Baillie Gifford™

Strategic Bond
Q3 investment update

October 2024

Investment manager Robert Baltzer and investment specialist Sandy Jones give an update on the Strategic Bond Strategy covering Q3 2024.

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

Sandy Jones (SJ): Welcome to the Q3 2024 Strategic Bond update. My name is Sandy Jones. I'm an investment specialist in the Credit team, and I'm joined by Robert Baltzer, co-manager of the strategy.

As a reminder, this is a global best-ideas corporate bond portfolio. We seek to add value through bond selection and active management of portfolio credit risk. We're going to talk about performance, positioning, and give you an update on the insurance sector, which we're excited about at the moment.

Welcome, Robert. Let's start with performance. Q3 will have been quite uncomfortable for a lot of investors, with market sentiment shifting between soft landing and hard landing for the US economy. We saw lots of volatility in August. In this context, can you tell us what happened in corporate bond markets and how the strategy performed?

Robert Baltzer (RB): You're absolutely right. It was an interesting quarter across the piece. We actually saw good performance from the corporate bond market with a return of around 2.5% . And our strategy, which was slightly risk-facing relative to our benchmark, performed slightly ahead of that. Those moves were driven largely by falling government bond yields, which lifts prices of bonds. The spread on corporate bonds, that risk premium, went roughly sideways over the quarter. But it did mask intra-quarter moves.

So, the start of August saw some really sharp falls in equity markets triggered by a divergence in interest rate policy between the US and Japanese central banks, which is quite an arcane cause. But the impacts were real. So, the Japanese equity market at one point was down nearly 20% in a matter of days. And other markets fell in sympathy with that. That though was recovered just as quickly. And as we sit here today, we've passed a few weeks of record levels of corporate bond issuance.

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So, the market has shrugged this off and taken it in its stride. Those high levels of issuance have been really well absorbed. There's been strong demand for them, and yields have continued to fall towards the end of the quarter.

SJ: So that's the really important point. The corporate bond market continues to look really healthy. That provides us with a neat segue to move on and discuss portfolio positioning. If I was to summarise our view, it's that the backdrop for corporate credit is likely to continue to remain supportive. So, growth has started to slow, but we're still in a growth environment. And the Federal Reserve has started to cut interest rates.

In that context, can you give us an overview of current portfolio positioning?

RB: Sure, so with that fairly benign backdrop, as you've described, the strategy is positioned in quite a typical way. So, our setup is to be heavily invested in what we consider to be the sweet spot of credit markets, either side of the investment rate and high yield boundary.

So around 60% of portfolio assets are in BBB and BB-rated bonds, which provide attractive yield and where we find a lot of our winners over time have come from. We also have around 10% of assets in single B-rated bonds. Having had a bit of a dearth of issuance over the last couple of years, this year the market sprung back to life.

We've been able to diversify the portfolio and ad yield with attractive issuers like Kiko Milano, an Italian cosmetics retailer, and BestSecret, which is a German members-only off-price fashion website. In addition to those core return-generating parts of the portfolio, we have dry powder in the form of higher-rated bonds, which are very defensive, and then short-dated bonds, which currently provide attractive levels of yield with really very little risk.

SJ: So, if I was to take a step back and summarise current positioning, the strategy's positioned relatively neutrally, but continues to outyield the reference index, and that's driven by an overweight to BBB- rated investment grade bonds.

I'd like to move on and talk about valuation opportunities. The market backdrop is very supportive. That's reflected in valuations. So, I think the question a lot of clients are going to be asking is, can you find attractive valuation opportunities in this market? The answer is very much yes. So, we have recently added to UK water utilities. This is a sector that's under pressure. Can you outline the opportunity there?

RB: Sure. There shouldn't be an opportunity in the utility sector. Its raison d'etre is to provide core infrastructure and to do that in a well-managed way with a low cost of funding. Historically, that's what it has done. That means there's not typically a lot to go for as a bond investor in the sector. We started this year with no investments in the UK water sector, for example. However, the woes of the weakest name in this market, Thames Water, have really brought things to life. So, it is financially stretched. It has been operationally underperforming for a number of years. And the whole sector is under scrutiny just now as it has a periodic five-year review process ongoing.

