Investment update

20 December 2011

Christine Johnson, manager of the Old Mutual Dynamic Bond Fund and Old Mutual Corporate 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.

Finding the 'sweet spot' in 2012

Global, real economy businesses are in a strong financial position – and paying high absolute yields. If you are looking for an attractive, lower risk return in 2012… follow the money

Every economic cycle is different. A characteristic of the developed world as we now know it is huge state debt. A significant proportion of this was accumulated bailing out banks, which had become bloated through a prolonged episode of expanding credit to consumers and to small and medium-sized businesses.

States and banks have become locked into an uneasy but apparently inescapable patron-client relationship, struggling to cope with debt on one side and inadequate capitalisation on the other. Their own clients, individuals and small and medium-sized enterprises, are being forced to bear the cost through higher taxes, as governments seek to raise revenues, and stringent credit conditions, as banks cut back lending, whether for mortgages or business finance.

The only segment of the economy outside the vicious circle is large corporations, which have been able to shift their operations to economies with the lowest costs and their sales to regions with the highest growth. In many cases, they are in command of significant free cash-flows and increasing accumulations of retained earnings.

In the past, investors looking for safety moved first to financials and, when things got really weird, into governments. Is it time to stop rushing for refuge into burning houses? Should we not reverse our thinking and follow the money? The evidence would suggest that it is the 'real economy' – large businesses with a manufacturing base or a meaningful service offering – that is most likely to provide reliable real returns over the medium to longer term.

One example, from a corporate bond point of view, might be GE Capital. One of its current bonds is A+/Aa3 rated, callable in September 2017. Denominated in sterling, its current yield is 9.7% which, discounting the latest CPI figure of 4.8%, leaves a real yield of 4.9%. This is a company with a net income in 2010 of USD11.6 billion and an earnings to interest cover of nearly 10 times. Compare that to a 10-year gilt yield of 2%, which on the same discount for inflation gives you a real loss of 2.8%.

Where will it end?

It is possible that we will move to a deep global recession and that the benign conditions being seen by global corporates will reverse. It is possible, but unlikely. At a macro level, the two key current issues are developed world government debt and developing world inflation, especially in China, of which inflation in the UK and US is in some measure a knock-on effect. On this basis, the most probable medium-term future will be a variation on one of two scenarios:

- Limited recession in the eurozone or more broadly through western Europe, with a slowdown in recovery in the US and Japan but continued higher rates of growth in emerging markets

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

- More generalised global slowdown – but not recession – again with the US less affected and emerging markets relatively robust

In almost any scenario – other than a rapid return to global recovery – there is likely to be a degree of disinflation (that is, low or falling inflation) through the short to medium term. If there was a serious recession, the current strong financial position of global non-financial companies would provide a meaningful shield, quite probably more effective than anything available to our vastly-indebted governments.

In either of the more likely scenarios, large corporations could be expected to prosper – as they would in a rapid recovery – and by historical measures the real return on their bonds would be among the best-performing assets. Given they are already in good financial form, even a low level of growth should keep down default rates, while disinflation means that, in real terms, each coupon is worth a little more than the last.

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. 12/11/U6226