HIGH YIELD BOND FUND – MANAGER INSIGHTS

Rob Baltzer, joint manager of the High Yield Bond Fund, gives an insight into the performance of the fund, current market trends and the opportunities of the future.

The value of an investment in the fund, and any income from it, can fall as well as rise and investors may not get back the amount invested. Past performance is not a guide to future returns.

This film was produced and approved in December 2021 and has not been updated subsequently. It represents views held at the time of recording and may not reflect current thinking.

Rob Baltzer (RB): High yield bonds are debts issued by companies who judge by independent credit rating agencies to be somewhat less creditworthy than their blue-chip investment grade rated peers. They therefore pay investors more to borrow, offering the potential for higher returns.

The High Yield Bond Fund provides clients with access to our best ideas in global high yield bond markets. As we take stock of the market today, the recovery from the Covid-19 shock appears complete. We can see this in bond pricing, in bond issuance and in the level of defaults.

High yield bond prices have recovered from last year's lows and correspondingly the yields on offer on these bonds have fallen back to the levels we saw before the outbreak of the Covid-19 pandemic. Even bonds in the worst affected sectors by and large have fully recovered.

That's sectors such as airlines, airports, casinos, and cinemas. New bond issuance is strong and is being met by high investor demand. We're seeing a great variety of issuance and that provides a lot of really interesting opportunities for the portfolio.

The wave of defaults that investors worried about last year didn't materialise, in part due to the swift action by governments to support the economy. Defaults peaked at a fairly moderate level and have quickly returned to the low levels of recent years where they're predicted to remain.

The market's focus has switched from the hit to economic demand to the functioning of the supply side of the economy, where disruptions continue, they are very evident in the shops in the headlines, and they're expected to last into next year. Heavily impacted sectors of those such as logistics, whether that's international container shipping or domestic trucking.

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Just-in-time supply chains are struggling, in part because of those challenges in logistics, but also because of much bigger than expected swings in demand and heavy reliance on a small number of critical suppliers.

In semiconductors, for example, the chips, which are key components of many of the things we buy and use on a daily basis, there have been big knock on consequences of supply disruptions. Anyone wanting to buy a PlayStation 5 or a new car just now will know this.

These factors are having an impact on inflation today, and markets are thinking about what that means for interest rates and bond yields going forward.

Our long-term record of delivering returns for clients remains strong, but the last twelve months or so have been good rather than great.

In the latter part of 2020, after the initial strong market recovery from the lows in March, we felt that a number of companies in the travel and leisure sectors, those which rely really heavily on people being out and about, mixing freely, had taken a significant balance sheet hit from those first lockdowns.

We viewed them as less resilient from that point on than we felt comfortable with, and as a result, the portfolio has been very little exposed to the Covid-19 impacted sectors, which have subsequently benefited the most from the very positive news that followed in terms of vaccine rollouts and the gradual, albeit uneven, easing of social restrictions.

The portfolio's holdings have performed well, but we've missed some opportunities others have taken.

We've been active in refreshing the portfolio this year. A number of longer standing investments have performed well, with markets coming into our view with they're very solid creditworthiness and bond prices rising as a result. Netflix is the shining light in this regard.

When we first invested in 2017, bond markets were sceptical. The high spending on content and infrastructure, which was causing Netflix to borrow heavily, the market didn't quite believe that Netflix could go toe to toe with behemoths like Disney, Apple, and Amazon, who are spending heavily in this area too.

At that point, though, Netflix is already closing in on 100 million paying subscribers and have since gone on to double that figure, helped of course by everyone having to spend more time at home in the last 18 months than they planned.

The company's revenues have continued to grow, the market has continued to expand and accommodated that increased competition without holding Netflix back. As a result, profitability is improving fast, and the company's credit ratings have been upgraded several times since we invested.

Most recently, S&P granted them their first investment grade rating. The market's scepticism has diminished, prices have caught up with events, and we've now sold your Netflix holdings.

Amongst the new additions to the fund over the last year are companies as varied as InPost, the leading provider of automated parcel lockers in Poland, which is rapidly expanding in the U.K., France and Italy.

Burford Capital, the leader in Commercial Litigation Finance, CrowdStrike, an innovative cybersecurity business and Mercado Libre, the front runner in Brazilian ecommerce.

Our focus on resilient businesses, the companies of tomorrow, positions as well to face whatever the future may hold.

The key uncertainty on everybody's mind today is whether current high inflation rates will persist and how central banks and bond markets will react if they do.

While these concerns are top of mind for investors in assets, to be very sensitive to government bond yields like sovereign or investment grade rated bonds, we actually view them as secondary for high yield bond investors for a couple of reasons.

Firstly, individual high yield bonds are typically refinanced every three years or so on average, so that if bond yields rise, investors are able to lend at the new higher rates relatively soon.

Secondly, the impact of an extra 1 or 2 per cent interest cost for companies who are currently paying 4 or 5 or maybe more per cent to borrow is relatively limited. You don't actually have to go back very many years to find a time when higher borrowing costs were the norm, without companies struggling to cope.

Our objective is to make sure that the companies in the fund have a sufficiently strong competitive position, that they can pass on the cost increases they face to their customers without an undue squeeze on profits. And all of the indications that we're seeing currently are very positive on that front.

We believe today's portfolio is robust and is set to continue delivering an attractive income over the long term.

Annual Past Performance to 30 September Each Year (%)

	2017	2018	2019	2020	2021
Baillie Gifford High Yield Bond Fund	9.2	2.0	6.8	0.3	7.7
Investment Association Sterling High Yield	7.9	1.4	4.7	-0.4	10.6

Source: FE, total return in sterling. B Inc shares.
The managers believe an appropriate comparison for this fund is the Investment Association Sterling High Yield Bond sector average given the investment policy of the fund and the approach taken by the manager when investing.

Past performance is not a guide to future returns.

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Bonds issued by companies and governments may be adversely affected by changes in interest rates, expectations of inflation and a decline in the creditworthiness of the bond issuer. The issuers of bonds in which the fund invests may not be able to pay the bond income as promised or could fail to repay the capital amount.

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