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The Basics of Investing in Leveraged Companies

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Owning mutual funds that invest in the securities of companies whose bond ratings are below-investment-grade can be a way to diversify your portfolio and potentially increase your total return. The objective of this paper is to help investors to understand the potential risks and rewards of investing in leveraged-company securities through mutual funds.

Why invest in companies rated below-investment-grade?

The average investor tends to be unfamiliar with the potential benefits of owning mutual funds that invest in the securities of leveraged companies -- i.e., those whose debt is rated below-investment-grade, or "high yield." The debt of these companies generally may offer higher yields than domestic investment-grade debt securities, but also carries more risks and volatility -- although less volatility in general than equities have experienced.

The performance of leveraged-company securities over time has been attractive, but furthermore has demonstrated relatively low correlation to that of other asset classes. The combination of these two characteristics offers investors who are prepared to accept greater than investment-grade price movements and credit risks the potential to achieve solid risk-adjusted returns while moderating the overall volatility within their portfolios.

Also, the market for securities from non-investment-grade companies has grown tremendously since the 1980s, according to Merrill Lynch and Credit Suisse First Boston. The high-yield bond market is nearing $1 trillion in size, and accounts for almost 25% of domestic corporate bond debt outstanding. In addition, approximately $1 trillion of corporate debt is outstanding in another category of securities known as leveraged loans. Furthermore, the outstanding market capitalization of the leveraged equity market now exceeds $4 trillion. Many attractive investment opportunities may be found in these large segments of the market.

What are non-investment-grade or leveraged companies?

Non-investment-grade companies are often capital-intensive or early-stage growth companies that lack the operating history or balance-sheet strength to merit investment-grade status. In other instances, high-yield bond issuers may be former investment-grade companies that have been downgraded due to operating or financial difficulty, also known as "fallen angels."

Major rating agencies such as Standard & Poor's or Moody's Investors Service issue opinions, in the form of credit ratings, on the ability of companies to repay their debt,* also called "leverage." New or outstanding bonds of companies that have what the agencies consider the best capacity to repay interest and principal are rated AAA by S&P or Aaa by Moody's. The agencies will generally assign a lower rating if they believe some uncertainty exists about the company's future ability to service and repay its debt. Bonds rated below BBB by S&P (e.g., BB, B, CCC) or Baa3 by Moody's are considered non-investment-grade or "high-yield" bonds. Non-investment-grade companies are typically those whose bonds would be considered below-investment-grade by the rating agencies.

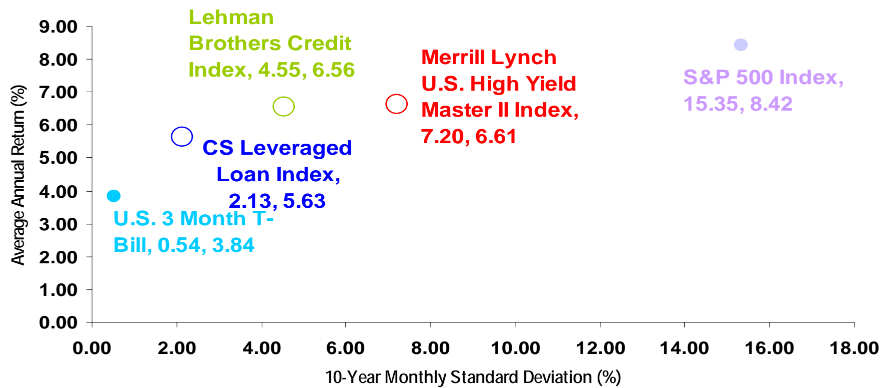
When determining which rating to assign to each of a company's bonds, the rating agencies will typically examine a wide range of factors that can influence the issuer's business prospects, such as the size of its outstanding debt burden, the ability to generate cash flow, recent sales trends, and capital expenditure needs. Additionally they will examine qualitative factors such as the experience and track record of the management team.

What is risk, and how does low correlation help moderate risk in an investment portfolio?
Although high-yield bonds share some attributes with investment-grade bonds as well as stocks, they have significantly different risk and return characteristics. These differences are highlighted by correlation coefficients, which measure the way two asset classes move in relation to each other over time. Sophisticated investors may attempt to hedge their overall portfolio risk and attempt to enhance returns by combining asset classes that are less-than-perfectly correlated to each other, to protect against the chance that every type of security in a portfolio will decline in value at the same time.

