisis which became a liquidity crisis on the convertible bond market**. This phenomenon began in August 2007 and peaked in October 2008 after Lehman Brothers went bankrupt.

Convertible bonds were hit badly by the financial crisis because 70% of the pool was held by hedge funds with average gearing of 4 times. When these funds were confronted by large redemptions, their leverage forced them to sell significant amounts of convertible bonds in their portfolios which amplified the liquidity problem on the market. Furthermore, Lehman Brothers was a major player on the convertible bond market both in terms of its proprietary books and as a market maker. Its downfall accelerated the process. After analysing the causes behind the convertible bond fall in 2008, I estimate that 10-15% was due to equity market falls and 20-25% down to the other factors discussed above.

What opportunities and risks are there in investing today?

Convertible bonds are currently **very cheap and boast attractive technical characteristics**. They offer an average bond yield of almost 10%, for a delta of 20% on investment grade issues and generally have short-dated maturities of 2.5 years. For an historically low entry price, they allow investors to benefit from the potentially large rebound in equity markets with much less volatility. Convertible bonds should also benefit from high short term equity volatility which enhances the value of the integrated option. Although I cannot rule out the risk of a second liquidity crisis, it is not the most probable scenario: on the one hand, hedge funds now own less of the pool and have radically reduced leverage, and on the other, investor demand for the asset class has risen especially on valuation grounds. Liquidity on the convertible bond market was very low last autumn but has now almost returned to pre-crisis levels and is similar to the corporate bond market.

Can we expect to see a recovery on the primary market in 2009?

The primary market has been lacklustre over the last few months but **the conditions are now right for new issues**: credit spreads are high and companies are confronted with large financing requirements as can be seen in the record levels of new issues on the corporate market since the beginning of 2009. However, equity valuations are currently very depressed and could prove a deterrent: companies could think twice before diluting their capital at such low levels.

What is your investment policy today?

Lack of visibility on equity markets means we have to be very flexible and mobile in our investment choices. Markets in any case should remain very volatile. As a result, **the fund is structured with rather a low average delta of 25 which is achieved by overweighting three sectors in particular: telecoms, pharmaceuticals and oil refining**. These sector options match the convictions of our European equity managers. Within these sectors, we focus on investment grade issues that have ratings between AAA and AA. The portfolio has an average A rating, a short average maturity in line with the pool i.e. 2.5 years and a yield to maturity of 9 %. Investment grade issues represent 80% of its holdings.

[1] The ability of a convertible bond to participate more in periods when equity markets rise than periods when they fall
[2] Measures the exposure of the convertible bond to the performance of the underlying equity.

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What is your geographical preference currently?

We have a clear preference for Europe over other zones which are confronted with structural difficulties at the moment. The North American pool is over-exposed to the financial, property and auto sectors; in Asia, convertible bonds which have high reimbursement premiums if not converted are problematic as the probability they will be converted is low, and in Japan the equity sensitivity has disappeared.

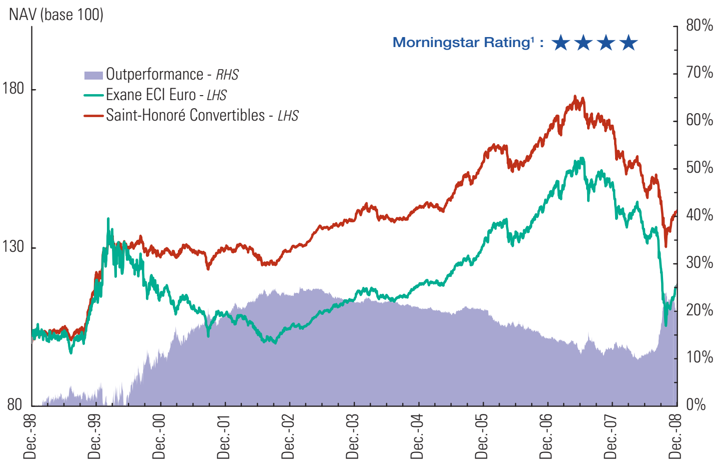
What convertible bond allocation would you recommend for a balanced investment?

Convertibles are an essential part of asset allocation whatever the market context. Their convexity effectively allows them to enhance portfolio efficiency. I believe a 10% allocation is optimal and I would currently be in favour of substantially overweighting the asset class given the valuation levels reached.

Saint-Honoré Convertibles : ★★★★

(MORNINGSTAR™ rating)[1]

- ✓ Active management that is independent of benchmark indices,
- ✓ A defensive approach typified by a selection of investment grade issues with better liquidity and mixed characteristics,
- ✓ An objective of sustained regular performance,
- ✓ Considerable experience with a track record of more than 15 years.



Source: EdRAM at 31.12.08

Performance refers to the Sicav Saint-Honoré Convertibles which was transformed into a FCP on 21/07/2005.

Characteristics

Inception date	13/12/93
ISIN Code 'A' share	FR0010204552
ISIN Code 'I' share	FR0010614586
Initial NAV 'A' share	EUR 152.44
Minimum initial subscription	'A' Share: 1 share - 'I' Share: EUR 1,000,000
Management fees	'A' Share: 1.20% net - 'I' Share: 0.80% net
Subscription fees	3% maximum negotiable
Redemption fees	None
Pricing	Daily
Subscription/redemption conditions	Each morning before 11am with execution at the next net asset value following receipt of the request.
Recommended investment horizon	2 years minimum

Potential investment risks

The fund's investment style depends on anticipating future trends on convertible bond markets. The fund's performance will depend on the issues chosen by the asset management company. As a result, there is a risk that the asset management company might not choose the best-performing issues. As the FCP does not have any guarantee or protection, the capital initially invested might not be restituted in full. Any investment in convertible bonds involves a risk associated with trends on interest rates and credit and equity markets. The valuation of convertible bonds is particularly influenced by the credit ratings of their issuers. As a result, the capital value of bonds fluctuates according to the market's perception of the financial health of their issuers. In order to protect the portfolio, at least 80% of its assets will be invested in investment grade issues or equivalent and exchange rate risk will be capped at 20%. Movements on equity markets can cause significant variations in the fund's net asset value. The FCP's equity market exposure may vary between 10-60% of its assets.