Baillie Gifford™

Strategic Bond
Q1 investment update

April 2024

Investment manager Robert Baltzer and investment specialist Sandy Jones give an update on the Strategic Bond Strategy covering Q1 2024.

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

Sandy Jones (SJ): Welcome to the Q1 2024 Strategic Bond update. My name is Sandy Jones. I'm an investment specialist in the Income Team at Baillie Gifford, and I'm joined by Robert Baltzer, who has recently become a co-manager of the Strategic Bond strategy alongside Lesley Dunn and Torcail Stewart. Robert has been at Baillie Gifford for over 20 years. He has co-managed credit strategies with Torcail for the last six years and has worked closely with Lesley since 2016. As a reminder, Strategic Bond is a global best ideas corporate bond strategy. We seek to add value through bond selection and active management of portfolio credit risk.

Robert, welcome. Let's start with performance. Q1 2024 has seen strong performance from the Strategic Bond strategy. What have been the key drivers?

Robert Baltzer (RB): Thanks, Sandy. It has been a good start. We've seen the strong momentum in bond markets, with which we finished last year, continue into this year, particularly in credit markets. Riskier credits have performed better as a broad theme, whilst the rally in government bonds has petered out somewhat at the start of this year. Our positioning towards BBB and BB rated bonds in the middle of the credit rating spectrum has actually been very helpful in this environment. In terms of specific holdings that have performed well and contributed to the strategy, it's been some of our riskier positions. I know that Torcail, in previous updates, has mentioned the value that we have seen in the somewhat out-of-favour property sector and the potential for some of our holdings, and that has started to be delivered this quarter. To take a particular example, a company called CPI Property that we spent a lot of time on last year, an analyst in the sector, Nektarios, met them on-site twice last year, and that due diligence has paid off. We have benefited from a 10 per cent return on those bonds just in this first quarter alone.

SJ: So really strong performance from our holdings in the property sector. Are you tempted to take profits on these names?

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
98601 10045992

RB: Not yet. I actually think there's more to go for here. That example I mentioned, CPI Property, although it has had a really good start to the year, we feel continues to offer a lot of value. The yield premium over and above what government bonds are paying is still at an elevated 5 per cent, so 5 per cent more than government bonds, about 9 per cent in total. This is despite those bonds still having an investment grade credit rating, they’re senior ranked, and they're actually still trading at relatively low cash prices at a discount to par, which protects us to a degree in terms of downside risk. Putting all of those things together, I think there's still plenty to go for in that case.

SJ: There remains an attractive opportunity in property bonds. Let's move on and talk about the broader credit market in general. A lot of our clients have been asking us about refinancing risk. This is not necessarily a risk that is particularly well understood. What is refinancing risk and what risk does it pose to a corporate bond portfolio?

RB: Sure. I think that's a great question and it's very much on investors' minds at this moment. So, companies tend to use debt as a semi-permanent part of their financing. What that means is when they borrow money, they don't necessarily intend to ever repay that borrowing in full, get back to a zero debt position. As long as their creditors, the bond investors such as ourselves and the bank lenders remain happy that they are credit worthy, they can maintain a debt balance and creditors will continue to get paid their interest. Any particular bond or loan though will have a fixed maturity date and over time that will come closer. It's the job then of the company's chief financial officer or the treasurer to weigh up the costs and benefits of refinancing each debt maturity early or deciding maybe to run the clock down a little bit. They are making a call there on the financing environment, the costs and benefits of acting now and locking in today's financing costs or perhaps waiting longer. The risk point from investors' perspective is that the company misjudges that decision, that they perhaps wait too long and find that the market is not there at the point that they need to refinance. In a worst case scenario, that might mean the company can't then repay the debts that are coming due and could default. Because of that, it's clearly very much at the front of the investors' minds.

SJ: So, in the current market where yields are higher, so the cost of financing is higher, is this something that you're particularly concerned about?

RB: It's very relevant just now. Many companies have bonds and loans outstanding today that they borrowed several years ago when financing costs were lower than they are today. The flip side from an investor's perspective of yields being high today is that it means companies do have to pay a higher cost when they seek to borrow again. Most companies in this last couple of years when financing costs have been rising have sought to wait rather than lock these costs in too soon. They have bided their time and in fact that will have served many of them well because the market environment now is better, market appetite to lend is stronger, but companies have been shrinking that margin of safety, running the clock down. So, it's been a really busy start to the year for new issuance as companies refinance. Now for stronger borrowers, the kinds of companies that we are keen to lend to, they are getting a good reception. They are having to pay yields that we consider attractive. In many cases, double the levels of coupon that they were previously paying, but nevertheless that's affordable for strong businesses. To take some specific examples, we have bought new bond issues as companies have refinanced this quarter from the likes of Pinewood, Kyndryl and Telefonica, each of which have paid in the region of 6 per cent on these new bonds, significantly higher than the rates that they were replacing. It's very much affordable for those companies and we think those are attractive income opportunities. There are though, to strike a cautionary note, there are a cohort of excessively indebted companies who are going to find paying today's financing costs much more difficult and we are seeing some quite large businesses with significant debt loads looking at the market environment today and deciding they are not going to be able to carry out conventional refinancing. Instead, they're exploring options for restructuring their balance sheets. That will mean imposing losses on lenders and bondholders, which clearly is an adverse outcome. We are deliberately not heavily exposed to that risk in the Strategic Bond strategy. We only 2.5 per cent of the strategy's assets around about that figure in lower rated bonds, which also have a low maturity for the maturing in the next three years. So, this is an issue we've been careful to avoid.