In the investment world, one of the definitions of "risk" is unpredictability -- the chance that reality will turn out to be different (worse or better) than one expected. Although past results are, famously, no guarantee of future returns, one of the ways investors set expectations about the future is through understanding the historical behavior of a financial instrument. A measure of historical risk is the degree to which actual returns over a series of time periods deviated from the average return overall. Of two investments that both averaged a 5.0% annualized return over a 36-month period, the one whose monthly returns varied only between 4.9% and 5.1% is considered to have been more predictable, less risky, and less volatile than the one whose returns varied between 4.0% and 6.0%. Mutual funds typically disclose to investors the standard deviation of prior monthly returns as a measure of historical volatility. Using this measure, the performance of non-investment-grade debt is historically more volatile than that of investment-grade debt, but less than that of stocks. Leverage can magnify the impact on a company of adverse issuer, political, regulatory, market or economic developments.

Figure 1
RISK & RETURN
Leveraged Company Debt vs. Selected Other Asset Categories
December 1996 - December 2006

Average Performance and Volatility (12/96 - 12/06)



Source: FMR as of 12/31/06

Past performance is no guarantee of future results.

The Y axis indicates the average annualized returns vs. the overall average for the ten-year period 12/96 - 12/06, and the X axis indicates the standard deviation of annualized) returns vs. the overall average during that period.

The Merrill Lynch® U.S. High Yield Master II Index is an unmanaged market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities, and is not an investment vehicle. Qualifying bonds must have maturities of at least one year, a minimum amount outstanding of $100 million, a fixed coupon schedule, a credit rating lower than BBB-Baa3 and not be in default.

The Standard & Poor's 500 Index (S&P 500®) is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Lehman Brothers® Credit Index is an unmanaged market capitalization-weighted index consisting of SEC-registered publicly issued investment-grade rated U.S. corporate debentures issued by corporations and non-corporate entities.
Credit Suisse (CS) Leveraged Equity Index is an unmanaged market-weighted index designed to represent securities of the investable universe of the U.S. dollar denominated high yield debt market.
The Russell 2000® Index is an unmanaged market capitalization-weighted index measuring the performance of the smallest 2,000 companies, on a market capitalization basis, in the Russell 3000 index.

You may not invest directly in any index.

A risk-related performance measure expressing the relationship between an investment's risk and return as a single number is the Sharpe ratio, which measures the historical return of an asset class **relative to** its historical volatility. The Sharpe ratio is calculated by subtracting a risk-free rate of return — for example, a Treasury bill — from the security's actual absolute return. This represents the incremental return of the security vs. the risk-free Treasury. The resulting figure is then divided by the security's standard deviation — a measure of its total volatility — which then produces the Sharpe ratio. The higher the numerator relative to its denominator, the more attractive the return of the asset class given its volatility or risk.

Figure 2
ASSET-TYPE EFFICIENCY
Sharpe Ratios [1] of Selected Asset Categories
December 1996 - December 2006

High Yield Bonds [2]	Leveraged Loans [3]	Ten-Year Treasuries	Large Stocks [4]	Investment-Grade Corporates [5]
0.43	0.89	0.30	0.37	0.63

[1] Sharpe ratio calculation: (total return minus return on 91-day Treasury Bills) divided by standard deviation of total return.
[2] Merrill Lynch U.S. High Yield Master II Index.
[3] Credit Suisse Leveraged Loan Index.
[4] S&P 500 Index.
[5] Lehman Brothers Credit Index.
Source: Fidelity Management & Research Company as of 12/31/06.

Over the past ten years, high-yield bonds, leveraged loans, and leveraged equities all have demonstrated low correlation with other major asset types:

Figure 3

CORRELATION MATRIX

Correlation of Monthly Returns of Selected Asset Categories
December 1996 - December 2006

	High Yield Bonds [1]	Leveraged Loans [2]	Large Stocks [3]	Small Stocks [4]	Investment-Grade Corporates [5]	Ten-Year Treasuries
High Yield Bonds [1]	**1.00**					
Leveraged Loans [2]	**0.58**	**1.00**				
Large Stocks [3]	**0.49**	**0.14**	**1.00**			
Small Stocks [4]	**0.55**	**0.34**	**0.72**	**1.00**		
Investment-Grade Corporates [5]	**0.37**	**0.03**	**0.04**	**0.05**	**1.00**	
Ten-Year Treasuries	**(0.04)**	**(0.20)**	**(0.21)**	**(0.23)**	**0.86**	**1.00**

[1] Merrill Lynch U.S. High Yield Master II Index.
[2] Credit Suisse First Boston Leveraged Loan Index.
[3] S&P 500 Index.
[4] Russell 2000 Index.
[5] Lehman Brothers Credit Index.
Source: Fidelity Management & Research Company as of 12/31/06.

