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Portfolio Manager  
Ivy High Income Fund

## Why moving up in quality may make sense given this year's credit rally

*Below, Ivy High Income Fund Portfolio Manager Bryan C. Krug discusses the Fund's current positioning in the high-yield corporate debt market.*

Risk-based assets, including equities and credit instruments, have had massive rallies over the past six months. Both high-yield bonds and senior floating rate notes have participated in this rally and have enjoyed significant price appreciation so far in 2009. Ivy High Income Fund has benefited from this movement even as market conditions have been favorable. One characteristic of 2009's credit rally is that yield spreads — the difference in market yield between Treasuries and comparable maturity bonds — have narrowed substantially since January. For example, at the start of the year the yield spread on the average high yield bond was around 1,700 basis points (bps). Over the course of the year, they have tightened to less than 900 bps in late August. Historically, average spreads are approximately 500 bps and were in the low 200 bps range as recently as 2007.

### More liquid markets reduce bankruptcy risk

Since mid-March, credit markets have become much more liquid on the hope of a global economic recovery. Improved valuations on company equity and credit have allowed companies to access the capital markets to issue and/or refinance debt to improve their balance sheets. The improved capital markets, combined with the deep cost cutting many companies have undertaken, should result in a default cycle that will not be as severe as the ratings agencies and others had predicted earlier this year. It is my belief that the overall default rate for high yield will finish 2009 between 9 and 10 percent. Year-to-date, the market is at 7.6 percent, and it is our expectation that the default rate for 2010 will come down modestly versus 2009. We believe defaults will be concentrated in secularly challenged businesses, such as domestic auto suppliers, commodity cyclical businesses and leverage buyouts that were completed in the credit market excess of 2006 and 2007 with too much debt and unsustainable capital structures without a sharp recovery in economic growth. We have avoided the auto catastrophe and have been extremely selective when we have invested in the leverage buyouts completed at the height of the credit markets excesses.

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**Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. For a prospectus containing this and other information for the Ivy Funds, call your financial advisor or visit us online at [www.ivyfund.com](http://www.ivyfund.com). Please read the prospectus carefully before investing.**

# Ivy High Income Fund

Seek More Income Potential to Meet Your Goals

## PORTFOLIO PERSPECTIVES | SEPTEMBER 2009

### Reaching for yield may be a mistake

If you were to examine the performance of the credit markets, in general, you will find the lower quality companies and the most subordinate part of the capital structure have rallied the most in 2009, after selling off the most in 2008. Earlier this year we believed the market was pricing the riskiest part of the solvent market as if it was insolvent. We made the argument that, at these low levels, the riskiest part of the market had little risk to the price of the bond due to insolvency because of where the bonds were trading. With the significant rally, portfolio managers have continued to chase performance similar to the equity market. We believe managers who have been buying lower dollar priced bonds of speculative credits could face losses because of where the valuations of these securities are. We do not believe we will see a sustainable, strong recovery. Some of these companies that have had significant runs from very low levels face valuation risk because, ultimately, they may have unsustainable capital structures. In our portfolio we have been doing the opposite, we have not chased the rally and instead we upgraded the issuer quality of the Fund's fixed-income and floating rate securities, or moved within the capital structure to a more senior tranche.

### New-issue market for high yield is attractive

We believe there is a significant opportunity to take advantage of the evaporation of the structured product market in the leverage finance market. Until the markets cracked, approximately two-thirds of the senior floating rate market buyer base was Collateralized Loan Obligations (CLOs). With structured product investors experiencing losses that were not predicted by their models, we have seen those market participants leave. A typical floating rate loan deal has a six- or seven-year maturity and typically requires loans to be refinanced or paid back a year before they are due. Effectively, companies have five to six years of financing. As a result of the significant supply of maturing paper, we expect companies to extend maturities preemptively with new loans or term it out as a secured bond. Companies thus far that have termed out their secured bank debt have replaced 2.5 percent to 3.5 percent interest rates with debt costing them 8.5 percent to 11.5 percent.

We think the supply coming to the market will offer investors attractive terms for a longer time frame, but it will also prevent tightening from happening as fast as it has over the past nine months. So far we have seen very attractive investments in this area. The yield of some of these transactions has been slightly less than the unsecured market, but with significantly less risk. To size the risk comparison, in a typical high yield transaction after an approximate 25 percent impairment of the capitalization of the company, the bonds would start to experience losses. In general, when investing in the secured part of a capital structure, the company's total valuation would have to decline by approximately 50 percent before there is any impairment to the senior part of the capital structure.

### Ivy High Income's flexibility allows us to seize opportunities

Our prospectus provides great flexibility in selecting many types of debt, as well as modifying percentage weightings within the Fund's portfolio. The Fund can own a range of securities from cash to high-yield bonds. We have been increasing our exposure to senior floating rate and senior secured. The new favorable pricing is only available on new transactions, so we are waiting for the pipeline to come to market and we are finding the best risk rewards. Currently, the Fund's allocation is 52 percent unsecured high yield, 25 percent secured bond and floating rate, 10 percent investment grade, 10 percent cash and 3 percent convertible investments. In the weeks and months ahead, we intend to take full advantage of our flexibility to both pursue opportunities and effectively manage the risks associated with our broad investment universe.

Are we predicting another major market setback? No. However, we think high-yield bonds should not be looked at in a vacuum. If there is a major sell off in the capital markets, this asset class will likely sell off, but we do not expect it to sell off as severely as equities. Likewise, if stocks continue to rally, we believe it is reasonable to think that high-yield bonds have the potential to rally, too. In down markets, corporate bonds have historically sold off less than equities, while in up markets corporate bonds have historically lagged equities.



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