

Investment update

25 November 2011



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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.

Back to the real economy

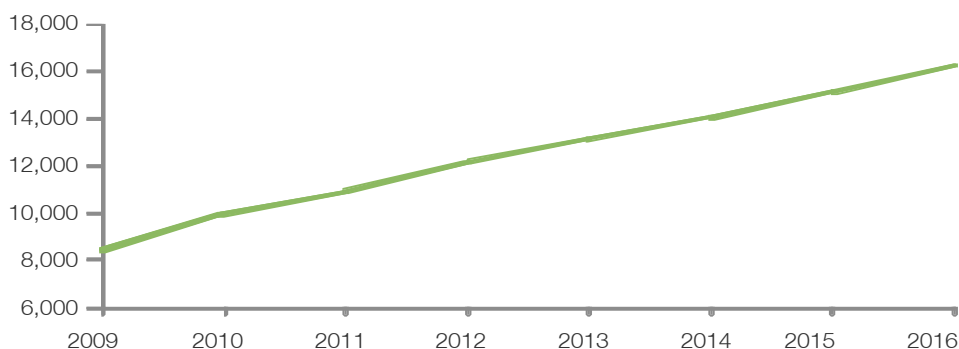
Government and bank debt is the problem, not the solution. If you want safety, follow the money - to large corporates

In the past - that faraway place! - investors looking for safety moved first to banks and, when things got really bad, into governments. Is it time to stop rushing for refuge into burning houses? The evidence would suggest that it is the 'real economy' - large businesses with a manufacturing base or a meaningful service offering - that are most likely to provide reliable real returns over the medium to longer term.

No more Mr Risk-Free

The concept of 'risk free' ended in New York on 5 August 2011 when Standard & Poor's downgraded the general government debt of the United States. It was largely symbolic, but it highlighted a shift away from the paradigm of sovereigns, investment grade and high yield each having their allotted place on the risk spectrum, a favoured time in the economic cycle. Now everything is a credit. Every debtor needs to be judged on its merits.

Figure 1: US Federal Debt



Source: IMF

Core sovereign bonds - as issued by the US, UK, Germany, Japan, France - performed strongly in 2011, despite that on fundamental measures, such as net debt to income or income security, they have little if any value. They performed for two reasons. One is that they have a legacy reputation as 'safe-havens' and in a difficult market investors felt the need to move quickly. The other is the tight seller's market created through massive state intervention in the form of quantitative easing.

No one expects the core sovereigns to default in the short to medium term, but given their vast indebtedness there is clearly significant political risk. Even David Cameron admits that reducing the UK deficit is proving much more difficult than anticipated, and his coalition has made little practical progress. The Congressional 'super-committee' charged with identifying cross-party solutions to the US federal deficit achieved nothing. In Germany, which has a good fiscal balance, a recent auction of government bonds struggled to raise two-thirds of the €6 billion on offer.

In return for the 'safety' of their bonds, core governments offer low to negative real yields. In the UK, inflation is 5.5% relative to a 10-year gilt yield of 2.2%. The equivalent figure in the

US is only mildly more attractive. Inflation in Germany is 2.9% relative to a 10-year yield of 2.3%. Japan is the only major state still paying a positive real yield, and it has public debt at 230% of GDP.

