

# Fixed Income Market Update

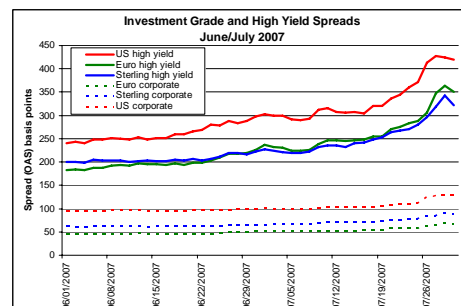
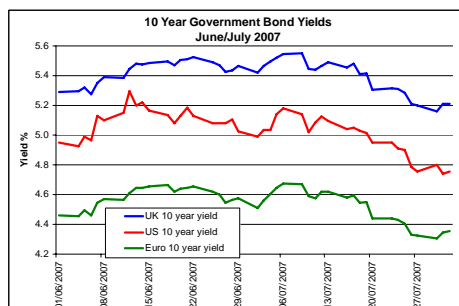
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## Summary

- In recent weeks, global bond markets have been exceptionally volatile, with extreme daily and intraday price movements. This has seen a typical 'flight-to-quality', from credit markets to government bonds.
- The main driver has been financial contagion from weakness in US sub-prime mortgage backed issues which has led to a general re-pricing of credit-related risk. Structured debt, high yield, subordinated bank debt and investment grade credit have all been impacted. However, much of this is as a result of indiscriminate selling, rather than by a proven deterioration in underlying economic fundamentals or company prospects.
- Fidelity's UK bond funds, including Fidelity MoneyBuilder Income, have been well protected from the turmoil in the US sub prime sector, as they do not currently hold sub-prime mortgage issues or Collateralised Debt Obligations (CDOs) in portfolios. This has helped them to maintain strong performance compared to peer group funds over this volatile period.

## What has happened?

After several years of remarkably low volatility and narrowing credit spreads, global bond markets have reacted spectacularly in recent weeks, posting large losses in credit-related bonds (shown by widening spreads) and major gains in government bonds (shown by falling yields).



Source: Datastream as at 02.08.07

A notable feature of recent events has been the 'contagion' as investor concerns have spread from investments with direct exposure to the US sub-prime sector to other classes of fixed income investments and even to other asset classes such as equities.

Exposure to the US sub-prime market through leveraged structured products has been widespread among the financial community, including hedge funds, bank trading desks and final investors.

Collateralised Debt Obligations (CDOs) commonly create various tranches of investment, with different levels of liquidity, credit quality and gearing and with a 'tiered' relationship such that the impact of underlying risk events should be first borne by, and hopefully limited to, the highest risk tranches. However, when defaults in the sub-prime mortgage market started to escalate and the rating agencies moved to downgrade the credit rating on CDOs, the prices of the

underlying instruments fell sufficiently to trigger losses across different tiers and tranches of CDO investments and a new risk pricing became necessary across the board. Liquidity dried up very quickly which impacted indirect holders of sub prime paper including investors in supposedly 'top quality' CDO tranches.

Hedge funds in particular became forced sellers of investments as they needed to meet liabilities within highly-g geared portfolios. Simultaneously, hedge funds found that their prime brokers were sharply increasing the refinancing rates on their credit facilities to reflect their own changed assessment of the risks. This contributed to a rapid downward spiral as sellers attempted to get out of these investments and liquidity evaporated.

Once it became obvious that events in the US sub prime mortgage market would impact a large number of financial institutions, this triggered a global 're-pricing' of credit risk. As a result, the entire credit spectrum moved to sharply higher spreads including high yield, emerging markets and even investment grade bonds. Conversely government bonds were seen as safe-haven assets and yields declined.

This caused wide-spread fear of a large scale financial crisis because of the number of players impacted in one way or another by events in the sub prime sector. Although it is incontestable that many banks are in excellent financial shape and announcing record profits, the complexity of the events unfolding in credit markets - and the fact that exposure to these risks could not easily be quantified - spooked investors and took sentiment to crisis levels. It is probably this factor, combined with the fear that credit for equity deal making would suddenly dry up and remove one of the strong recent supports for equity valuations, that caused equity markets to fall sharply at the height of the bond market spread-widening.

