

Quarterly Portfolio Update

Pioneer Funds – Euro High Yield

30 December 2011

Bond

Review

Pioneer Funds – Euro High Yield (Class A, non-distributing, EUR units) was up by 4.1% over the quarter, behind its benchmark, the BofA ML Euro High Yield Constrained Index, which returned 4.22%.

Eurozone Growth Anaemic in Q3 – But German Business Confidence Improves in November

The eurozone economy maintained anaemic growth of 0.2% (q-o-q) in the third quarter, the same as Q2, although most of the growth was due to France (0.4%) and Germany (0.5%), with both countries improving on the previous quarter. Forward-looking indicators have been pointing to lower growth and there is a reasonable chance of a contraction in the fourth quarter. The EU has severely cut its growth expectations for the eurozone in 2012 to 0.5% from 1.8%, while the European Central Bank (ECB) unexpectedly cut interest rates by 25 bps to 1.25%, with Mario Draghi predicting a mild recession. However, German Business Confidence unexpectedly rose in November for the first time in five months, with the Ifo Business Climate Index rising from 106.4 to 106.6 (107.2 in December), compared to economists' expectations of a fall to 105.2 (Bloomberg survey). Many analysts are now predicting a eurozone recession starting in Q4, but it is possible that growth could bounce back from anaemic to moderate in a hurry if confidence returns – everything rests on a credible solution to the debt problems that can be played out over the next few years. Investors are running out of patience with policymakers, which is aggravating the situation. While we do not believe that a recession is inevitable, it is looking increasingly likely.

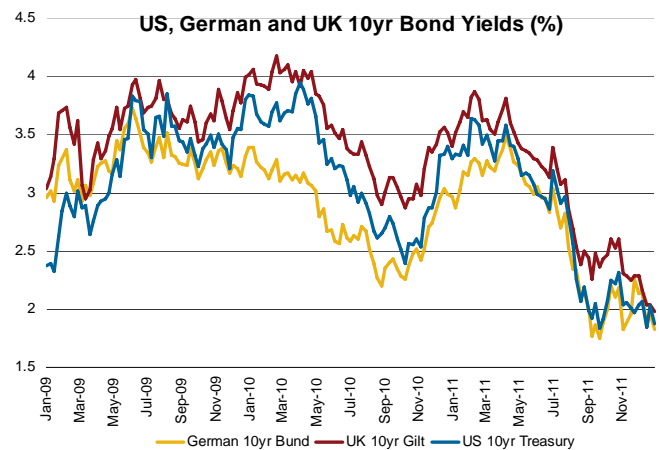
Yields Hit Euro-era Records in Italy, Spain and Portugal

Yields on government debt from the GIIPS countries spiked to record levels in the fourth quarter. Italian generic 10-year yields spiked from 5.5% at the start of the quarter to a high of 7.24% on 25 November; they subsequently fell back below 5.9% in early December on ECB buying but ended the year at 7.03%. Portuguese bond yields increased by 243 bps during the quarter (10.93% to 13.36%), hitting a high of 14% at the end of November. Spanish yields actually fell slightly during the period (5.13% to 5.09%) but also hit a record of 6.7% on 25 November, although the

government had to pay 6.98% on a new auction of 10-year paper.

US, German and UK Government Bond Yields Fall

Yields on US and German yields fell slightly (4-6 bps) over the period due to their safe-haven status, although UK Gilts rallied more sharply, with yields falling by 45 bps to end the year at 1.98%, only slightly above Germany and the US. However, there was a brief divergence between Bunds and Treasuries in late November, with Bunds moving more in line with riskier paper as a German auction of 10-year paper was short of bids, with the weakest demand since 1998.



Source: Bloomberg, weekly data, 2 January 2009 – 30 December 2011

UK: Third Quarter GDP Better than Expected

Following sluggish 0.1% growth in Q2, UK GDP came in at a higher-than-expected 0.5% (q-o-q) in the third quarter, following the pattern in France and Germany.

CDS Insurance Costs Hit Highs

Most countries such as Italy, Spain, Turkey, Russia, France, Germany and the UK saw CDS costs reach new highs in this cycle. Ireland and Portugal are still down from the mid-July peaks. Over the quarter, insurance costs fell in Portugal, Germany, Turkey and, particularly, Russia, which has seen strong macro data in recent months. France saw the biggest increase in CDS costs.

