



STEPHEN SNOWDEN has run the £511m Old Mutual Corporate Bond fund since 2004, joining the firm from Aegon.

Recovery facilitated by cheaper credit market

Stephen Snowden runs the Old Mutual Corporate Bond fund. He answers questions from James Smith.

Q: How is the portfolio positioned?

A: The main feature of recent months has been a move from 10% in cash and gilts to 2%, and we have aggressively re-invested since the credit market turned in March. We are now as fully invested as we can be in current conditions, bearing in mind an issue or redemption could always be round the corner.

Q: Your performance has struggled in recent times although numbers have bounced sharply in the short term - what has caused that?

A: The credit market changed direction three months ago and has rallied strongly since. I have been buying into a falling market for a while, which exacerbated underperformance last year and early in 2009, but I always said that when things turned it would be aggressive. Three months ago, it was difficult to sell credit, now it is as hard to buy it. Every sell-off eventually sees a rally, although with hindsight I never expected the market to hit Great Depression levels. We continued to buy cheap stock into the selloff and while that caused some performance pain, our view was that it would generate great longer-term returns.

Q: Is there a fear the recent spread recovery is just a bear market rally?

A: Again, every rally is interrupted by a spate of panic, as we saw in March 2003 when the market was recovering from Enron and WorldCom the previous year. But you have to remember how cheap credit is and while there might be a pause, it is impossible to judge when. However, I am confident we have seen the bottom. It is worth noting equities have not sold off as aggressively as credit, which went through Great Depression levels. Credit is much cheaper, so there is more valuation support for the recovery.

Q: You kept faith with financials when many peers deserted the sector - why did you do this and is it now starting to pay off?

A: With perfect hindsight, it was wrong to hold any financial bonds three years ago. But equally, it has been just as wrong to hold nothing in the sector this year, as the recent rally proved. Having made mistakes in this sector, I had to

make a call - would the government keep financial firms afloat or should I ditch my holdings? I took the view that these companies are systemically important and would ultimately recover losses. This caused some misery last year but has benefitted recent performance.

Some commentators said subordinated bank debt was worthless. That may be the case with some individual credits, but that statement is wrong generically.

Many banks are still troubled and the sector had another downward lurch last year when Deutsche Bank decided not to call some of its bonds, but that seems to be an isolated incident. Investors have started looking at banks as a value play. Banks themselves have been the first buyers of cheap financial debt, and more managers coming into the sector provides increased valuation support for our holdings. We had been neutral in financials, relative to the index that was overweight relative to peers, but increased this when banks started buying back debt in March. We were already positioned for their recent upturn, so we have not had to chase a rallying sector in recent months.

Q: Which other parts of the credit market look attractive?

A: Safer areas are priced accordingly and there is little value left in telecoms, utilities or pharmaceuticals. We prefer sectors that remain troubled like pubs, where collapsing share prices have been mirrored on the bond side. With a stock like Punch Taverns, there is an aggressive covenant on the debt which traps cashflow generated for the benefit of bondholders. The share price has fallen and dragged the bonds down, but the latter are robust and the company is structured in their favour.

Another interesting sector is property. I am not expecting a dramatic rally, but considering the price of the bonds and double-digit yields you are compensated for market difficulties.

Q: Your holdings have included troubled stocks, such as AIG, Lehman Brothers, Bradford & Bingley and Taylor Wimpey - what attracted you to these?

A: We bought both AIG and Lehmans

after serious underperformance, in expectation of a rescue or rally that never came. On the latter, I expected the government to step in as it had done with Bear Stearns, but it turned out Merrills was also in trouble and they had to pick one to save. On Bradford & Bingley, I have been invested for several years and was unable to exit the position post-Northern Rock.

As for Taylor Wimpey, if you had told me that housing starts would fall to levels not seen since 1942, I would not have gone near residential housing. The company had strong covenants in place, but that cannot protect you in the event of complete collapse.

Q: How is the overall economic background affecting credit markets?

A: So far, the government has bought back around £600m in sterling corporate bonds, which has helped. It is also buying back gilts, which is a politically acceptable way of printing money, and a necessary evil given the state of public finances.

Overall, quantitative easing has had a positive affect at the margin but has also brought back the spectre of inflation. On the credit side, the Bank of England has generally bought back bonds the market likes, and is happy to hold, rather than less liquid assets. Therefore, this policy will not make the difference between market recovery or not. Putting it in context, total purchases from the government only equate to two weeks' inflows into the IMA Corporate Bond sector.

Q: What is your outlook for investment grade credit relative to gilts and high-yield?

A: Investment grade remains extremely cheap, and while there is potential for higher absolute returns in high-yield, there is a material amount of extra risk. On a risk-adjusted basis, we see investment grade as the most attractive. With gilts, we have no firm view: with 4%-4.5% yields and low deposit rates they are attractive in valuation terms, but this is offset by a poor technical picture in light of huge supply.

Q: Where do you stand on the bond bubble argument, with so much money flowing into credit portfolios?

A: We are coming out of the worst credit bear market in history and investors are buying these assets as cheaply as they can for another generation. Bubbles are all about valuation excesses and bond prices are at extremes, but they are cheap rather than expensive. With low deposit rates and high bond yields, current flows reflect a sensible reallocation of capital. And this is the first time in years the switch has been so marked.