

Artemis High Income Fund Investment Review - 7th August 2007

Introduction

We welcome new unitholders and for those who would want to know more about the way in which the Fund is managed, this is set out in detail in the 2004 annual report (a copy of which is available via our website: www.artemisonline.co.uk, or from our client services team on 0800 092 2051). A précis of this document is that we look to gain as high a yield as possible from bonds, shares and convertibles, where we are comfortable that the state of the industry and company enables interest / dividends to be paid and in the case of bonds, the loan repaid.

Performance

The Fund returned 6.1%* for the year, in other words only a little more than the interest and dividends received. The return was nicely above government bonds which returned 1.0%* and better than the sector average of 1.4%*. As past readers know, we never tire of reminding investors that over the long term the Fund return should exceed that of government bonds as we are investing in higher yields which are only available because the assets themselves are riskier than government bonds. The Fund was ranked number one in its peer group. However, before planning any ticker tape parade, it should be noted that the return at the interim stage was 7% and so notwithstanding income received, the capital value of the Fund declined over the second half of the year. The income performance improved, rising by 8.1% over the year. This was due to the high yields available as interest rates rose and, to a lesser extent, better organisation on our part!

It is probably of most use to investors if we set out our report as a series of questions, although to some degree the answers are similar to the statements made in our interim report.

1. Why did the Fund have a difficult second half of the year?

Interest rates in most economies rose in response to strong economic growth and signs of a resurgence in inflation. The Fund is largely invested in high yielding bonds and when the yield on cash and government bonds rises, investors quite rightly are more attracted to these less risky assets, at the expense of higher yielding bonds. In addition, at the very end of the period we began to see the impact of the “credit crunch” and investors seeking safer assets

as a result. The credit crunch stems from the rise in interest rates hurting those who, during the prolonged period of low interest rates, have taken too much debt to go about their business.

Ordinarily the financial community adopts a rather matronly attitude to the high levels of consumer debt in the UK, but at the same time it has been using vast amounts of borrowing to boost its own returns. But we shouldn't worry because this debt, unlike that of the consumer, is in the hands of professionals. Well, interest rates have risen steeply from very low levels but they are not very high relative to history and yet the higher cost of borrowing has begun to hurt many of these professional participants. I almost used the word ‘investors’ there but in truth many of these players are just that – some would call them speculators. They are attempting to magnify returns by investing multiples of the capital they are given. For example, for every £10,000 received for investment in this Fund we generally invest £10,000. Strange, old fashioned but true. Many of today's hedge funds have found banks willing to lend them £50,000 against the £10,000 investment thus enabling them to invest £60,000!

Hedge funds, private equity and various other entities have been living in a hall of mirrors, or more precisely, in the section where everything looks bigger! If you take a very modest return but borrow and then invest five times the money then in benign conditions this “modest return” becomes a magnificent return. These entities are now entering the section of the hall of mirrors where everything looks a lot smaller. Many intelligent parties have participated in this period of excess lending and excess borrowing and it is now unwinding. Banks are having second thoughts about the wisdom of lending to these funds and some investors, sorry speculators, want their money back.

2. What has our strategy been?

It is an interesting period for the Fund because as we said in our interim report we expected a period of negative return. Why? Because unlike equity funds the upside in bonds is confined to the interest you receive on the bond and the repayment of the loan. Against that background bonds were fairly valued and therefore vulnerable to any deterioration in the market environment. Given this view we have held lots of cash and gilts - not a natural thing for us to do. We estimate that at the peak of our

“defensiveness” in July cash, gilts and floating rate notes accounted for about 25% of our assets. In addition, we have kept exposure to private equity related bonds low (less than 10% of assets) and remain selective in our companies and industries. (In making selections many bond investors ask whether a bond is cheap relative to that of a bond of similar standing, where “similar standing” is the credit rating prescribed by an agency whose expertise is to rate or grade bonds. The problem here is that the bonds compared are issued by different companies and may even be in different industries. We look at a bond versus the risk return. If it is good value then we ask whether we think the entity can pay the interest and give the money back at the end of the loan?).

Maintaining this cautious stance has been a bit of a challenge because as a result of the extensive use of debt to magnify returns we have been presented with many of the most eye-watering yield opportunities imaginable – opportunities that on paper would have significantly boosted our distributions to unitholders but in the current environment would have led to a significant capital loss. The employment of debt to enhance returns made us uncomfortable and in the main we resisted such opportunities. We have not been perfect and lost 0.3% of our net asset value in Caliber, a leveraged bond operator. Some of this, however, was included in last year's performance and has served as a sharp reminder to be aware of leveraged operators bearing attractive yields.

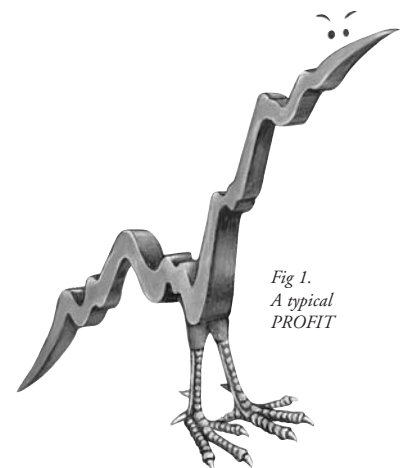


Fig 1.
A typical
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Outlook

We are finding our markets attractive for the first time in a while. That is because in this turbulence perfectly sensible companies with good long term businesses have bonds which have fallen to levels where they are attractive versus returns on cash and government bonds. Hence we have started to invest our cash and sell down holdings of gilts which look fully valued. We do not regard inflation as a major risk. We think interest rates will stay at current levels for some time as central banks want to wash out the financial excesses from the system. We do not think the speculators will be bailed out and handed another seaworthy vessel in which they can sail. In summary we are more optimistic about the assets in which we invest and will spend the next few months rebuilding the exposure to higher yielding bonds and reducing our holdings in government bonds.

Adrian Frost & Adrian Gosden Fund Managers

*Source: Lipper Limited, bid to bid basis with net income reinvested to 7th August 2007.

Risk Warning

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