## Fidelity's View

The recent credit markets turmoil does not, in our view, represent any fundamental change in the economic situation. Nor does it reflect an unexpected change in economic conditions or in factors that impact credit fundamentals in the Sovereign or Corporate bond sectors. Outside the sub prime sector, the credit default rate has not unexpectedly increased and, at this point in the economic cycle, there is no reason to expect a significant rise. However, markets certainly reflect a profound change in the way investors perceive risk and how credit risks are priced.

Given the magnitude of the contagion effect in July, it has been difficult for bond fund managers to be fully immune since all categories of credit have been impacted. The only true protection was in cash and government bonds holdings.

Fidelity's UK fixed income portfolios had no direct exposure to sub-prime mortgage issues or Collateralised Debt Obligations (CDOs). Credit exposure in the portfolios has been impacted by the recent widening of credit spreads, but the relatively cautious positioning of our funds has been supportive.

Fidelity's credit research team continues to highlight that the global corporate sector has made a strong effort to contain leverage and most large corporates have managed their balance sheet and credit rating well.

Although the current credit turbulence may not be resolved rapidly, Fidelity's Fixed Income Portfolio Managers believe that investor response has so far been very indiscriminate. The current situation, though still unstable, provides opportunities to buy bonds with strong long term commitment to credit quality and cash flow generation at what could represent attractive valuations levels on a long term perspective.

## Fidelity MoneyBuilder Income Fund

Portfolio Manager Ian Spreadbury offers his views on the performance of Fidelity MoneyBuilder Income Fund.

### How has the recent market volatility affected Fidelity MoneyBuilder Income Fund?

Over the last two years we have found it increasingly harder to find attractive opportunities within the core UK corporate market due to tight valuations, particularly within the highest-rated sectors. Accordingly, we have been holding over a third of the portfolio in government bonds and AAA rated securities. We have also been investing outside of the benchmark in sectors such as floating rate notes, high quality asset-backed issues, and emerging market issues. We were also underweight banks and financials which have been hit during the recent volatility. This has benefited our fund versus the benchmark and some of our peers who were more aggressively positioned in the credit market.

### Does the Fidelity MoneyBuilder Income Fund have any exposure to the sub-prime mortgage market?

The portfolio does not hold US sub-prime mortgages. It also does not hold any CDOs or any other structured products that may contain exposure to sub-prime mortgages.

### How is the portfolio currently positioned?

The recent market volatility has brought spreads more in line with fair value and I have taken this opportunity to increase exposure on a selective basis, particularly to utilities and telecom sectors. I have also retained my small overweight exposure to high-yield and emerging Europe in issues where I have a high level of conviction.

I have moved the portfolio from an underweight duration position to a modest overweight duration position as I believe the future path for short term interest rates is now more balanced after this significant credit spread widening.

## Consistent performance

	1m			1 yr			3 yr			5 yr		
	% Chg	Rank	Qrtl	% Chg	Rank	Qrtl	% Chg	Rank	Qrtl	% Chg	Rank	Qrtl
Fidelity MoneyBuilder Income	0.79	22	1	-0.94	29	2	11.4	24	2	23	16	1
Fidelity Sterling Bond	1.4	6	1	-1.13	35	2	N/A	---	---	N/A	---	---
AEGON Sterling Corp Bd A Acc	0.02	77	4	-1.39	51	3	12.91	11	1	28.47	3	1
INV PERP Corporate Bond Acc	0.83	20	1	0.69	2	1	11.92	18	1	35.09	1	1
M&G Corporate Bond A Inc	0.58	36	2	-1.08	34	2	12.46	14	1	21.62	19	2
New Star Sterling Bond Inc	0.12	65	3	-0.4	18	1	11.62	22	2	25.58	9	1
Norwich Corporate Bond	0.42	50	3	-1.63	60	3	10.47	36	2	21.49	20	2
Old Mutual Corporate Bond Acc	-0.17	85	4	0.18	10	1	17.02	1	1	29.44	2	1
Threadneedle UK Corp Bnd	0.49	45	2	-1.61	59	3	10.29	39	2	18.86	33	2
<b>Mstar UT UK Corporate Bond</b>	<b>0.46</b>	<b>94</b>		<b>-1.36</b>	<b>92</b>		<b>9.85</b>	<b>86</b>		<b>18.9</b>	<b>65</b>	

Source: Morningstar to 01.08.2007 on bid-bid basis with net income reinvested.

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