

Still more to play for in US high yield

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Harley joined Fidelity's US affiliate company in 1996 as a high yield analyst. He has been managing US High Yield portfolios since August 2000. In addition to managing FF US High Yield Fund, he is responsible for various funds focused on high yield bonds, leveraged loans and preferred stocks.

He holds a BSc in Business from Syracuse University and an MBA from Wharton School of Business at the University of Pennsylvania.

It's been a turbulent few years for investors in US high yield. 2008 saw the worst annual return on record, but, no sooner was that out of the way than 2009 posted its best return to date – a mighty 58%. With the economic environment continuing to show signs of improvement, can the asset class sustain the pace in 2010? Harley Lank shares his thoughts.

AFTER SUCH A STRONG RETURN IN 2009, DO YOU THINK THERE IS MORE UPSIDE IN US HIGH YIELD?

I think we are still in the early-to-middle innings of a period of strong performance from US high yield. I don't think we will see a repeat of the near-60% total return we saw last year, but I do think there are several years of positive returns ahead. Historically, high yield has delivered multi-year positive returns coming out of a downturn and I don't see it being any different this time.

Investors often ask how sustainable the rally can be when the trailing default rate is close to 14%. I would argue that the default rate is a lagging indicator. You only have to look at the very strong performance in 2009, when defaults were on the rise, to get an understanding for how the market is looking through this and thinking about the bigger picture.

I think a better leading indicator is the distress ratio – the proportion of the high yield market that is trading with a spread of ten percentage points or more over Treasuries. That has dramatically declined over the past twelve months as liquidity has improved. I think that trend will continue and will eventually feed through into a decline in the default rate.

Right now, spreads are about ten basis points wide of the long-term average, more if you exclude the extremes of the past couple of years and look at a pre-crisis average. My base case sees spreads continue to narrow to that pre-crisis level of around 500 basis points (from around 550 today). If that happens, and we add in the 8.5% average coupon that's now available, I think we could see US high yield deliver a cumulative total return of around 20% over the next couple of years. That's my base case. But remember that there are times when spreads have come in below the long-term average. If that happens, we might even see a higher return.

Factor in that bonds are trading, on average, around 95 cents on the dollar, when they have historically traded at a premium to par, and there should be some additional upside from here.

WHAT RISKS COULD PREVENT THAT OUTCOME FROM OCCURRING?

The biggest risk to high yield not performing would be a double-dip recession. This is a risk asset class which is prone to underperforming in poor economic environments. However, I think we'll see a period of slow economic improvement. Not a v-shaped recovery, but something steadier and more measured. The fundamental research we're doing tells us that most companies don't expect things to get worse. Most companies have improved their outlooks and are talking about things getting better.

We've seen a lot of new issuance this year and that's also led to some concerns that the market won't be able to digest this if the pace continues. However, most of the new paper is being used to pay down existing debt. That improves the liquidity position of companies and tends to be looked upon favourably by credit markets.

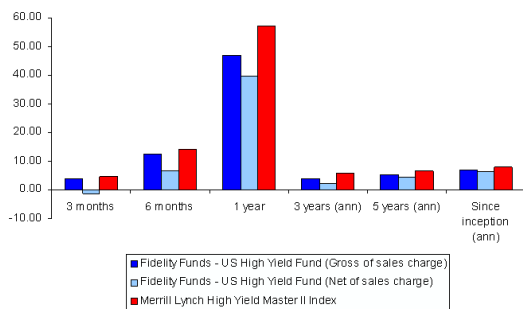
HOW DOES THAT BASE CASE TRANSLATE INTO THE FUND POSITIONING TODAY?

Turnover in the fund is relatively low so investors shouldn't expect to see any dramatic changes to the portfolio unless there are dramatic changes taking place in the marketplace. If something is fundamentally changing with one of the big issuers or valuations move dramatically, then you are more likely to see me move the portfolio in a noticeable way.