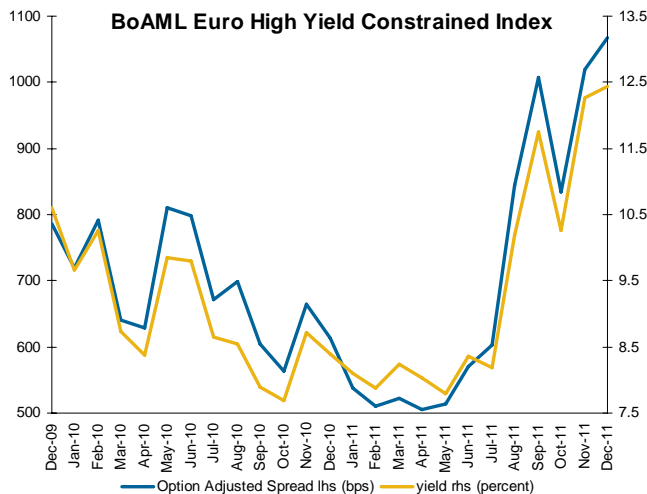
CDS Prices (bps)

	End Sep	Q4 Peak	End Dec
Italy	470	570	503
Spain	382	491	393
Portugal	1110	1123	1092
Ireland	700	781	726
Turkey	294	321	287
Russia	309	338	275
Germany	112	119	103
France	187	250	222
UK	94	105	98

Source: Bloomberg

High-Yield: Spreads Hit New Highs in this Cycle

Spreads on the BofA ML Euro High Yield Constrained Index rose from 1007 bps to 1068 bps over the quarter. Spreads and yield (12.43%) ended the quarter at the widest/highest levels since August 2009. Euro high yield also substantially underperformed US high yield, ending the year 342 bps wider.



Source: Bloomberg, monthly data, 31 December 2009 – 30 December 2011

As spreads have widened considerably over recent months, spread-implied default rates have also increased. For euro high yield, the implied default rate over five years, assuming a 30% recovery, is now 53.4%; even taking the most conservative assumption of 0% recovery implies a default rate of 41.4%. This means that spreads are pricing in default rates much worse than has ever happened in the asset class, including the credit crunch in 2008/2009.

Five-Year Default Rates

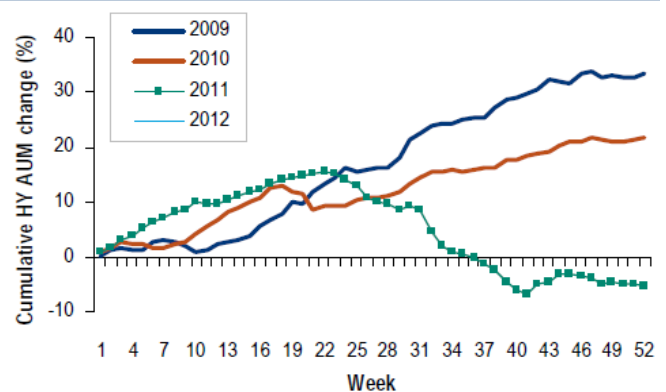
	Spread Implied:		Actual:		
	Five-Year Spread	30% Recovery	Zero Recovery	worst	average
USD High Yield	726	40.5%	30.4%	31.0%	19.3%
Euro High Yield	1068	53.4%	41.4%	31.0%	19.3%
iTraxx CDS Main	174	11.7%	8.3%	2.4%	0.9%
iTraxx CDS Xover	754	41.6%	31.4%	31.0%	19.3%

Sources: Bloomberg, Pioneer Investments and Merrill Lynch, 30 December 2011

Technical Poor Again in November and December

Euro high yield was a very popular option for investors during the first half 2011, helping it to perform well throughout the second quarter despite the rise in sovereign spreads. The technical backdrop has since changed dramatically, with big outflows from investors and new bond issuance significantly lower following a record first five months of the year. Money started flowing back into the asset class in the latter half of October, but turned negative again through November and December.