Debt issued by companies with lower credit-quality ratings involves a greater risk of default or price changes resulting from poor operating results than the debt of companies rated investment-grade. To help protect investors from the greater risk of holding lower-rated securities, non-investment-grade companies need to offer significantly higher yields or coupons than would be required for the bonds or loans of higher-quality, investment-grade companies.

To achieve investment-grade status, high-yield companies may undertake various measures -- cutting costs, selling non-core assets, improving revenues. Investors in a company that improves the condition of its balance sheet and credit rating will be receiving a coupon that is relatively high given the lowered risk, and may also find that they are able to sell these securities for a higher price, representing a gain from capital appreciation.

Investing in non-investment-grade securities is not without risks and volatility, particularly within short time periods. Risks that can significantly hurt this market include weak macroeconomic conditions, geopolitical uncertainty, high default rates, widespread corporate malfeasance, an oversupply of new issuance, a flight to quality, and a large volume of bonds being rapidly downgraded from investment-grade to high-yield. Therefore an investment into non-investment-grade securities should generally be undertaken with a time horizon of at least several years in mind.

Who are the leveraged companies?
The roster of high-yield companies includes a range of names that would be surprisingly familiar to the average investor. Some prominent names are General Motors, Xerox, Qwest

Communications, Ford, Georgia-Pacific, Allied Waste,, Marriott Hotels, and Lucent Technologies. Nextel Communications, Echostar Communications, Rogers Wireless, and American Tower are easily recognized names that have used leverage to fund early-stage growth. Some of the most familiar capital-intensive businesses that have used debt to expand and reposition their businesses are Charter Communications, Cablevision Systems, Mandalay Resorts, and Iron Mountain.

The non-investment-grade universe is much broader now compared to fifteen years ago. For example, as of year-end 2006, four of the five high-yield bond issuers with the largest dollar value of bonds outstanding according to Merrill Lynch were from different sectors: Ford Motor Credit (Automotive), GMAC (Automotive), El Paso Corporation (Energy), HCA -- The Healthcare Co. (Healthcare) and Charter Communications (Cable TV).[1]

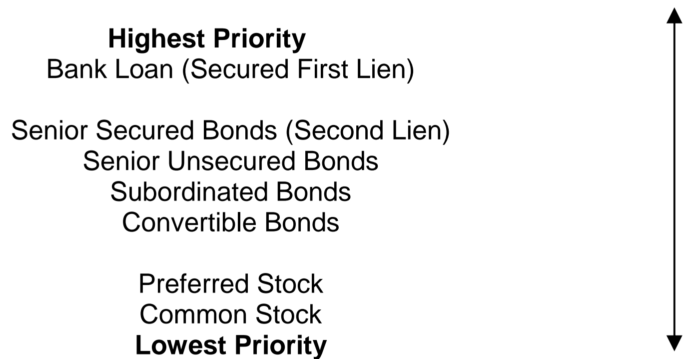
What types of securities are issued by non-investment-grade companies, and what is the role of an index?

The capital structure of a company is made up of its different outstanding classes of debt and equity. The debt within a non-investment-grade company's capital structure consists of instruments such as bank loans and high-yield bonds, while the equity consists of instruments such as preferred and common stock. High-yield debt investors are particularly concerned about the priority of claims against collateral to which they are entitled in the event of a bankruptcy or distressed situation. The type of financial instrument determines an investor's priority of claim. Generally speaking, the lower down a financial instrument resides in the company's capital structure, the greater the potential risk and reward for the investor.

