STRATEGIC BOND
Q2 INVESTMENT UPDATE

Investment specialist Sandy Jones and investment manager Torcail Stewart give an update on the Strategic Bond and Global Strategic Bond strategies covering Q2 2023.

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Sandy Jones (SJ): Welcome to the Baillie Gifford Strategic Bond Q2 2023 update. As a reminder, these are global best ideas corporate bond strategies. We seek to add value through bond selection and active management of portfolio credit risk.

My name is Sandy Jones, I'm an investment specialist in the income team at Baillie Gifford, and I'm joined today by Torcail Stewart, co-manager of the Strategic Bond strategies.

We're going to talk about performance and portfolio positioning today. Let's start off with performance. Can you give us an update on performance over the last six months?

Torcail Stewart (TS): Yes. Our strategic bond strategies are slightly behind benchmark year-to-date, and that has been caused by some spread widening among our investment grade corporate bonds. Now by spread, what do we mean? That means the extra yield compensation that one receives over and above government bond yields. We've also seen a little bit of poor performance among one or two of our high yield companies.

What we saw at the start of the year was some pressure on the credit markets, and what you tend to find is the strong company bonds selling off with the weak, but as results start to come through, the market begins to reappraise and recognise the differences. That's what we're seeing starting to happen now within the markets, which is positive. When we look at the fundamentals of the companies that we lend to, we remain quietly confident in their potential long-term performance.

SJ: You mentioned a couple of names that had underperformed over the last six months. I think it'd be useful to get a bit more insight into what's been going on at an individual bond level.

TS: Yes, so two of the company bonds that have reduced performance recently have been that of Ubisoft and AMS Osram. Now, Ubisoft is a gaming company. You may be aware of their long-term franchise in Assassin's Creed, and that's still been doing well. But some of its more novel, innovative, new games haven't landed as well, and indeed some of them have been delayed, like Skull and Bones.

Now, why do we remain positive on this company? Well, it's really because of its excellent liquidity. There's a huge amount of cash on the balance sheet. What that means is that it's really got the time to be able to turn around the business. Some of the most recent tentative signs have been quite positive. For example, XDefiant, one of their new games, has landed very well. When we look at the actual yield that's being offered on these Ubisoft bonds, they look absolutely excellent when you compare it with the long-term fundamentals and the backlog of games that they've been building to release to the market. We think that's one where if you're patient, it should play out in the long run.

Now, AMS Osram is a high yield company which is a combination of an Austrian business and a German company; AMS produce sensors and Osram are specialists in lighting solutions such as microLEDs. Well, it caters to cyclical end markets of autos and telecoms, and what we've seen over the last nine months is that a number of their clients have been running down inventories. That will eventually turn around, and they are guiding towards the second half looking a lot more positive as many of their clients have to rebuild those inventories. So once again, this is a business on a high yield, but we can see that when we look at the fundamentals, there's a way out for this company, it is going to do better, we think, in the years ahead, and that should be positive for the bond price.

SJ: So, some challenging positions, but you remain confident in those. I know that performance has ticked up over the last couple of months. Could you tell us what's been going well?

TS: Yes. We've seen a number of our high yield companies starting to pick up a canter, pick up tempo. One, in particular, would be the likes of Marks & Spencer. We've seen resilient sales and EBITDA (Earnings Before Interest, Tax, Depreciation, and Amortisation) margins coming through, which is positive for the bonds. Also, Paymentsense, a payment processing company based in the UK with a wonderful low-cost offering. You may have come across their Dojo payment terminals, which are becoming increasingly ubiquitous across the UK. As its sales have been growing, we've seen leverage coming down, which has been positive for the bonds.

Another one is that of Cellnex, a European tower consolidator. It is a company that has good cash credentials. It's also been reducing leverage, and indeed it's what we term a "rising angel", which means we think it's going to get its composite, its overall rating, up to investment grade. Indeed, it's on a "positive outlook" by S&P just now. Should that occur, we think it should be very positive for the bonds.

Now, overall, we have had a bit of performance weakness recently, but what has been one of our key learning points from the Covid crisis is that the bar for companies getting into our portfolios is actually very high. A number of the businesses we lend to are actually very resilient, and what we found in the Covid crisis, and what you generally find with good quality businesses, is that their owners tend to, stump up capital and support them in their times of need.

But also further a learning point is that when you look at cyclical areas, demand and supply eventually does rebalance. You just have to have the patience to see that play out. The bad times don't last forever in that sense. So, we are seeing certain sectors where they have their own little microcosm of a cycle going on, and we should see that improving going forward in the likes of AMS. The key is really focusing upon those fundamentals and having the patience, and we think that will ultimately be quite rewarding for many of the bonds within our portfolio.

SJ: Patience has been a really important part of our philosophy in corporate credit. I'd like to turn to talk about portfolio positioning now, very keen to get your views on current valuations in the market and how has that been impacting portfolio positioning.

TS: We've started to see credit markets beginning to rally. When we actually look at where investment grade spreads are, and when we also look at the yields (because that's the key thing to look at just now) we see there's quite a dichotomy between spreads and yields. Investment grade spreads are around average levels relative to history, whereas if we look at high yield spreads, they're actually inside their average levels relative to history. So, it doesn't look that compelling on the spread level. But when we look at absolute yields, the absolute yield in investment grade, particularly in "BBBs" (the lowest rung of investment grade), is at the highest yield level since the Global Financial Crisis. If we look at high yield markets, the current yield has been reached a couple of times, so it's not as compelling.

