Investment update

7 May 2010

Stephen Snowden, manager of the Old Mutual Corporate Bond Fund

Stephen Snowden is a highly experienced fund manager who has specialised in corporate bonds for the last ten years. Earlier in his career he focused on equities, which gave him a strong grounding in company analysis, which is at the cornerstone of his investment process. Stephen combines top down analysis with bottom up stock selection, believing that selecting good bonds, rather than good companies, is the key to delivering returns for investors.

Stephen Snowden joined OMAM in 2004 and is the manager of the Old Mutual Corporate Bond Fund, as well as the bond element of the Old Mutual Extra Income Fund. He was previously Head of Retail Fixed Income at Aegon Asset Management where he managed the Aegon Extra Income Fund.

Credit market update

The credit market has come under pressure from European sovereign concerns and following the UK election outcome, but Stephen Snowden, manager of the Old Mutual Corporate Bond Fund, believes that events now are different to those of September 2008 and that investors should not be panicked into selling. This Q&A outlines his current thoughts.

What are the corporate bond market themes for 2010?

On the positive side corporate results are strong, economic data is broadly improving and corporate bond issuance is modest, but against this budget deficits are huge. The credit market is experiencing its third wobble in six months as these two competing forces are jockeying for position. Market sentiment is ebbing and flowing between fear and euphoria; we are currently in the fear zone.

Why is the market currently being dominated by fear?

Clearly the Greek fiscal deficit situation is no longer contained. The recent 110 billion package did not calm fears and now the markets are hammering the other PIIGS. The key consideration is whether the markets manage to damage Spain's ability to tap government bond markets. Whereas Greece was priced in (and manageable), a full sovereign panic of Spain and/or Italy is not. Greece or Portugal or Ireland is one thing, but Spain/Italy is the real problem. Fear abounds and rightly so, with sharp intra-day moves in the US equity market adding to uncertainty.

What is likely to happen?

We expect that until the markets are given a reason to stop hammering Spain and related sovereigns, the negative spiral will continue. European policy makers will eventually announce some measures designed to try to stabilise the situation. The European Central Bank (ECB) is able to instigate quantitative easing (through secondary market activity), but given its anti-inflation remit, such measures may be a long way off, if they are implemented at all. We expect something to be done to help the sovereign bond market, but it will take time and the ECB is unlikely to stand by and just let it happen. Clearly there is a risk if they don't act eventually, the situation will no longer be within their control. Refocusing on the fundamentals should help to improve the situation - western governments are heavily in debt, but we must remember that Greece is a lot worse and has an additional credibility problem following the restatement of its deficit.

How much is priced in already?

The market's sell-off over the past few days has been savage and is on a par with the worst that we witnessed in 2008. Some Tier 1 bank bonds are already down 20 points and some high yield bonds are down 10 points. Therefore a considerable sell-off has already occurred and there are signs that the market is starting to stabilise at lower levels, although time will tell if it is just pausing for breath.

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Do these events signify a repeat of 2008?

We do not believe that they do. We correctly anticipated a drop in risk appetite and de-risked the portfolio accordingly in April. In the credit market the situation is better than in 2008. Bank bond ratings have already been cut to junk status, so there is no forced selling, lots of subordinated bank bonds have been called, tendered and bought back and levels of outstanding stock are considerably lower than they were two years ago.

What action have you taken in the portfolio?

During April we took advantage of the strength of the market to reduce risk and in the expectation that increased sovereign risk would panic investors into selling, we increased our cash weighting. We also increased our exposure to AAA-rated issues and are not experiencing any liquidity problems. Finally, it is worth noting that exposure to the PIIGS markets is both extremely modest and well diversified.

Do recent events represent a repeat of September 2008 for the fund?

We would say in no uncertain terms that they do not. PIIGS risk is low, the portfolio is well diversified (with 145 holdings rather than 100) and we have continued to improve the quality and liquidity of the fund this year. We have also timed well the ebb and flow of the sovereign concerns since they started with Dubai in December 2009. The fund has had a very strong year and although current events are leading to some short term underperformance, we do not expect this to be dramatic, given the scale of the market sell-off and the previous outperformance. This is very different to the experience of September 2008.

What conclusions do you draw?

We expect sovereign concerns to persist for another 18 months or so and we will find ourselves in the fear zone from time to time. With valuations having improved dramatically, when the market does focus on corporate results, economic recovery and strong market technicals, it will rally again. We have liquidity and as we have done twice in the last six months, we will use that liquidity to buy cheap assets. The market may weaken further in the short term, but right now there are bonds which represent exceptional value once again.

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