SJ: So refinancing risk has increased, but primarily at the lower end of the credit spectrum. As you say, we're very conscious of this and we've reduced exposure to those segments of the market. That brings us neatly on to talking about portfolio positioning. Last quarter, we signalled that the strategy was slightly overweight investment grade bonds. We have added high yield exposure over the last three months as the market backdrop has improved. Can you give us an overview of current portfolio positioning?

RB: Absolutely. So, the context here is one, as I've alluded to, of attractive yields in aggregate across the market, which is one of the reasons we've been enthusiastic to take those opportunities. We've seen strong momentum that's allowing companies to refinance, that's been good for the price of existing bonds, and that has driven valuations to higher levels today. So, credit spreads are relatively narrow. That's in part justified by the improved economic backdrop. So, inflation, which has been a source of much concern, a lot of difficulties, and the reason behind rising interest rates and bond yields, is now under much better control, it seems. And investors' minds are very much turning to when and by how much interest rates will be cut, rather than worrying about whether we have more to go in terms of increasing interest rates. Growth has stayed positive and expectations are for more of the same. So that is a constructive backdrop. Our positioning in that context is to capture attractive levels of income. We're doing that primarily through what we consider to be the sweet spot of credit markets, BBB rated and BB rated companies that sit either side of the boundary between investment grade and high yield credit ratings. So, the strategy of delivering an above market yield, I've already mentioned that we've been somewhat wary of the most levered, lowest rated businesses. So, we actually have quite low exposure to low rated bonds. And as a result, we have dry powder, we have roughly a quarter of the strategy's assets in high grade assets, rated single-A and above, which should be defensive and liquid and provide us with optionality, should we see a period of market weakness in the future.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

SJ: Okay, I want to spend some time talking about opportunities. Earlier, we talked about property sector as a part of the market that offers attractive return potential. Are there any other areas of the market that look particularly attractive at present?

RB: So, we're seeing a lot of good opportunities across different sectors, but maybe one to call out would be the broadly defined financial sector. So, by that, I mean, not just banks, but insurance companies, asset management companies, investment companies, and others. Our investments are spread across a range of different geographies as well. So, this is a diverse and significant part of the portfolio. We invest across the capital structure. So, from very safe and senior bonds to more subordinated and somewhat riskier bonds. A good example to draw out that was a new investment for us in the first quarter of the year is Investec plc. It's a company we have lent to for quite some time, but not at this most subordinated level. They have issued a so-called Additional Tier 1 instrument and that offered a 10.5 per cent coupon. This is the riskiest bond that they have outstanding, but this is a company that has succeeded over several decades in building a strong, niche, franchise in UK banking and wealth management that we are very enthusiastic about. And we feel we're being very well rewarded with that double digit yield.

SJ: So, in summary, the portfolio has performed strongly in the first quarter of 2024. This has primarily been driven by bond selection in the property sector. Overall positioning is neutral, reflecting high valuations in the context of a strong market backdrop. The strategy continues to out yield the index. This is driven by an overweight allocation to BBB and BB-rated bonds. Finally, we continue to find attractive opportunities. New issuance has picked up and sectors such as property and subordinated financials provide attractive income and capital appreciation opportunities for the strategy.

Robert, thank you for your time.

RB: My pleasure.

SJ: And thank you for joining us.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Strategic Bond

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

	2020	2021	2022	2023	2024
Strategic Bond Composite	-2.6	14.1	-4.8	-9.3	9.0
Strategic Bond Benchmark*	-1.4	11.6	-4.3	-8.1	8.1

Annualised returns to 31 March 2024 (net %)

	1 year	5 years	10 years
Strategic Bond Composite	9.0	0.9	3.3
Strategic Bond Benchmark*	8.1	0.9	3.1

*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.

Risk factors

This communication was produced and approved in April 2024 and has not been updated subsequently. It represents views held at the time and may not reflect current thinking.

The views expressed should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect opinion and should not be taken as statements of fact nor should any reliance be placed on them when making investment decisions.

This communication contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research, but is classified as advertising under Art 68 of the Financial Services Act ('FinSA') and Baillie Gifford and its staff may have dealt in the investments concerned.

All information is sourced from Baillie Gifford & Co and is current unless otherwise stated.

The images used in this communication are for illustrative purposes only.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Important information

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). Baillie Gifford & Co Limited is an Authorised Corporate Director of OEICs.

