Baillie Gifford™

Strategic Bond
Q1 investment update

April 2025

Investment manager Theo Golden and investment specialist Sandy Jones give an update on the Strategic Bond Strategy covering Q1 2025.

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

Sandy Jones (SJ): Welcome to the Q1 2025 Strategic Bond update. My name is Sandy Jones. I'm an investment specialist on the strategy, and I'm joined by Theo Golden, co-manager of the strategy.

As a reminder, this is a global best ideas corporate bond portfolio benchmarked against a composite index comprising 70 per cent investment grade bonds and 30 per cent high yield bonds. We seek to add value through bond selection and active management of portfolio credit risk. We're going to talk about performance, positioning, and dig into some of our best ideas.

Theo, welcome. Let's start with performance. Optically, Q1 2025 has been a pretty chaotic period in financial markets. In particular, we've seen the shine come off the Trump bump. How has the strategy performed in what's been quite challenging market conditions?

Theo Golden (TG): For sure. And great to be here. So, as you say, Sandy, I mean, credit investors could be forgiven for having whiplash after this quarter, after this massive swing from U.S. exceptionalism and Trump Nirvana to a tariff-induced kind of growth scare. I'm pleased to say that the strategy has performed well in the back of this volatility. We have outperformed the index, but we also delivered a positive total return. So, we're really chuffed about that.

So, what were the core drivers of this performance? Well, starting from the top down, as you say, the asset allocation, the real goal here was to protect the strong performance as some of those exceptional ideas started to feed through. And so, as Robert laid out at the end of last quarter, we've been reducing risk over time. We did that again in January. We used credit default swaps, which is kind of a very common derivative to adjust portfolio risk. And that really came to fruition at the end of the quarter as risk asset started to sell off on this kind of Trump uncertainty and the portfolio was in a good place to deal with that. So, it was about setting the right portfolio context to allow these exceptional ideas to generate the returns they deserved.

With that in mind, from the bottom-up perspective, maybe I'll highlight a couple of ideas that I think were really quite impactful. The first is Annington Finance. Again, a stellar year last year, and then bleeding into January, it also generated outperformance, and we've now closed that position. You've written a nice note on the website about what we did there.

And then maybe a second one is Aberdeen, a U.K. asset manager and competitor of ourselves. But it's underperformed in recent years, but then it got to mid last year and the valuation opportunity was quite exceptional. It's outperformed high-yield bonds and investors have reappraised what is essentially a well-capitalised business and a management team that is turning it around.

And the last one to highlight is Yorkshire Water. So, last year, UK water utilities, the absolute taboo of the credit market. We felt that that was kind of missing some of the nuance. We were seeing this kind of top-down avoid, but there were some interesting things below the surface. So, we didn't go out and buy Thames Water. We weren't comfortable with the risk. But what we did do is we went and bought Yorkshire Water, which did a new issuance in September and that came very cheap and it's performed very strongly and been a core generator Q1. And I really like that example because it's kind of, it's a good example of our kind of contrarian bottom-up approach at Baillie Gifford.

SJ: So, the absolute key message here is a really strong first quarter of performance driven by bond selection in quite challenging market conditions. Let's move on to talk about positioning and outlook. Perhaps you could start by giving a sense of how we form our market view and then move on to talk in a bit of detail about credit asset allocation in the portfolio at the moment.

TG: For sure. So, when we form a market view, as you know, we're thinking about three main anchors. Macroeconomic backdrop, so growth versus inflation in our core markets. The second is valuations, the most important thing. And then the last is company fundamentals. We're at this kind of weird juncture now where credit spreads, that extra compensation you get for buying corporate debt, they're very tight. But the all-in yields available to investors in the asset class are quite meaningfully attractive.

So, we're buying selective opportunities where we think we're getting an extra return in terms of yield for the unit risk that we're buying, but we're not chasing risk. And the reason for that is we're starting to get quite nervous about the U.S. macro backdrop. The U.S. is slowing, admittedly, from a very, very high point, but growth is moving back towards trend. And there are these kind of incremental downside risks coming out from the tail, out of the woodwork, which, for example, tariffs.