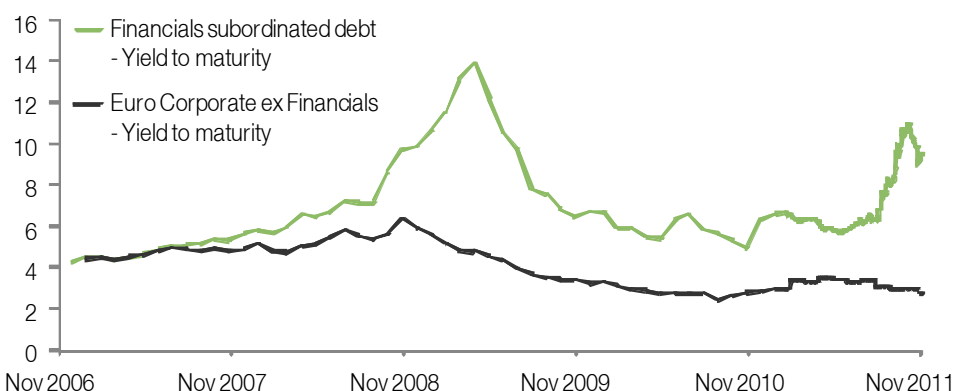
Don't bank on it

If there is no more risk-free, a meaningful number of banks, certainly in Europe but quite possibly worldwide, are already insolvent. In the last round of stress tests conducted by the European Central Bank, banks were allowed to count as capital sovereign bonds, with the exception of Greece, at nominal value. Real time prices tell us every moment that that is not true for Italy, Spain or France, nor it would now seem even for Germany.

It is a truth no one seems to wish to confront, but behind thin veils of euphemism, it is changing the way fixed income markets operate. A week before the German government bond auction, Banco Santander tendered for a Tier Two bond issue. The terms were draconian. By my calculation, investors would have to forgo what would have been, at market prices, a 25% total return from the previous day's price to the earliest call date. The alternative was to be left with a piece of paper paying 1.4% over Euribor until 2017, in other words, close to nothing.

In an area of the markets rarely if ever disturbed by outside interest, the Daily Telegraph reported 'accusations' levelled by credit analysts and the Association of British Insurers threatened legal action. The suspicion spread that Santander faced 'problems' unknown to the market. What was really surprising was that Santander threw its reputation to the wind to save an amount that would have little impact on its balance sheet.

Figure 2: Banks pay more



Source: Barclays Capital

Like the US downgrade, the Santander deal is emblematic of a much wider sickness. Banks and states are gripped in a devils' dance. States own bank equity and banks own state debt. Banks depend on the state, by way of monetary authorities, for their liquidity. They may not admit their poor solvency, but they have all but ceased lending to each other.

Since the collapse of Dexia, banks have queued to make their bond-holders offers they can't refuse. It is being called 'liability management' but it is a form of default. The rules that once applied are no longer relevant. Once the state is involved regulation can be re-written, as can the law. Where politics is concerned, etiquette is brushed aside.

Back to the real economy

A revealing exercise is to compare the Federal Government of the United States, Banco Santander and Jaguar Land Rover. Looking at the numbers, the question immediately arises

- why is the US a safe-haven while JLR is rated 'speculative' by both Moody's and Standard & Poor's? The second question needs to be - why is JLR, and many other similar companies, in such an apparently good position when the rest of the economy is so evidently struggling?

	USA	Jaguar Land Rover
Net Debt	USD 10 trillion	Nil
2011 profit/(loss)	(USD 1.4 trillion)	USD 1.6 billion
Net debt to income	80%	N/A
Recent Credit History	Down	Stable
Credit Rating	Aaa / AA+	B1/B+
10 year yield - nominal	2%	8.9%
10 year yield - real	(2%)	3.4%

Source: Bloomberg; IMF; JLR annual report 2010/11

Conventional wisdom tells us that a business like JLR, an old economy manufacturer rated sub investment grade, should be a high beta proposition, sensitive to every economic twitch. We should be looking to the federal governments of the US and Germany for safety in a downturn, not to a car-maker based in the Midlands and owned by an industrial conglomerate headquartered in Mumbai. But that is surely not what is in the numbers.

A significant proportion of the current public debt in the UK and the US results from the massive 'bail outs' of 2008 and 2009. The purpose was to avoid recession, sustaining employment at a level thought to be the minimal necessary for political expedience. Since then, central banks have assumed responsibility for interest rate risk, keeping yields low through quantitative easing, in the process hugely expanding their balance sheets and adding to the gridlock besetting what has become a political-financial debt complex.