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We looked very closely at the sector earlier this year from top to bottom and remain uncomfortable with the outlook for Thames specifically, but also one or two of the other weaker positioned companies in the sector. That being said, this is a sector that will survive where the basic framework I think will come out intact and it's easy to identify the stronger companies too.

The baby has been thrown out with the bathwater here to some extent. So even the strongest companies in the sector have seen their bond spreads widen. That's where we have added, so far we've dipped our toe in the water, just over 2% of assets in a couple of the stronger names in the sector.

SJ: So as you say, this is really a case of the strong selling off with the weak in a sector that's under pressure, creating an attractive valuation opportunity in resilient companies. So, these are characteristics that we're looking for.

I'd like to move on and talk about another sector that's close to your heart, insurance. You were recently at a conference, you came back very enthusiastic. This is a position that's quite large in the strategic bond strategy. Tell us more.

RB: So to provide context, the insurance sector makes up around 12% of strategy assets today and is a longstanding favoured sector for us. Our insight here is, I think, to act against the reflexively negative instinct of investors generally towards insurance. I think that comes from the fact that insurance companies exist to take risk, to absorb risk from you and I as individuals, from companies, for a fee. What that means is anytime anything bad happens in the world, the natural question as you look at your portfolio is, well, who's exposed? Which companies might suffer? And when you look at the insurance sector, the answer is often lots of companies in that sector will be exposed to the bad things that are happening because it's their job to absorb risk from the rest of the economy.

Where I think they don't get enough credit is for actually the very good job that the large, diversified insurance companies have done over the years of managing these risks. So, I've been looking at these companies for more than 20 years and I've been consistently impressed with how they've navigated very different environments, lots of difficult events. Interest rate movements would be a great example here for life insurance companies in particular. That's a big swing factor. And we've seen a protracted fall in government bond yields over many years, which caused a lot of angst. More recently, we saw a big uptick in bond yields. And in both cases, actually, those risks have been well managed, as proven by resilient capital positions.

I was at a conference last week. I saw a number of life insurers, non-life companies, and reinsurers. And the message from all of them, I think, was one of a sector in rude health, strong capital positions, good current levels of profitability, clarity on where growth is coming from, and a return discipline that I think is really welcome, probably helped by the adoption of the Solvency II regulation in recent years.

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And the best opportunities, I think, at the moment in the insurance sector are for companies taking advantage of pension buy-ins and buy-outs, even individual annuities making a comeback here in the UK. We are exposed to that through Phoenix Group, Legal & General, Rothesay Life, and Pension Insurance Corporation.

RB: Thank you, Robert. I think that's a very positive note on which to finish.

There are three key takeaways from this discussion. The first is that the strategy outperformed the reference index over the quarter as falling government bond yields drove total returns. Second, the strategy is broadly neutrally positioned in terms of credit risk, but continues to out-yield the reference index driven by an overweight to BBB-rated investment grade bonds. Finally, we continue to find attractive valuation opportunities. We've talked about holdings in the insurance sector and additions in the water utilities space. These are just two examples of positions that hold significant potential to add value for the strategy.

Thank you for your time, and if you do have any follow-up questions, please don't hesitate to get in touch with your Baillie Gifford contact.

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Strategic Bond

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

	2020	2021	2022	2023	2024
Strategic Bond Composite	2.1	4.0	-20.6	7.9	12.4
Strategic Bond Benchmark*	2.9	2.8	-20.0	9.1	11.1

Annualised returns to 30 September 2024 (net %)

	1 year	5 years	10 years
Strategic Bond Composite	12.4	0.5	3.2
Strategic Bond Benchmark*	11.1	0.5	3.0

*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: Revolution, ICE. sterling. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite. 1 year figures are not annualised.

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