

Yearly Portfolio Update

Pioneer Funds – Euro Strategic Bond
31 December 2009

Bond

Review

The beginning of 2009 has been highlighted by the efforts of central banks and governments to ease the strains in the credit markets. Having cut interest rates to zero, central banks in the US and UK have resorted to unconventional measures and provided a huge pool of liquidity to credit institutions (quantitative easing) in order to keep interest rates low. In the meantime, high risk aversion and news coming from the corporate side continued to hurt the credit markets. However, from the end of March the improvement in some indicators of confidence supported a dramatic change in mood and a sharp rally began amid increasing optimism about the recovery. The signals coming from the economic side continued to be mixed, with US consumer expenditure and increasing unemployment rates in labour markets still pointing to a tentative recovery. But without inflation pressures, there was a high probability that the fiscal and monetary stimuli would remain in place and eventually support the recovery.

In the second half of the year, the combination of low government bond yields and investors' retreating risk aversion spurred demand for riskier assets. Investment-grade, high-yield and emerging-bond markets continued to gain momentum with plenty of issuance in the primary market well received.

On balance, almost the whole year, has been marked by massive spread tightening across all of the credit universe: the Merrill Lynch Eur High Yield Index was up more than 70% and the Merrill Lynch Eur Emerging Markets Sovereign and Credit Index gained 52%.

Performance Analysis

The Portfolio (Class A, non-distributing, EUR units) closed the year with a robust absolute gain of 88.35%, benefiting from the strategic positions in euro high yield and emerging markets corporate debt. Since the beginning of the year we believed that a strong mean reversion would take place in 2009: the Portfolio was rewarded by the market recovery, spurred by a low opportunity cost and a steep yield curve on both sides of the Atlantic. Our name selection in the emerging and high yield component outperformed, but also our holdings in the corporate

investment grade as well as loans proved favourable in the second half of the year.

In terms of Portfolio positioning, in the first quarter we sold some corporate bonds in order to cash in and sought to improve our risk/reward profile in the high yield and emerging area, in order to meet redemptions. We also took any opportunity to rebalance the Portfolio when liquidity improved, raising a reasonable cash cushion. In May we reduced our duration stance from five to two years, closing the long position on German 5-year futures and putting in place an arbitrage between the euro and US 10-year Treasury futures.

In the following months we continued to take profit on some high yield holdings that largely recovered their value as liquidity came back to the markets and that we deemed to offer little upside from there onwards.

In the third quarter we also reduced our holdings in the high-grade universe: even if the Financial sub-sector improved further and some subordinated issues were still trading at a discount to their pre-crisis value, we did not believe that they can entirely recover those values. We also made the decision to partially immunise the Portfolio against systematic risk, buying protection with the iTraxx Crossover Index and credit derivative swaps on a single emerging markets country, and emerging markets equity puts.

At the end of December emerging and high-yield debt accounted for 58% of the Portfolio compared to 68% at the end of June, while at the same time our investments in high-grade issuers decreased from 6% to 2%.

The Portfolio was also enhanced by the recovered value in the CDS positions that exhibited stressed out valuations during the crisis, but whose curves have now normalised with the return of liquidity to financial markets. In this regard we have seasoned the Portfolio by allowing a substantial part of our CDS positions to mature over the last 14 months without replacement. At the same time, the longer dated CDS positions have become shorter in tenor and have improved their valuations to reflect positive performances as curves have normalised.

Outlook

Looking ahead, we believe that current monetary conditions are still creating a benign environment for the credit markets. In spite of the ongoing rally since March, significant opportunities remain after the dislocation experienced in 2008. Name selection and risk profiling will be crucial in order to create value in the Portfolio. Our preferred strategy is still to build up liquidity and improve the credit quality of the Portfolio by divesting selectively the junior part of our credit exposure and reallocating those resources to the senior pieces of the capital structure in selected names. The short maturity nature of the Portfolio and the sale of some cyclical names allowed us to increase the amount of disposable cash. We will reinvest it as we see undervalued opportunities or as we perceive a solid upturn in the global economy.

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