Walking on a tightrope

The last year has seen a very disparate performance between different sectors of the bond universe. High yield bonds have done very well whilst government bonds and many investment grade bonds have struggled. This has been driven by rising interest rates undermining the government bond markets. Meanwhile, sustained strong economic growth is keeping default rates low, helping the high yield market to perform well. The next year may well see a dramatic shift in fortunes.

The prospects for bonds do look challenging and certain sectors look expensive. The high yield market, for instance now looks comparatively dear. However, it is not all doom and gloom and plenty of opportunities do still exist in the bond universe. Furthermore, the rise in yields in government bonds may well soon approach levels where some of them start to offer some genuine value.

There are a number of pitfalls potentially on the horizon for bond investors. In particular, if interest rates rise more than current expectations. Growth numbers have been better than originally forecast but more worrying, inflation seems to be gaining traction in some economies – for instance in the UK, where inflationary expectations are increasing. The danger is if we see greater pay awards by employers; a bout of wage inflation would lead the Bank of England to respond with higher interest rates.

The European Central Bank has clearly signalled further rate increases and will only pause when yields reach 4%. The US has tightened policy quite aggressively

Fund Manager
James Foster

over the last couple of years but there is a chance the Federal Reserve may have to push them a little higher.

With this background government markets may well remain under pressure in the short term. However, once interest rates reach a peak this is a good buying opportunity and the subsequent bond rally would be significant. Interest rates have not yet hit that level, but it is possible this could be attained during the first half of this year.

Investment grade bonds are struggling from the increased Private Equity activity and the rising interest rate environment. They tend to be very closely correlated with government bonds. However, with Private Equity in the wings, the downside is potentially catastrophic if you are caught in a bond which is subsequently taken over. The yield rises to reflect the normally high yield nature of the acquiring Private Equity company. To avoid this scenario, the bonds need appropriate covenants to give you protection. In this current environment of high merger and acquisition activity, owning the well covenanted stocks is a good strategy.

Fundamentals in the high yield market still remain very good with company profitability generally improving. Technicals have also been strong, with demand outstripping supply as the hunt for yield continues. These factors have led to many areas of the market being overbought. In these circumstances of risk being underpriced, stock selection remains paramount. It is important to focus on senior secured bonds or bonds benefiting from positive event risk (or preferably both). For example, in the last year we have seen some consolidation in the

Telco industry and Invitel bonds benefited from being taken over by a higher rated entity.

The Artemis Strategic Bond Fund is designed to take advantage of these circumstances. The Fund is able to invest in all areas of the bond universe, both high yield and investment grade to maximise returns. In the last year the average investment grade corporate bond fund has fallen in value by 1.2%* whilst the Artemis Strategic Bond Fund has gone up by 5.7%*. This outperformance has been due to the broad remit and flexible nature of the Fund. We consider that the next 12 months may well be difficult for bond investors and the nimble approach is crucial to maintain good returns.

* Source Trustnet™ 1 year to 12/02/07

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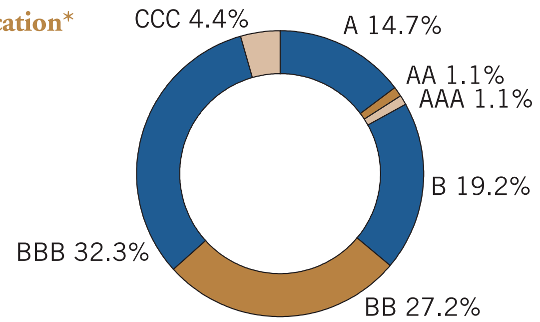
Asset Allocation*



Source: Internal as at 31st January 2007. * Without cash.

Top Ten Holdings*	% Fund
GMAC LLC 6.375% 2007-12-07	2.3
Barclays plc 03/49	2.1
Reed 5.625% 2016	2.0
Dubai Holdings 6% 2017	2.0
Beazley 7.25% 2026	1.9
Slough Estates 5.625% 2020	1.8
Rentokil Initial 5.75% 2016-03-31	1.8
FirstGroup plc 6.125% 2019	1.7
Cable & Wireless 8.625% 2019	1.7
Bombardier	1.7

Source: Internal as at 31st January 2007. * Without cash.

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