Corporate bonds – avoiding the broken clock

Fund manager, Old Mutual Corporate Bond Fund

Stephen Snowden, manager of the Old Mutual Corporate Bond Fund, believes that just as a broken clock is right twice a day, defensive positioning was the right strategy at the low point of the market. However, since the market started to recover in mid-March, a higher exposure to credit has been key to delivering returns.

Being fully invested in credit, the Old Mutual Corporate Bond Fund underperformed more defensively positioned funds as the market fell

The demise of Lehman Brothers last September heralded a sharp decline in the corporate bond market. Credit continued to weaken for the rest of the year as the financial system remained under considerable pressure, with governments on both sides of the Atlantic announcing rescue packages for a number of troubled financial institutions. During this period the Old Mutual Corporate Bond Fund remained fully invested in credit, including having exposure to banks, in the belief that corporate bond valuations had fallen to the lowest levels ever seen, including during the dark days of the Great Depression in the 1930s. As the market continued to fall, this detracted from the performance of the fund relative to its peers, many of which were more defensively positioned, holding a much larger proportion of their assets in cash and gilts.

A greater proportion of the fund is now being valued using industry standard prices than was the case earlier in the year

The recovery in the market has meant that we are able to value a greater proportion of the fund using industry standard prices. Under the terms of its fair value pricing policy, OMAM has sought, where possible, to use industry standard pricing vendors to value the underlying investments in the fund. However in cases where it was felt that the industry standard price was not fully reflective of the levels at which trades were being transacted in the market, some bonds have been valued using independently sourced prices. This meant that the value of these holdings was being understated, further contributing to the negative performance of the fund. However, whereas bonds valued using independently sourced prices represented slightly more than half the total value of the fund earlier in 2009, the proportion has now fallen to less than a fifth.

Interest rate cuts have led to lower deposit rates, causing investors to switch to riskier assets in the search for income

Meanwhile the worsening economic environment led the Bank of England to cut interest rates to close to zero. While this meant a dramatic reduction in the cost of borrowing, it also had a similar effect on the interest paid on deposits. This has proved to be good news for the corporate bond market as the search for income has led to an increased appetite for risk with investors moving from cash to riskier assets such as corporate bonds.

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The bank sector has rallied strongly from mid-March, outperforming all other areas of the market

Whereas non-financial bonds had been rallying from the start of the year, it took until mid-March for banks to begin to stage a recovery, benefiting from mounting expectations of an economic recovery next year and news that a number of major banks had returned to profitability in the first quarter of 2009. Since then financials have bounced strongly and have been the best performing area of the market, which is clearly a positive development for the Old Mutual Corporate Bond Fund, which has maintained its exposure to the sector.

Liquidity is such that it is proving difficult to switch cash and gilts into credit in a rising market

Although the market is in much better shape than has been the case for a while, liquidity has nonetheless yet to return to previous levels. The sea-change in confidence has meant that those portfolio managers who were struggling to sell corporate bonds as the market was falling may now find it difficult to buy in a rising market. This inability to switch holdings of cash and gilts into credit clearly may make it difficult to reposition a defensive fund to benefit from this renewed risk appetite.

The Old Mutual Corporate Bond Fund is well placed to benefit from a market recovery

In conclusion we believe that the world has moved on since the broken clock was showing the correct time and that now is not the right time to be positioned defensively. Having maintained our exposure to credit in general and financials in particular throughout the downturn, we believe that we are well placed to reap the rewards as the market recovers. Signs are that this is now starting to happen. While most sectors are now rallying, banks are outpacing other areas of the market. They have been key to the very strong performance of the fund in recent weeks and we expect them to continue to define performance for the remainder of the year.

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