Investment update

2 September 2011

Christine Johnson, manager of the Old Mutual Dynamic Bond Fund

Christine Johnson joined OMAM in September 2010 from Halbis Capital Management (formerly HSBC Asset Management), where she was a senior fixed income fund manager, initially focusing on sterling credit before also managing global portfolios. She moved to Halbis from Investec Asset Management, which she joined as a high yield credit analyst, becoming a high yield fixed income fund manager a year later. She began her asset management career as a credit analyst at Royal & Sun Alliance Investment Management, having previously been a relationship manager at NatWest Bank. Christine has a BA in Economics from Manchester University.

Nothing to fear

Corporate bonds are currently valued at levels that investors could breakeven in almost any circumstances seen in recent memory, including the 2008/09 meltdown

Andrew Haldane, the Bank of England's executive director for financial stability – used the famous Franklin D Roosevelt line 'the only thing we have to fear is fear itself' in a recent speech to discuss the spiralling weakness in financial risk assets. Economics and financial markets are especially self-referencing. We can talk our way into a recession as corporates and individuals change their behaviour in anticipation of behaviour changes by others. Financial markets have their own version of this – played out more rapidly and more violently as every piece of data is pored over and no-one wants to be last to the party.

Trying to out-guess the market in a competitive round of 'who's the most afraid' or running after the rally in the fear of missing the up escalator is an exhausting and typically unrewarding process. So at least for bond investors we can go back to the reassuring hard parameters of fixed income maths and hope it will provide some certainty in what is currently a very uncertain world. So what, indeed, as corporate bond investors, should we be fearing? Or are we jumping at shadows?

In essence it's always the spectre of defaults we fear – of absolute losses resulting from coupons or capital not repaid in full. In return for this possibility we get paid a 'risk premium'. During the month of August the risk premium for high yield credit exceeded 7% over swaps. That is a lot of compensation – you would still breakeven if 10% of all high yield issuers defaulted in the next 12 months, repaying only 40% of the face value of their bonds. If they repaid only 20% of face value, the breakeven default rate would still be a relatively comfortable 8%.

To put this into context, Moody's latest default forecast puts 2012 expectations at around 2%. More aggressive reductions of GDP expectations might push that up to 4%, still only half what is discounted at current yields. The popular Credit Default Swap index, known as the 'cross-over', has an aggregate credit quality higher than the universe it represents, and at current spreads compensates an investor by more than twice what would be needed were we to see a repetition of 2008/09, the worst default episode of recent history.

So it does seem some irrational terror is being priced into corporate bonds at the moment – fear of fear is eclipsing the sanity of bond maths. In such a world we begin to feel cautiously optimistic – there is a bumpy road ahead with many unresolved issues – especially in the sovereign arena but in high yield credit there are starting to be real opportunities - for the rational investor.

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

OLD MUTUAL ASSET MANAGERS

Please see important information overleaf

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

OLD MUTUAL ASSET MANAGERS

Important information: Past performance is no guarantee of future results. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested. OMAM has no house market view and opinions expressed are the views of individual fund manager(s) as at the time of writing. These views may no longer be current and may have already been acted upon. Any underlying research or analysis has been procured by OMAM for its own purposes and may have been acted on by OMAM or an associate for its or their own purposes. OMAM is the appointed investment adviser for Old Mutual Fund Manager's in-house OEIC funds. Old Mutual Asset Managers is the trading name of Old Mutual Asset Managers (UK) Limited and Old Mutual Fund Managers Limited. Old Mutual Fund Managers Limited, 2 Lambeth Hill, London EC4V 4AD. Authorised and regulated by the Financial Services Authority. A member of the IMA. Old Mutual Asset Managers (UK) Limited, 2 Lambeth Hill, London EC4P 4WR. Authorised and regulated by the Financial Services Authority. Telephone calls may be recorded for security purposes and to improve customer service. 08/11/U5991