Figure 4

BALANCE SHEETS

Typical Leveraged Company Capital Structure



Major financial companies such as Credit Suisse First Boston, Merrill Lynch, and Lehman Brothers track the performance of securities within subcategories of these security types and construct averages, or indices, ranging from narrow to broad. Similarly, Morningstar and Lipper calculate average statistics for groups of mutual funds they judge to be similar.[2] These indices and rating groups -- also sometimes called benchmarks -- are often used to compare the performance of a particular security or mutual fund to the average of a pool of similarly managed instruments.

What are high-yield bonds?

High-yield bonds (rated below BBB- or Baa3 by major rating agencies Standard & Poor's or Moody's) are classified as debt securities, but are often described as hybrids because they display characteristics of both bonds and stocks. Generally, the price of high-yield bonds is less sensitive than that of investment-grade bonds to interest rate fluctuations, and more sensitive to company-specific factors -- like stocks. On the other hand, the income component of a high-yield bond tends to make it less volatile than the same company's stock -- and on average, has made the category of high-yield bonds less volatile than stocks. The high current income component also generally results in lower sensitivity to interest rates for high-yield bonds than for either investment-grade or Treasury bonds.

Consequently, over the long term, high-yield bond returns have been higher and more volatile than those of investment-grade bonds, and lower and less volatile than those of stocks.[3] An allocation to high-yield bonds has historically been appropriate for investors with long-term time horizons who are moderating the risk of an all-equity portfolio or for investors looking for potentially higher income, less interest-rate-sensitive alternatives to investment-grade bonds.

What are leveraged equities?

Leveraged equity investing focuses on companies that purposely use debt, or leverage, to achieve their business goals -- the same kind of companies that issue high-yield bonds. The "leverage" in this type of equity investing refers to the large amount of debt on the companies' balance sheets.

The leveraged equity investment universe is made up of companies that usually are characterized by debt-to-equity ratios of 50% or more, with the debt typically rated below-investment-grade.

Stocks of non-investment-grade companies can be volatile, so leveraged equity investing historically has been more appropriate for relatively sophisticated shareholders with long-term investment horizons who are looking for capital appreciation from an aggressive complement to an already diversified portfolio.

Picking the right companies and stocks is critical, due to the increased risks associated with investing in companies that are highly leveraged. For better or worse, leverage tends to make everything happen faster for companies. Equity shareholders in a company that uses debt successfully to grow its operations, revenues and cash flow could potentially be part owners of a bigger and stronger company even after servicing and repaying the debt. But equity shareholders in a company that fails to improve its condition sufficiently after borrowing will find the debt obligations an additional drag on the performance of their capital.

What are leveraged loans?

Another way for non-investment-grade companies to fund operations or growth is to issue leveraged loans (sometimes termed "bank loans" because of a lead bank's role in the corporate loan syndication process). Once again, the term "leveraged" refers to the amount of debt on the balance sheet of the company borrowing, i.e. issuing the loan instrument.

Leveraged loans are also known as floating-rate loans because of the adjustable interest rate payable by the borrowing company. The coupon or interest rate paid by a company issuing a leveraged loan is generally based on a short-term borrowing rate such as LIBOR (London Inter Bank Offer Rate) plus a spread depending on the credit quality of the issuer. The coupon on the leveraged loan is typically reset every 90 or 180 days. The income from leveraged loans thus tends to track short-term money market rates.

Typically, leveraged loans carry a higher coupon than money market instruments from less risky issuers like the government or investment-grade companies -- but a lower coupon than high-yield bonds because they are more senior in the capital structure, better collateralized, and less risky for the investor as compared to high-yield bonds. Leveraged loans are generally secured by the issuer's tangible assets, such as property, plant and equipment. If the issuer defaults, investors attempt to recover their principal by selling the assets backing the leveraged loan.

Investors may be attracted to leveraged loans due to the floating-rate nature of the coupons the securities may carry and their historically stable prices. Over the long term, leveraged loan returns have been higher and more volatile than those of short-duration investment-grade bonds as well as money-market funds, and lower and less volatile than those of high-yield bonds. An allocation to leveraged loans has historically been appropriate for investors who are prepared for net asset value and credit risks, are seeking to receive potentially larger income payouts, and have an investing time frame of at least 2 years.

Why are mutual funds a good way to invest in non-investment-grade securities?

Perhaps the most important benefit offered to investors in non-investment-grade securities by an actively managed mutual fund is the team of credit analysts and portfolio managers who monitor the markets and the companies, their collateral, and their business plans on a daily basis. Individual investors do not always have the time and analytic support to stay on top of the risks and opportunities in the high-yield company universe.