Baillie Gifford Overseas Limited provides investment management and advisory services to non-UK Professional/Institutional clients only. Baillie Gifford Overseas Limited is wholly owned by Baillie Gifford & Co. Baillie Gifford & Co and Baillie Gifford Overseas Limited are authorised and regulated by the FCA in the UK.

Persons resident or domiciled outside the UK should consult with their professional advisers as to whether they require any governmental or other consents in order to enable them to invest, and with their tax advisers for advice relevant to their own particular circumstances.

Financial intermediaries

This communication is suitable for use of financial intermediaries. Financial intermediaries are solely responsible for any further distribution and Baillie Gifford takes no responsibility for the reliance on this document by any other person who did not receive this document directly from Baillie Gifford.

Europe

Baillie Gifford Investment Management (Europe) Limited provides investment management and advisory services to European (excluding UK) clients. It was incorporated in Ireland in May 2018. Baillie Gifford Investment Management (Europe) Limited is authorised by the Central Bank of Ireland as an AIFM under the AIFM Regulations and as a UCITS management company under the UCITS Regulation. Baillie Gifford Investment Management (Europe) Limited is also authorised in accordance with Regulation 7 of the AIFM Regulations, to provide management of portfolios of investments, including Individual Portfolio Management ('IPM') and Non-Core Services. Baillie Gifford Investment Management (Europe) Limited has been appointed as UCITS management company to the following UCITS umbrella company; Baillie Gifford Worldwide Funds plc. Through passporting it has established Baillie Gifford Investment Management (Europe) Limited (Frankfurt Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in Germany. Similarly, it has established Baillie Gifford Investment Management (Europe) Limited (Amsterdam Branch) to market its investment management and advisory services and distribute Baillie Gifford Worldwide Funds plc in The Netherlands. Baillie Gifford Investment Management (Europe) Limited also has a representative office in Zurich, Switzerland pursuant to Art. 58 of the Federal Act on Financial Institutions ("FinIA"). The representative office is authorised by the Swiss Financial Market Supervisory Authority (FINMA). The representative office does not constitute a branch and therefore does not have authority to commit Baillie Gifford Investment Management (Europe) Limited. Baillie Gifford Investment Management (Europe) Limited is a wholly owned subsidiary of Baillie Gifford Overseas Limited, which is wholly owned by Baillie Gifford & Co. Baillie Gifford Overseas Limited and Baillie Gifford & Co are authorised and regulated in the UK by the Financial Conduct Authority.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

Hong Kong

Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 is wholly owned by Baillie Gifford Overseas Limited and holds a Type 1 and a Type 2 license from the Securities & Futures Commission of Hong Kong to market and distribute Baillie Gifford's range of collective investment schemes to professional investors in Hong Kong. Baillie Gifford Asia (Hong Kong) Limited 柏基亞洲(香港)有限公司 can be contacted at Suites 2713-2715, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. Telephone +852 3756 5700.

South Korea

Baillie Gifford Overseas Limited is licensed with the Financial Services Commission in South Korea as a cross border Discretionary Investment Manager and Non-discretionary Investment Adviser.

Japan

Mitsubishi UFJ Baillie Gifford Asset Management Limited ('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.

Australia

Baillie Gifford Overseas Limited (ARBN 118 567 178) is registered as a foreign company under the Corporations Act 2001 (Cth) and holds Foreign Australian Financial Services Licence No 528911. This material is provided to you on the basis that you are a "wholesale client" within the meaning of section 761G of the Corporations Act 2001 (Cth) ("Corporations Act"). Please advise Baillie Gifford Overseas Limited immediately if you are not a wholesale client. In no circumstances may this material be made available to a "retail client" within the meaning of section 761G of the Corporations Act.

This material contains general information only. It does not take into account any person's objectives, financial situation or needs.

South Africa

Baillie Gifford Overseas Limited is registered as a Foreign Financial Services Provider with the Financial Sector Conduct Authority in South Africa.

North America

Baillie Gifford International LLC is wholly owned by Baillie Gifford Overseas Limited; it was formed in Delaware in 2005 and is registered with the SEC. It is the legal entity through which Baillie Gifford Overseas Limited provides client service and marketing functions in North America. Baillie Gifford Overseas Limited is registered with the SEC in the United States of America.

The Manager is not resident in Canada, its head office and principal place of business is in Edinburgh, Scotland. Baillie Gifford Overseas Limited is regulated in Canada as a portfolio manager and exempt market dealer with the Ontario Securities Commission ('OSC'). Its portfolio manager licence is currently passported into Alberta, Quebec, Saskatchewan, Manitoba and Newfoundland & Labrador whereas the exempt market dealer licence is passported across all Canadian provinces and territories. Baillie Gifford International LLC is regulated by the OSC as an exempt market and its licence is passported across all Canadian provinces and territories. Baillie Gifford Investment Management (Europe) Limited ('BGE') relies on the International Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

Israel

Baillie Gifford Overseas Limited is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the Advice Law) and does not carry insurance pursuant to the Advice Law. This material is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com