So, what does that mean? Well, it really means that the opportunity cost of not owning high yields is actually very low just now. It's quite a good idea to move up the capital structure because you're being compensated well. And so, what we've been doing within our portfolios, as we've seen this spread rally occurring, is that we've been reducing risk. We've been moving from high yield into investment grade credits. We now have a lot of dry powder within the portfolios. Indeed, we have around about three-quarters of the portfolios in investment grade credits. And if you look through that, half of it is in "single-A" and above-rated credits. "Single-A" and above is the best portion, the highest calibre of investment grade.

What is also intriguing is that the yield on these strategic bond strategies is above the benchmark. What does that tell us? It tells us, really, that in spite of not taking default risk, the yield compensation is high because the market isn't recognising the true fundamentals of those businesses.

SJ: Let's take a step back and talk about high yield in isolation. It's interesting to me that high yield has been rallying recently. I would have thought with interest rates going up and the cost of financing being higher, that would have negative implications for those more highly leveraged corporates. What's driving that rally in high yield?

TS: It's an excellent question, Sandy, and really it relates to some of the things coming out of the Covid crisis. One of the key reasons is the fiscal stimulus that went through. What people did during that time was pay down their debts, and so leverage fell. We also saw a rise in labour bargaining power. Why was that? Because a number of people approaching 50 decided to retire. We also saw, sadly, reduced worker productivity because increases in Long Covid came through.

Countering that, we also saw people coming out of Covid and spending. They were out, and about, they wanted to enjoy themselves. We saw a substantial amount of spending occurring. That resulted in economies being more buoyant than many anticipated. But spending can't go on ad infinitum. Savings have a limit. And also, we've seen one of the fastest pieces of rate hikes in the last couple of decades.

Now, as we know from the past, those rate hikes will bite eventually, and those will slow the economy, and it will cause spreads to rise, particularly for those more indebted companies. And really, when that occurs, bond selection has to be excellent because then you're having to navigate a higher default environment.

SJ: That provides a neat segway to talking about the strength of individual positions in the portfolio, individual companies. Are you happy with the shape of the portfolio?

TS: Very positive about the shape of the portfolio, Sandy. We've gone through each of the key areas to make sure that they are resilient in the face of potential future pressures. A good example of that would be the property sector, which, as we know, is under pressure these days. We sent our analyst Nektarios out to both Prague and Berlin to look at a company, CPI, to kick the tyres effectively and see what the quality of the assets were. From his research, it was quite helpful to see that the asset quality is sound and that the company has the ability to shore up its balance sheet through asset sales. And yet, we are lending to the senior bonds of that company on double-digit yields. So, we're being really handsomely compensated by lending to that business, and yet the fundamentals are sound, we can see a way for it to improve its balance sheet going forward.

SJ: So very confident in the company fundamentals of positions in the portfolio. Did any new ideas make their way into the strategies over the last three months?

TS: Yes, a rare issuer from not very far away from Edinburgh (their HQ is over in Glasgow), is Weir Group. That's the multinational engineering company that specialises in pumps for the mining sector. It's a business that is cash generative and has a good track record of running with a conservative balance sheet. Indeed, it's also on positive watch at Moody's, so there's a potential for the bonds to do well through an upgrade.

The pipeline of new ideas coming from the team just now is really second-to-none. We're getting a wonderful choice of new ideas to put into these strategies.

SJ: That’s a very, very positive note to finish on. In summary, there have been some challenging positions in the portfolio over the last six months, but the key message is that we remain patient and very confident in the company fundamentals of those individual portfolio constituents.

From a top-down perspective, we favour investment grade over high yield where we think there’s a better relative value opportunity, and we're positioned underweight in high yield as it stands. The other key point is that the funds continue to out-yield their respective indices. Anything to add?

TS: We’re very positive on the trajectory of the fund. One just needs the patience to see some of those positions play out.

SJ: Thank you very much for your time, Torcail, and thank you for joining us.

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

	2019	2020	2021	2022	2023
Strategic Bonds Composite - GBP	6.2	4.3	4.9	-13.2	-1.7
Strategic Bond Benchmark* - GBP	7.3	3.0	6.9	-15.1	-2.2
Fixed Interest Global Strategic Bond Composite - USD	8.9	6.8	8.1	-15.4	2.5
Global Strategic Bond Benchmark** - USD	9.3	5.7	5.4	-13.4	3.9

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years
Strategic Bonds Composite - GBP	-1.7	-0.3	3.1
Strategic Bond Benchmark* - GBP	-2.2	-0.3	2.8
Fixed Interest Global Strategic Bond Composite - USD	2.5	1.8	3.2
Global Strategic Bond Benchmark** - USD	3.9	1.8	3.0

*Prior to 30/06/21 the composite benchmark was ICE BofA European Currency High Yield Constrained Index (Hedged to GBP).
**The composite's benchmark is composed of the following: 70% ICE BofA Global Corporate (Hedged to USD), 30% ICE BofA Global High Yield (Hedged to USD). The benchmark is rebalanced daily. Prior to 15/01/21 the composite's benchmark was Bloomberg Barclays Credit (Hedged to USD)

Source: Baillie Gifford & Co and ICE. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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0723 Strategic Bond Q2 update
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