Banks, the supposed beneficiaries of both the bail outs and QE, and the targets for much political discontent, in fact became entangled in public debt and have now been forced, as we have seen, into a process of aggressive re-capitalisation and re-regulation. This leaves them with little flexibility to lend and their own clients, individuals and SMEs, are withering under what has now become a prolonged and severe shortage of credit.

Large companies, by contrast, such as JLR, which don't need banks because they can access capital markets directly, have found themselves in an exceptionally good position. Protection from recession risk has brought default rates to historic lows, with the best forecasts indicating that they are likely to remain at below average levels. Interest rate protection has ensured that their cost of capital is negligible. In many cases, they are companies which have been able to move their operations to economies with the lowest costs while focusing their marketing on those with the highest growth. The result, as we see, is strong free cash-flow and an accumulation of substantial spare capital.

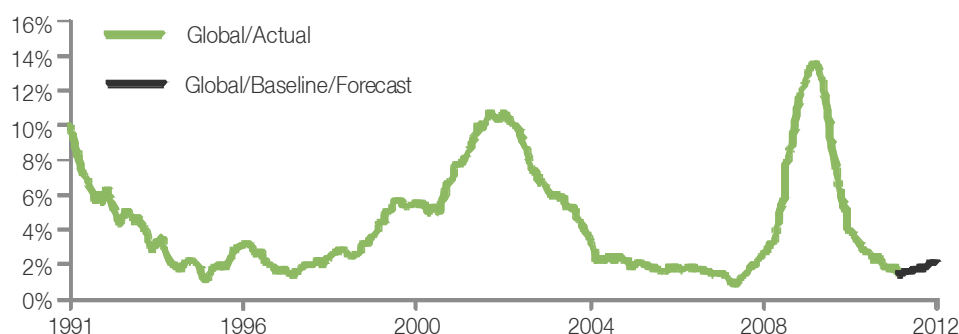
By a strange intorsion, investor sentiment and political expedience have combined to ensure that while absolute yields are low, spreads are historically wide. For those investors prepared to take on the supposed risk of corporate bonds, the result could be excellent returns in both absolute and relative terms, with a fair 'margin of safety' - safety reflected in financial accounts rather than political promises.

Other than under the somewhat broad rubric of 'real economy' there is no simple definition of these company's defining characteristics. They are unlikely to be dependent on home market

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consumers, such as high street retailers, but they include domestic businesses, such as cable companies - Kabel Deutschland or Virgin Media - supplying broadband services increasingly considered essential. They also include companies such as JLR or BMW whose home markets are relatively resilient to economic stress. They certainly include companies like LVMH, able to provide a low level access to 'luxury'. Others might be CNH, which makes agricultural machinery, Smurfit Kappa, the packaging business, or Kuka, a German machine-tool maker. They also include companies that might be characterised as 'survivors' - those with the products, revenues, assets, credit, management and strategy to weather even the most extreme economic crises.

Figure 3: Default rate



Source: Moody's Investor Services

However you define them, as an indication of the potential investment universe, there are over 3000 companies in the MSCI World Index. These are companies of global scope, headquartered and regulated in developed economies. Most of them will issue some form of debt in one or more of the major reserve currencies. There is, in other words, a very wide and liquid pool in which to select corporate fixed income investments.

A point not always sufficiently emphasised by fixed income professionals is the granularity of bonds. Buying a corporate bond is not like buying an equity. You are not buying the company and its entire destiny. A bond is an individual instrument with precisely covenanted characteristics, with a contractually fixed payback and a defined, transparent place in the issuer's capital structure. If nothing else, you know where you are.

As strategic investors we understand that fundamentals are not always the primary drivers of asset values. Quantitative easing may be an artificial distortion that will eventually need to be abandoned, such is its cost. But it is a reality while it lasts. Sentiment may or may not be well-founded, but it ultimately determines what investors will pay for an asset on any particular day. We also know the truth will out and that, at some point in the future, fundamentals will come back into the foreground.

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