Chart 5: Cumulative AUM increase/decrease (HY)

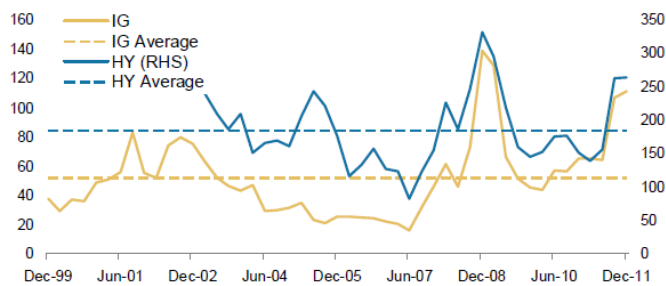


Sources: BoAML Credit Strategy, 6 January 2012

Fundamentals: Valuations Attractive Despite Rising Defaults

At current levels, euro high yield looks to offer very good value for the medium- or long-term investor. The need for yield will drive investors back into high yield at some point: euro-denominated paper looks particularly appealing against other fixed-income options, including governments, investment grade and US high yield. High-yield companies have continued to deleverage over the past year, with strong earnings growth allowing a build-up of cash reserves. The following chart looks at spreads divided by leverage in January 2012: it shows that value is better than at any time in the last decade bar a brief period following the collapse of Lehman Brothers.

Spread per Leverage Are Well Above their Long-Run Averages

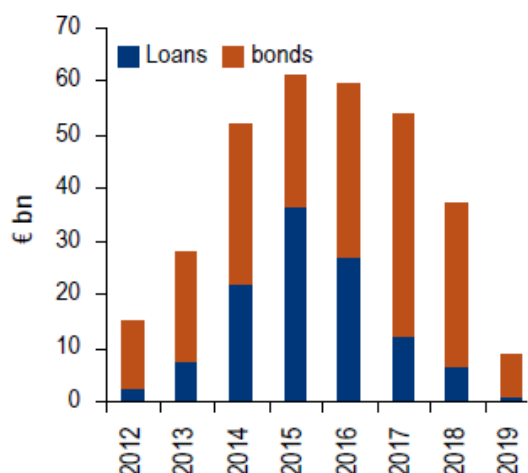


Sources: Morgan Stanley European Credit Strategy, 6 January 2012

Fundamentals for the asset class have deteriorated recently, with default rates edging higher for three consecutive months. However, the 12-month default rate was still only 2.6% in October, up from July’s trough of 1.05%. Defaults may rise next year, although the outcome will be dependant on what happens in the European macro environment. JP Morgan is predicting a 2012 default rate of just 2% under its base-case mild-recession scenario, but 6% if growth deteriorates to a 2008/9 recession level. Bank of America Merrill Lynch is more pessimistic, forecasting 6%. Even this level seems well compensated for by current prices and is considerably lower than in 2008/9. We believe that around 70% of defaults will take place in the loan market, given the superior maturity profile of the bond market.

Refinancing risk in high yield will be higher in 2012 than last year but it looks manageable. The maturity wall has been pushed out due to strong issuance over the past couple of years, with the peak not occurring in the bond market until 2017.

Refinancing requirements



Sources: BoAML Credit Strategy, 1 December 2011

Performance Analysis

On a strategy perspective, the underperformance was primarily caused by Currency (GBP and US\$) and Macro Hedges (CDS protection on Italy and France), with small negatives from Equity (our residual position in media company INM) and Emerging Markets. We performed very well in High-Yield Spreads (active benchmark exposure and non-benchmark high-yield names) and, to a lesser extent, Leveraged Loans. On a sector basis, the main negatives were Industrials and Insurance. Conversely, we added value in Financial Services/Banks, TMT and Consumer Goods & Services.

Portfolio Strategy

Our investment style is flexible within the European High-Yield arena. We use hedging and derivatives (swaps and futures) for managing market beta, curve and duration. Corporate spread duration is the critical aspect for generating alpha in this asset class. One key theme in the Portfolio is European issuers with significant emerging-market exposure, given their superior growth prospects. We ended the year with around 94% of NAV in Bonds, 1% in Equity, 1% Cash and 4.5% in Leveraged Loans, plus protection policies on the iTraxx Crossover (-6.3%) and country CDS (-5.7% on France and -2.8% on Italy).

On a sector level, our main overweights are TMT and Consumer Services & Goods, with a strategic allocation to off-benchmark Leveraged Loans. Conversely, we are significantly underweight Financial Services/Banks, with smaller underweights in Industrials, Autos and Utilities. We have been defensive and continue to be more selective in a competitive market as we seek to preserve and enhance the quality of the Portfolio, and ensure that we maintain good liquidity.

October Activity

Following the sell-off in September, we removed our protection strategies on the iTraxx Crossover, the UK, Italy and France as the market was looking too cheap given its fundamental attractions. Liquidity improved in October but was still lower than normal. The main theme on the bond side was to reduce our underweight in Industrials. French building-materials company Lafarge was a “fallen angel” (lost its investment-grade rating) that joined the high-yield index with a 3% weight, thus boosting the benchmark weight of Industrials. We added a small position in Lafarge, along with Heidelberg Cement (Germany), Sappi (South African paper products), Fiat (Italian car company) and Santos (Australian oil E&P). All

activity was in the secondary market. We also added to our holding in Nordenia (German flexible packaging products, including closures and elasticated waists for nappies, where it is the main supplier to P&G).