In addition, directly purchasing some types of non-investment-grade securities from the issuing company usually requires a high minimum investment that may be beyond the reach of most individual investors. The minimum initial investment required by a mutual fund is usually just a few thousand dollars.

Although allocation does not ensure a profit or guarantee against loss, mutual funds generally can spread risk better than the average individual investor by holding the securities of many companies. Even a mutual fund that is considered concentrated in terms of the number of individual issuers -- and therefore more volatile than an unconcentrated fund or the market as a whole -- is likely to hold more than one hundred different issues. The ability to evaluate combinations of sectors, companies and security types is another service provided by the research staff of actively managed mutual funds.

Mutual fund investors should watch for the use of leverage in the management of the fund itself. Some mutual fund managers -- particularly those managing closed-end funds -- add even more debt at the fund level, on top of the debt employed by the companies issuing the securities in which the fund invests. This type of mutual fund may be attempting to bolster its returns by borrowing money in the capital markets, using the fund's assets as collateral, in expectation of earning a higher return overall. But if the vehicle in which the fund invests the borrowed money fails to achieve a return higher than the cost of the borrowed money, then the fund may have to sell other holdings in order to repay the borrowed funds.

For income-sensitive investors, a mutual fund holding many individual bonds can potentially achieve a fairly steady stream of current income. A true open-end mutual fund also provides investors with "daily liquidity" -- the opportunity to buy and sell shares at will (although extra short-term trading fees may apply). Furthermore, mutual funds may have lower expense structures, particularly when compared to the transaction costs that could be incurred by an individual attempting to assemble a diversified portfolio of high-yield securities.

Why Fidelity® mutual funds?

ACCESS. Fidelity is one of the country's largest mutual fund companies, and a leader in the field of high-yield-company investing.[4] Fidelity's investment professionals have access to the top management teams of these companies.

RESOURCES. We have one of the industry's largest and best-equipped teams of credit and quantitative analysts focused on the task of understanding the capital structures and business plans of non-investment-grade companies.

INTEGRITY. More than 50 years earning the trust of mutual fund investors.

Fidelity's leveraged company mutual funds are all open-end, daily liquidity funds, and do not borrow or use additional leverage in the management of the funds themselves.

Principal Investment Risks

Investing in high yield securities involves greater risk due to payment of principal and interest because of lower credit quality of the issuers.

Past performance is no guarantee of future results. Non-investment-grade funds may invest in securities of companies with lower credit ratings, or of foreign companies, which generally may offer higher yields than domestic investment-grade securities, but also carry more risks and volatility. Leverage can magnify the impact of adverse issuer, political, regulatory, market or economic developments on a company. Certain funds are considered non-diversified or concentrated in terms of issuer, and changes in the market value of a single investment could cause greater fluctuations in share price than would occur in a more diversified fund. Even for funds that are diversified across multiple types of securities, markets or issuers, any or all may experience periods of volatile returns, and it is possible for all investment categories to decline at the same time. **Investors must be willing to accept greater price movements and credit risks.**

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Relatively volatile instruments may not be suitable for investments intended to be left in place less than several years.
Mentions of specific securities or companies should not be construed as a recommendation.
All indices are unmanaged, and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made in any index.

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[1] Merrill Lynch U.S. High Yield Master II Index as of December 31, 2006.

[2] For each fund, Morningstar calculates a Morningstar Rating TM metric each month by subtracting the return on a 90-day U.S. Treasury Bill from the fund's load-adjusted return for the same period, and then adjusting this excess return for risk. The top 10% of funds in each broad asset class receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. Although gathered from reliable sources, data completeness and accuracy cannot be guaranteed by Morningstar. Past performance is no guarantee of future results. Copyright 2007 Morningstar, Inc. All rights reserved.

Lipper, Inc. is a nationally recognized organization that ranks the performance of mutual funds based on total return, which includes reinvested dividends and capital gains, if any, and excludes sales charges. Each fund is ranked within a universe of funds with a similar investment objective.

[3] Please see Figure 1 for historical performance and volatility of referenced asset classes.

[4] Based on total assets in high-yield, multisector and bank loan funds 12/06.

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Before investing, consider the funds' investment objectives, risks, charges and expenses. Contact Fidelity for a prospectus containing this information. Read it carefully.

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