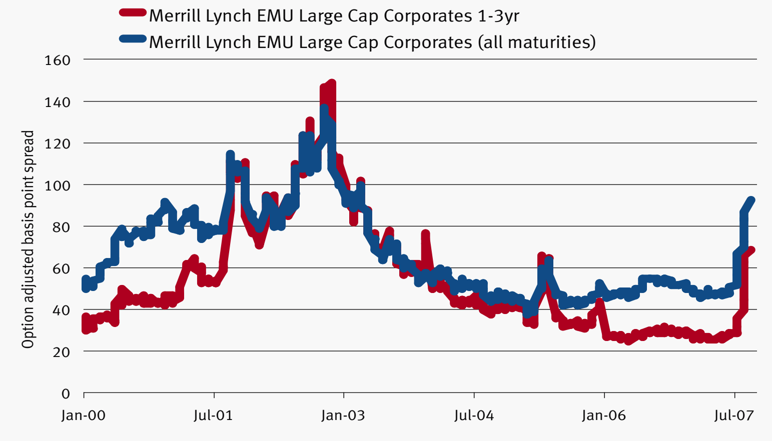
MANAGER OF MANAGER STRATEGIES

Low-risk opportunities in short-dated, high-grade corporate bonds

Short-dated, high-grade bonds are a good investment opportunity created by indiscriminate selling across the credit markets. Marco Pirondini, global chief investment officer at Pioneer Investments, explains why investors seeking a low-risk option which can out-perform cash should look in their direction

Indiscriminate selling across credit markets has created selective investment opportunities. We believe short-dated, high-grade bonds are a good example of this. Investors seeking a low-risk source of out-performance relative to cash and government bonds should consider investing in short-dated, high-quality credit to take advantage of the current price anomaly.

Figure one: EMU Credit Spreads



LOW-RISK OPPORTUNITY TO OUTPERFORM CASH

US subprime lending concerns have triggered a sell-off in mortgage-backed security markets which subsequently spilled over to structured credit products, asset-backed securities, commercial paper, corporate bonds and equities. This bout of investor "risk aversion" occurred despite little change in economic fundamentals. While tightening of liquidity conditions is likely to extract some penalty on global economic growth, we expect central bank liquidity injections and potential interest rate cuts by the Federal Reserve are likely to restore calm and help to offset the market's tightening of financial conditions. We also believe the third quarter reporting season is likely to provide important visibility for investors, particularly within financials, and may prove to be the catalyst for normalisation in markets.

The market turmoil has driven sharp spread widening in short-dated, high-quality corporate bonds. This is one of the safest areas of the market and presents a low-risk investment opportunity for those investors seeking to outperform cash. Indeed, at current spread levels, European short-dated, investment-grade credit is yielding 68 basis points above government/risk-free rates[1]. With defaults exceptionally low, this handsomely compensates an investor for the small additional risk.

Furthermore, the summer turmoil has driven spread widening in the safest areas of the market: short-dated, high-quality corporates: 40bp of widening in the EMU short-dated space versus

Key portfolio features, PioneerFunds – Euro Treasury

- Actively managed, short-dated corporate bond portfolio
- Focus on a diversified, core portfolio of high quality corporate issuers
- Investment approach is driven by bottom-up credit selection incorporating both quantitative and fundamental analysis, but with additional top-down strategic assessment
- Flexibility to invest in credit derivatives such as credit default swaps to generate additional alpha and improve portfolio efficiency
- Can take selective off-benchmark exposure in asset backed securities, high yield and emerging markets to enhance carry and add alpha
- Performance drivers include individual security selection, as well as sector and rating allocation and duration management
- Aims to deliver repeatable excess returns in a risk controlled environment

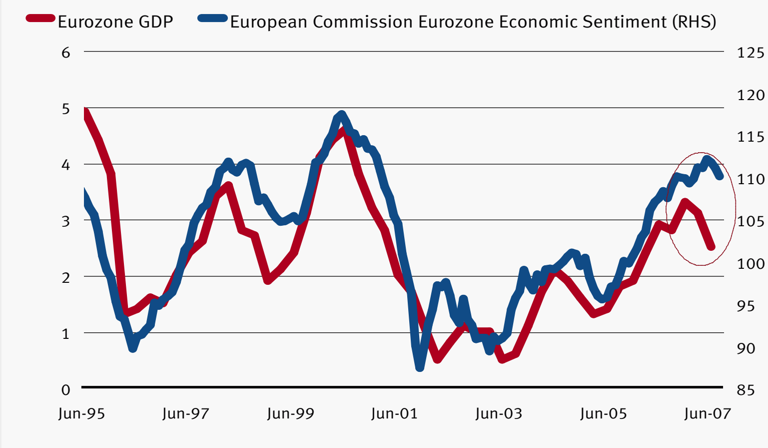
42bp in the broader corporate market (see figure one).

STRONG INVESTMENT CASE FOR SHORT-DATED CREDIT

Our favourable outlook for European short-dated credit is based on five factors:

- **European economic fundamentals are sound:** The latest business and consumer surveys suggest that, while slowing, the European economy retains good momentum. Indeed, we forecast Eurozone economic growth to remain above trend in the 12 months to June 2008, targeting growth of 2.2 per cent. We also do not expect a derailment of US growth and expect that potential Fed interest rate cuts are likely to help offset the tightening of financial conditions by markets.
- **Corporate fundamentals remain healthy:** Leverage is low, profitability is good and free cash flow is high. These are consistent themes our fundamental equity and credit analysts continue to identify in European companies.
- **Default rates are low:** Corporate default rates in Europe are low and below historic averages. Furthermore, the strong economy coupled with healthy corporate balance sheets and relatively low financing costs is likely to keep defaults low.
- **Investors have reduced credit exposure and the market is now more balanced:** The investment community scaled back exposure to credit amid the market turmoil and we have seen unwinding of positions by hedge funds and other leveraged investors. This is positive for the long-term health of markets and provides an opportune re-entry point for investing in short-dated corporate bonds.
- **Short-dated credits typically offer good value, outperforming government bonds:** Our analysis shows that investment-grade credits have historically outperformed government bonds in the US and Europe. The historic outperformance has been most compelling at the short end of the credit curve. For example, since 1986 one to three-year corporate bonds have outperformed government bonds by an annualised 19 basis points[2]. This compares to the current yield on European one to three-year corporates of 4.58 per cent, which is 68 basis points above the equivalent maturity government yield[3]. For investors looking to outperform a traditional cash return, we believe this spread, driven wide by the recent dislocation of corporate bond prices, represents a good investment opportunity at low risk.

Figure two: Sound economic fundamentals in Europe



PIONEER FUNDS – EURO TREASURY

Pioneer Funds – Euro Treasury offers investors the opportunity to enter the short end of European corporate bond investment space. Spread widening in this area of the credit curve has held back portfolio returns in recent months. But were spreads to stay at current levels, or narrow, returns in this investment space will be attractive relative to cash. Indeed, European one to three-year corporate bonds are currently yielding 4.58 per cent, or 68 basis points above equivalent government maturities[4]. In terms of risk, the high quality of the issues and short duration put the portfolio in a very defensive position.

1. Merrill Lynch Euro Corporate Large Cap 1-3 year Bond Index (07.09.2007)
(2) Merrill Lynch Bond Indices (10.09.2007)
2. Pioneer Investments research, using Lehman Brothers bond indices (December 2006)
3. Merrill Lynch Euro Corporate Large Cap 1-3 year Bond Index (07.09.2007)
4. Merrill Lynch Euro Corporate Large Cap 1-3 year Bond Index (07.09.2007)