Right now, I'm overweight CCC-rated bonds. I think that's the right thing to do at this point in the credit cycle. Historically, B and CCC credits outperform in an improving part of the credit cycle. But I have to say that I don't think the market is doing a good job of differentiating between risky

FUND RETURNS (%)

as at 28.02.10



Source: Fidelity International. NAV-NAV, gross income reinvested in USD
 Benchmark: Merrill Lynch High Yield Master II Index
 Inception date: 05.09.2001 (Annualised returns)
 Past performance is not indicative of future performance.

TOP TEN HOLDINGS (%)

as at 31.01.10

HCA 9.25% 15.11.16	1.1
Intelsat Jackson Holdings 11.25% 15.06.17	1.0
TXU Energy 10.875% 01.11.17	1.0
Servicemaster 10.75% 15.07.15	0.9
Digicel Group 8.875% 15.01.15	0.9
Rite Aid 7.5% 01.03.17	0.9
Freescale Semiconductor 9.125% 15.12.14	0.9
Sprint Capital 6.9% 01.05.19	0.9
Calpine Construction Fin 01.06.16	0.8
Ford Motor Credit 7.5% 01.08.12	0.7

Source: Fidelity

Benchmark: BofA ML US High Yield Constrained Index

References to securities are for illustrative purposes and does not construe as a recommendation to transact in them.

"I expect to see more upgrades than downgrades over the next twelve months because we are in an improving part of the credit cycle and companies are taking steps to improve their fundamental position."

Harley Lank, Portfolio Manager

credits that can improve in a slowly improving economic environment and those that need a v-shaped recovery to make their story work. Take health care as a good example. I'm overweight health care because it's not economically sensitive and the fundamentals look good in a steadily improving environment. I could get a similar coupon from a house builder but the market is already pricing in a dramatic improvement to the housing market that I'm just not sure is going to materialise in the right time frame. I'd rather clip my coupon from the health care company.

IS THAT WHY THE FUND HAS RECENTLY UNDERPERFORMED RELATIVE TO THE INDEX?

We are not alone; few of our peers have managed to beat the index over the last year. In part, that can be explained by the sudden snap back in the market. In early 2009, there was a rash of downgrades to a number of financial institutions that saw them move into the high yield universe. Given how quickly these previously investment grade-rated companies were downgraded, we simply didn't have time to react before they rebounded dramatically, so we missed that upswing.

It was a similar situation with a lot of smaller issuers. Some of these issues (that were maybe just 15 basis points of the index) fell up to 80% but then snapped back sharply. These small issues are ones we normally wouldn't consider, given concerns with illiquidity, and this was even more evident in the early days of 2009 when it was still a challenging trading environment for even the largest, most actively traded issues. The cumulative effect of so many of these issues coming back at the same time hurt the fund's performance relative to the index over the one-year period.

However, the biggest detractor to our performance over the last year was cash. The fund has almost tripled in size over the last twelve months and the downside of that is, despite doing a good job in putting funds to work in a rising market, we've nevertheless had an average cash balance of around 6%. Against a benchmark with no cash, we've been at an obvious disadvantage. So, while I'm obviously disappointed with the fund's one-year returns relative to the index, I am pleased that the fund's long-term performance record is still top quartile.

WHY IS FIDELITY WELL-PLACED TO MANAGE US HIGH YIELD?

Every day I meet with a CEO, CFO or other senior manager from one of the companies I own or from a competitor, supplier or customer of one of my companies. So, every day, I get a new incremental data point on a company or industry in which I invest. That's hard to replicate.

Last year, our Boston office hosted thousands of company visits. More were held in our overseas offices and, on top of that, we went out on trips to see companies on their home turf. As well as our own analysis, the high yield team in Boston sees the research from our investment grade and equity analysts around the world. That's an amazing resource to have at our fingertips.

We also have five dedicated high yield traders. Remember that this is an over-the-counter asset class. On a good day, a liquid name may trade with a bid-ask spread of 50 basis points. In more trying times, a less liquid name might trade with a spread of up to 5 percentage points. Not getting best execution over time can be a serious drag on performance. I know our traders can get me the lowest ask and the highest bid. The end result? The good long-term performance that you've seen from this fund.



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