Baillie Gifford™

Strategic Bond
Q2 investment update

July 2024

Investment manager Robert Baltzer and investment specialist Sandy Jones give an update on the Strategic Bond Strategy covering Q2 2024.

Your capital is at risk. Past performance is not a guide to future returns.

Sandy Jones (SJ): Welcome to the Q2 2024 update for the Strategic Bond Strategy. My name is Sandy Jones. I'm an investment specialist in the Income Team, and I'm joined today by Robert Baltzer, co-manager of the Strategy.

As a reminder, this is a global best ideas corporate bond strategy. We seek to add value through bond selection and active management of portfolio credit risk. We're going to talk about performance, positioning, and some new ideas.

Robert, the strategy performed strongly in the second quarter of 2024, and that's despite rising government bond yields. Can you explain what's been going on in markets and give a sense of what has been the key driver of that relative outperformance?

Robert Baltzer (RB): Absolutely. So, as you say, government bond markets did increase slightly during the quarter. I think that's as the hopes of the most optimistic investors, in terms of interest rate cuts, were perhaps dashed, expectations disappointed. The likelihood appears to be that interest rates here in the UK, but also in the US, for example, will stay at current relatively high levels for a bit longer. Central banks are very keen to push that inflation genie back into the bottle and are waiting for concrete signs of success before they start to lower interest rates.

To give some context to the scale of that performance, UK government bonds delivered -1% returns in the quarter. US and German government bonds, also important markets, didn't do a great deal better. Corporate bond spreads, that's the extra yield that corporate bonds pay you for the risk of lending to companies rather than to governments, those spreads held fairly steady over the quarter at relatively low levels.

We have seen strong demand for corporate bonds and good fundamental performance from the companies issuing them. That steadiness and spread, that extra income, allowed corporate bonds to outperform government bonds over the quarter, particularly high-yield bonds because of the higher income, but also because they're less sensitive generally to the movements in government bond markets. So, US high-yield bonds delivered +1% and European high-yield bonds close to 2% returns.

The Strategic Bond Strategy performed well in this context, helped by the high-yielding holdings that we have, also by the continued recovery in the European real estate sector, a sector we've talked about in the past, and from the stock picking in the portfolio. So, some of our biggest holdings, such as CPI Property and Admiral, delivered really well in the quarter.

SJ: So, taking a step back, looking at the corporate bond market as a whole, returns have really been flat over the last three months. It strikes me that the market's really in a consolidation phase at the moment. Does that seem like an appropriate characterisation to you?

RB: I think that's a really good way of summarising the current situation. So, in government bond markets, I think people are anxiously watching the economic data for signs around the path of inflation and what central bank policy will be. They're also keeping a hawkish eye on what's happening in the electoral cycle. We're in a busy electoral year this year, and there could well be changes to spending plans and fiscal policies that could be impactful for government bond markets here in the UK, and in many other places in the world. So, there's perhaps that nervousness, that apprehension in government bond markets. Corporate bond spreads are holding steady, but they are relatively low. I think some of the easy gains have been made. So really, it's about delivering income from here.

SJ: So really, momentum has started to slow in corporate bond markets. What does that mean for portfolio strategy looking ahead?

RB: So, there are two things that we're trying to do in the strategy. Firstly, is to focus on delivering low-risk income wherever we can, and then making sure there are positive catalysts behind any of the longer-dated holdings that we have, which can drive capital appreciation without relying on a broader market backdrop.

So, the lower-risk income that I'm talking about, for example, would include bonds that are short dated. I mean, those with a maturity of three years or less. That provides a really good natural source of liquidity to the portfolio, which we're continually recycling. So, companies often will buy their bonds back early. We've seen that happen. That can boost what might be otherwise lower yields. We've also benefited a lot from our holdings of so-called Additional Tier One bonds, AT1 bonds, that are bank capital instruments, which pay a high income because of their subordinated nature. We've focused on bonds that have a really strong incentive to be redeemed at the first opportunity and that incentive is because leaving those bonds outstanding would lead to a very high cost for the bank.

Over the last year that's delivered really well and where we can we're trying to recycle into the next phase, the next wave of those opportunities. We've also been buying non-financial holdings with one or two years to maturity at attractive yields from the likes of WH Smith, the retailer, and Burberry, the fashion brand.

SJ: So, one area of focus has been recycling out of short-dated bonds that are maturing into short-dated bonds that offer more attractive income potential. You also mentioned positive catalysts in our longer-dated allocations. This is an area where we typically seek to add value for clients. Could you give some insight into a name in that segment of the portfolio?

RB: Absolutely. So, to give context here, the longer-dated holdings that we're talking about typically have between five and ten years to maturity. And what we're looking for to drive some price appreciation is a de-risking story. So, where something that is concerning investors today is an issue that's likely to improve in our view. And that's true whether we're talking about bonds purchased in the new issue market or bonds purchased in the secondary market, those that are already outstanding.

SJ: I think it'd be useful to talk about an individual name in a bit more detail. One new issue that we purchased in the last quarter that caught my eye is Brightline East. This is a privately owned rail operator, a passenger service between Orlando and Miami. The first question that sprung to my mind when I saw this holding for the first time is, do Americans really take public travel or public services in between cities?

RB: Yes, we think they will, or at least on this route, we're confident that they will. But your question is a fair one, because Americans, typically, their intercity travel habits are dominated by road and by air travel, and intercity rail is quite an uncommon method of travel in the US at the moment. Florida in particular has gotten pretty congested because of growth in the population in Florida and the increasing visitor numbers. So those road and air routes are pretty unattractive. They're very busy currently. This new route opened up by Brightline East provides additional capacity. It's quicker than either of the other two routes. It's convenient because it takes you right from Orlando Airport into the heart of Miami, and it's cost competitive.

So, while it's a perhaps novel concept for an American audience and traveling public, we do think this is going to take on. It's quite a new project. While the construction is complete, it's only been in operation across its full length since September of last year. And there's a degree of wariness, I think, from American investors in particular about this project.

So, when they issued bonds, they issued them with an 11% coupon, a really attractive yield. And we've actually been able to buy more at slightly better yields again. The ramp up for a project like this, which has been seen in similar projects elsewhere in the world, typically takes a couple of years for people to change their travel habits, to adopt this new route. We think patient investors will be really well rewarded here.

SJ: So, the first key takeaway is that Americans do take public transport. I think that's a good point to finish. So, in summary, the portfolio has outperformed its index over the last three months with the primary driver of relative performance, bond selection. The strategy continues to out-yield its index. And finally, the strategy is full of potential. We've heard about Brightline East. This is just one example of an individual name that holds the potential to add significant value through bond selection in the Strategic Bond Strategy.

Thank you for your time.

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Strategic Bond

Annual past performance to 30 June each year (net %)

	2020	2021	2022	2023	2024
Strategic Bond Composite	3.0	6.9	-15.1	-1.7	11.4
Strategic Bond Benchmark*	4.3	4.9	-13.2	-2.2	10.5

Annualised returns to 30 June 2024 (net %)

	1 year	5 years	10 years
Strategic Bond Composite	11.4	0.5	3.1
Strategic Bond Benchmark*	10.5	0.6	2.9

*The composite's benchmark is composed of the following: 70% ICE BofA Sterling Non-Gilt Index, 30% ICE BofA European Currency High Yield Constrained Index (Hedged to GBP). The benchmark is re-balanced quarterly.
Source: Baillie Gifford & Co and ICE. GBP. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

Past performance is not a guide to future returns.

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