But then, equally on the European side, Germany's turned on the fiscal taps and we think that could be pretty supportive for credit. And then on the company fundamental side. Companies are robust.

They are in a good shape relative. There's a little bit of over leverage in pockets of the market, but we're avoiding them. But most can deal with some stress. So, all in, we're kind of selectively opportunistic, but remaining very disciplined.

On the asset allocation angle, we have moved very close in terms of credit risk, neutral, as we would say, to benchmark. We are underweight high yield because of the valuation picture. And we have a good amount of dry powder to deploy capital into any kind of market volatility. But investors should expect stock selection and the bottom-up ideas to generate the core of the outperformance, hopefully, over the next 12 months.

SJ: Well, let's move on and talk about those best ideas in more detail. This is a best ideas portfolio. You've recently become co-manager of the strategy, so I think it'd be very helpful to get some insight into the ideas that you're most excited about. One of the characteristics of the team is that all of our decision makers are also analysts. So perhaps you could start by giving some insight into a specific name within your sector coverage.

TG: Sure. So, I cover high yield diversified financials. And one of the ideas that I'd highlight there is Arrow Global. This was traditionally an old school debt collector buying debt on its balance sheet. And it's transitioning to a kind of alternative asset manager. It really underperformed last year in sympathy with the broader distress in the debt collection space. And we looked then and we got comfortable with what we saw. And primarily, we thought the markets were underappreciating the massive value that they had created in this asset management business.

Fast forward to now. I like to call it a fundraising machine. It's growing its AUM and it's growing the respective earnings from the management fee there. And trading kind of wide of sterling high yields, I think this is quite a compelling yield opportunity as we start to see management execute on what they plan to do.

SJ: So, a really good example of the strong selling off with the weak and providing us with an opportunity to lend to a resilient business at an attractive valuation.

Another hallmark of our approach is that we are sourcing ideas from across the credit team, investment grade and high yield. Perhaps you could give some insight, reasonably quickly, into some of the other best ideas that have made their way into the portfolio over the last quarter.

TG: For sure. So, two to highlight. Again, first is we wanted to refresh the event-driven part of the portfolio after Annington. We've bought Marston’s, which is a kind of UK pub estate where we think there's significant capital upside as they look to refinance their capital structure. We're very excited about that.

Another to highlight has come from our analyst, Leanna, in a name called Cheplapharm which is a European pharmaceutical. This company overstretched itself with M&A, saw operational issues associated with it, the market really didn't like it. The bond has underperformed. We took a look at it. We got comfortable. We see an operational turnaround in the next 12 to 18 months and we've taken a starter position. And we would expect that bond to be a strong performer at a 10 per cent yield, free cash flow generation, no near-term maturities. We're happy to be paid to be patient really.

SJ: That is a very positive note on which to finish. Thank you very much, Theo.

There are three key takeaways from our discussion. The first is that the strategy performed strongly in the first quarter of 2025, primarily driven by bond selection in quite challenging market conditions.

Second, the portfolio is neutrally positioned in terms of credit risk. It is underweight high yield in the context of high valuations and the potential for future volatility.

Finally, the portfolio is full of potential. We've talked about a number of positions today. These are just a few examples of individual positions in the portfolio that hold significant potential to add value through bond selection in the year ahead.

Thank you very much for your time. And if you do have any questions, please don't hesitate to get in touch with your Baillie Gifford contact.

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Strategic Bond

Annual past performance to 31 March each year (net %)

	2021	2022	2023	2024	2025
Strategic Bond Composite	14.1	-4.8	-9.3	9.0	6.0
Strategic Bond Benchmark*	11.6	-4.3	-8.1	8.1	4.5

Annualised returns to 31 March 2025 (net %)

	1 year	5 years	10 years
Strategic Bond Composite	6.0	2.6	2.9
Strategic Bond Benchmark*	4.5	2.1	2.5

*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.

Past performance is not a guide to future returns.

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