November Activity

The primary market was still quiet in November, although it has picked up from the summer. We participated in new issues from Faurecia (9.375%, 5yr, senior unsecured, Ba3), a French auto-parts manufacturer, Petroleum Geo-Services (7.375%, 7yr, senior unsecured, Ba2), a Norwegian oilfield services company, and Com Hem (10.75%, 8yr, senior secured, CCC+), a Swedish mobile-telecom business. We also added to the recent new issue from Heidelberg Cement (9.5%, 7yr, senior unsecured, BB), the German cement company.

Faurecia, based in France, is the world's sixth largest auto supplier with around €15bn of sales expected this year. Peugeot Citroen is the largest shareholder in the company with 57%, and is a key client, but its business is global in nature with a range of customers including BMW, Audi, Volkswagen, Ford, Mercedes, Volvo and Geely. Faurecia has four major business lines: Emission Control (35% of sales, 26% global market share), Seating (33% of sales, 12% globally), Interior (22% of sales, 15% globally) and Exterior (10% of sales, 28% globally). The company is targeting emerging markets as a key expansion area for the bulk of its capital expenditure. Auto parts will see further industry consolidation with several structural growth drivers including CO2 emissions, fuel efficiency and safety regulations. Car manufacturers are creating global auto platforms in different markets in order to increase component sharing and to lower the costs of new products. Thanks to its global manufacturing footprint, Faurecia is able to serve these platforms locally (including R&D centres). This, in turn, allows it to take market share from regional suppliers that fail to embark on the globalisation trend and to exploit economies of scale. Faurecia's new bond looks attractive relative to other auto companies and will help improve its maturity profile. It also has one of the lowest working-capital requirements in the industry and should continue deleveraging to below 0.5x net debt/EBITDA by 2014.

December Activity

The market was very subdued with tight liquidity, meaning we did very little trading. We bought a small amount of subordinated ABN AMRO perpetual bonds with a floating rate, as a switch from Lloyds, while reducing Bakkavor and Aston Martin.

Outlook

We believe that fundamentals remain supportive for high yield, although technical factors, the uncertain short-term outlook and volatile market conditions mean that it is hard to predict short-term direction. The indiscriminate sell-off since August has created compelling value. European and, to a lesser extent, US debt issues, along with global growth concerns, are likely to remain the key drivers of sentiment for the immediate future. Therefore, high yield and sovereign markets are likely to remain highly correlated.

Spreads on high yield remain attractive on both a relative and historic perspective. There is significant scope for spread tightening when economic worries alleviate and there are signs of a solution for Europe's debt problems and the future of the euro. Corporate balance sheets are strong and companies are maintaining sensible fiscal discipline, although volatility is likely to remain high. Additionally, although high-yield default rates are rising, they should remain relatively low through 2012 (maybe 3% or 4%), which is well below the long-term average.

Given the heightened tensions in Europe around debt funding, the European Central Bank may reduce rates further in the coming months (despite the cut to a 1% low on 8 December); the US should keep rates at record lows well into 2012 and probably 2013. We believe that Europe and the US will maintain sub-par growth. While there is a realistic chance of a recession in Europe, the US looks likely to avoid a double dip and growth seemed to be improving in Q4. Continued strong (albeit moderating) growth in emerging markets will help buoy developed markets. There is also a possibility of further fiscal stimulus measures in Europe and the US in order to promote stability.

Investors are anxiously waiting for further details and clarity on the European debt plans. A credible plan for the debt situation in Europe could be the catalyst that pushes investors back into risk, with more of a focus on fundamentals and value. If systemic concerns abate, markets look cheap and could be driven higher by the wall of money that is waiting on the sidelines.

Our base case for euro-high-yield returns in 2012 is between 8% and 10%. This factors in some capital loss as the current yield is around 12.5%. Therefore, we feel this is a realistic figure in a continuation of a mixed backdrop, with risk aversion continuing through the first half and growth picking up in the second half. Some optimism on the European debt situation, albeit in a similar environment to current conditions, could see upwards of

12%. A more positive resolution to Europe's woes could see 200 bps or more of tightening, meaning returns of around 20%.

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