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As a balance sheet recession deepens, we remain cautious

Below, Ivy Asset Strategy Fund's investment team, led by Portfolio Managers Michael Avery and Ryan Caldwell, discusses the Fund's current positioning, the consequences of government credit initiatives and recent market volatility. This commentary includes comments made during a March 10, 2009 Ivy Sound Solutions conference call with financial advisors.

Are we there yet? It is a question many parents hear on a long road trip. Much of what we are seeing across multiple asset classes suggests that many investors are eagerly awaiting a cyclical economic bottom, perhaps with too much short-term hope.

Global equity and credit markets remain largely dysfunctional despite the beginnings of a growth recovery in China, aided by what appears to be an effective package of government stimulus efforts since November. Meanwhile, Libor (London Interbank Offer Rate) has been ticking upward to the highest levels since early January amid skepticism about American and European measures to address bank failures and ailing housing markets.

In early March, U.S. equities rallied on the belief that the market had seen the worst of the cyclical downturn on what appeared to be cheap valuations using historical fundamental and technical measures. However, we believe it is too early to conclude that the (E in P/E stocks' price/earnings ratios) has hit a trough, especially with structural unemployment rising at a record pace.

What we are seeing is a balance sheet recession, which is rare. U.S. consumer spending is in an apparent secular shift that could take the savings rate much higher even as the government borrows trillions to spend on new and existing programs. (The positive effects of Washington's efforts are open to debate, and are generating negative, unintended consequences that add to market volatility.) What we believe is that the average person in this country is responding to lower asset values on their homes and their investment portfolios, coupled with threats to their earning potential. Income and assets have gone down, liabilities have not gone down.

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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. Please read the prospectus carefully before investing.

Ivy Asset Strategy Fund

Thinking Beyond Boundaries

PORTFOLIO PERSPECTIVES | MARCH 2009

There is a huge imbalance between assets and liabilities in the U.S., not unlike the situation in the 1930s. The classical response to this is to employ Keynesian economics — fiscal spending, which takes a long time before it has a real impact.

Financial sector pain continues

Equity hope is generally not reflected in the credit and bond markets. Holders of money center bank debt have little faith in bank memoranda and releases that suggest that the first quarter of 2009 may generate better-than-expected earnings in some operating units. Rather, new sources of financial anxiety seem to crop up daily, including the expectation of more provisions for bank loans that have soured as a result of the deepening global recession. Overseas, new problems have surfaced for some leading financial services firms — such as HSBC and UBS (we don't own either firm's stock or debt) — thought to be in relatively better shape than U.S. institutions that have required multiple government assistance efforts.

Asset classes that have rallied so far in 2009 — gold and high-yield bonds — have given back much of their gains after only a few weeks. This plus what we believe are too high of expectations for quick gains and/or a V-shaped equity market recovery have prompted us to increase our hedging positions in gold and equities, and deploy more cash (currently 35 percent of net assets) to investment grade corporate bonds and A1/P1 commercial paper.

Within equities, we continue to look for companies that have top-line (revenue) growth, earnings growth or at least earnings stabilization. Such stocks have been relatively elusive. We buy equities when we think they are cheap, and hedge them off when they get expensive. It's a premise we plan to stick with.

An increased investment grade bond weighting

The Fund's fixed-income position is currently about 15 percent of assets, with slightly more than half of that in corporate bonds with an average rating of A- and an effective duration of just under three years. This is significantly higher than our overall fixed-income weighting at Dec. 31, 2008 (At the time we had 5 percent of net assets in corporates and 3 percent in government bonds. We now have 9 percent corporates (8 percent investment grade, 1 percent high-yield) and 5 percent Treasuries).

We have used the high level of investment grade issuance this year — more than \$230 billion so far — to build positions with attractive income potential, and even actively approached some potential investment grade issuers that have credit characteristics we like. This process is called "reverse inquiry," which has the potential to result in very attractive yields. Generally speaking, we invest in bond issues that are typically \$500 million in size or greater. For example, we recently participated in Roche's financing of its bid for biotechnology leader Genentech (an equity position of 3.1 percent of net assets as of Dec. 31, 2008, our third largest holding). That's grown to 6.5 percent currently, a position that we expect to reduce as Roche completes its buyout offer.

We have hedged about a third of our 18 percent gold bullion position, and this has helped preserve capital as gold prices have fallen from a peak of more than \$1,000 an ounce a few weeks ago. We have also hedged our equities position with short futures contracts and this has helped our relative results as the S&P 500 has dropped sharply since January.

As we assess the multiple fiscal and monetary policy initiatives authorized and being implemented, our outlook remains very defensive. As we said last month, we believe the U.S. government-led process of unchaining credit markets, and freeing the global banking system from an era of too much leverage and interlinked debt, will be a slow and painful one. We are likely to be in an environment where U.S. economic growth is very sluggish for some time, and that China may recover first.

Increased China weighting

To benefit from China's apparent resurgence and shift from export growth to self-financed infrastructure spending, our equity positioning includes Chinese insurers and banks in western provinces. The data coming out of Beijing suggests a successful economic shift is ongoing. Urban fixed-asset investment in China has climbed 26.5 percent so far this year, the Chinese government says. Exports, meanwhile, have tumbled 25.7 percent.

We see a "fits and starts" type of recovery in China over the next six to 12 months, with the potential for real sustainable growth in 2010. We think surging infrastructure spending may outweigh the slump in trade because such investment accounts for as much as 40 percent of China's growth, versus 7 percent for net exports, based on our research and from what we have learned visiting cities such as Shanghai and Beijing. It's going to take some time for infrastructure spending to fully ramp up in China, but we feel it is a much more efficient process than here in the U.S. or anywhere else in the world. For example, railway investment has tripled from year-ago levels while agricultural spending has doubled, and coal-mining expenditures have jumped 59.6 percent, according to China's statistics bureau. The number of new projects has climbed 28 percent to 18,533. China has also started at least \$35 billion of energy projects since its stimulus plan was announced in November.

Our outlook

In the coming months, we believe China's GDP growth may surprise investors on the upside. Overall, we believe growth in China will look much better than other places around the globe as the year unfolds. We continue to closely monitor the situation to confirm that business profitability and productivity are benefiting from government spending.

In the U.S., however, we continue to face a credit crisis. It is a credit bubble that has burst and that will take the U.S. consumer a long time to work out. Our view is that the U.S. equity market will exhibit an L-shaped pattern within a volatile trading range. There are still a large number of risks out there because the market is looking for a V-shaped recovery. We view the U.S. market as being in a trading range, with potentially better opportunities outside the U.S. We will try to navigate that range as best we can, always with a three- to five-year investment horizon in mind. This has been our consistent philosophy for more than a decade.

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Why Ivy Funds?

Ivy Funds is an exceptional combination of investment managers that offers global reach and capabilities to advisors and their clients. Ivy seeks to enable its fund shareholders to remain comfortably committed to their long-term goals. We are:

Proven: We're part of an organization whose roots date to 1937, with an investment style emphasizing participation in positive markets and, especially, seeking to manage risk.

Focused: We do our own work, believe in our own research and act on our own ideas. Our steady approach is guided by a belief in fundamentals over fads.

Constant: We say what we mean, and do what we say. What we value most, and remember every day, is the trust that we have earned, and must continue to earn, from our shareholders.

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