Baillie Gifford™

Strategic Bond: back to the future

July 2024

Investment manager Robert Baltzer and investment specialist Sandy Jones give an update on the Strategic Bond Fund.

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

Sandy Jones (SJ): Welcome. Thank you for joining the Baillie Gifford Strategic Bond webinar. My name is Sandy Jones. I'm an Investment Specialist representing the strategy, and I'm joined by Robert Baltzer, head of Credit Research, and co-manager of the Strategic Bond Fund. Robert is going to give a short presentation of around 20 minutes, giving a brief overview of the strategy, before going on to talk about our outlook for corporate credit in a bit more detail, as well as current portfolio positioning, and best ideas. We will then move on to Q&A.

We are very keen for this to be interactive, so please do submit questions into the Q&A function, and we'll come back to these at the end. We have titled this presentation 'Back to the future'. This is really a catchphrase designed to communicate that yields are attractive, relative to history. The Strategic Bond Fund currently yields around 6%, and this is the first time that it has persistently done so since 2012. So, with that in mind, I'm going to hand over to Robert to begin our presentation.

Robert Baltzer (RB): Fantastic. Thanks, Sandy. Great to be here. And as we just wait for that first slide to come up, this is a snapshot of the Baillie Gifford Strategic Bond Fund. Our experience is that capturing and beating the returns, from a broad corporate bond opportunity set, will deliver our fund objective, which is to provide attractive income, with the potential for capital gains over the long term.

In doing that, we believe we will continue to provide sector beating returns. We are specialists in bond selection, identifying the individual bonds and companies that the market underestimates, and which are catalysts for derisking and improving market sentiment. The bond market is least efficient in this area, because there are thousands of diverse companies to choose among.

As you can see from our expected sources of alpha on the right hand side of the slide, this is where we expect to make most of our returns, relative to our benchmark. Our opportunity set encompasses both high quality investment grade bonds, and higher risk high yield bonds. As reflected in the comparator index on the slide, that 70/30 blend is our strategic benchmark, but we have significant flexibility to deviate from that, when valuations and market conditions merit it.

So, for example, our holdings of high yield bonds have ranged between roughly 20% and 50% in the past. The duration of the Fund today is in line with its benchmark index, it's round 4.7. We don't tend to spend time agonising over the direction of interest rates, or government bond yields, because those movements are probably the most picked over, and therefore, efficient in global capital markets.

Absent a compelling case to the contrary, we tend to run with a duration that is similar to the benchmark. In the same vein, we don’t take any currency risks, so although we have significant holdings or non-sterling denominated bonds, that risk is hedged into sterling, using currency forwards systematically. This straightforward approach differentiates us, relative to the peer group of funds.

We've been doing this successfully for over 25 years in a variety of very different market environments. As you’ll see over the next few slides, we think the current moment provides a great entry point into the asset class and into the Fund. Today’s yield environment, as Sandy mentioned, takes us back to the future, to levels of yield that we haven't seen in over a decade.

This slide shows that the yield on that 70/30 corporate bond benchmark, how that has changed over the last 20 years. It started at around 6%, and it's gone back there, with some very diverse conditions in between, some very significant highs and lows in between. Arriving back at today’s 6% corporate bond yields is welcome, but the process of getting there has been painful for bondholders with 2022, in particular, seeing very negative returns for bonds of all kinds.

Unfortunately, it’s not quite as simple as gunning the DeLorean at 88 miles an hour and arriving instantly at your destination. The good news, though, from today’s starting point, is that return expectations are very worthwhile. Key takeaways from this slide are that no matter the starting environment, where corporate bond yields begin gives you a very good basis for setting return expectations for the five years following.

So, this graphic is comparing a few things. In blue, the starting yield on our corporate bond benchmark at various different times over the last 25 years. In grey, you can see the returns on that benchmark over the five years followed from that starting point. And lastly, in green, you can see the returns on the strategic bond fund over that same five-year time period.

So, these starting conditions have been very diverse. Sometimes, as you can see, yields have been very high, sometimes, they’ve been very low. Within that, sometimes credit spreads have been at extreme highs, and at other times, at their very lowest levels. In each case, the graphic clearly shows that the starting yield is an important anchor the returns follow.

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

You can also see that in almost every case, our fund returns, in green, have compared favourably with the benchmark returns, in grey, through the use of bond selection and thoughtful credit risk management. With today's yields close to 6%, and our fund yielding slightly more, the stage is set for healthy returns. But why do I think that? It's because company fundamentals remain robust. The picture of corporate health that we see today is benign.

Companies' debt burdens are at typical levels, not elevated levels, and although interest costs are rising, most companies with the scale to borrow in the bond market still have profits that are roughly four times higher than their interest bill. The two metrics that I'm showing on this slide are really important ones for credit investors. I've focused on the European high yield market, but the trends in the US high yield market are very similar.

Likewise, in the investment grade world, you would see the same trends, but the absolute numbers would be more benign, reflecting the stronger balance sheets of those companies. So, the picture on the left, the gross leverage ratio, is similar to a debt-to-income multiple that you might think of in relation to a mortgage application. A higher number is less comfortable and more stretched.

The spike in gross leverage, starting in 2020, reflects a steep fall in profits for many sectors through the pandemic. But that has now been pretty much fully reversed. In the right-hand graphic, you can see how many times today's profits cover the company's interest costs. And again, here, when profits fell during the pandemic, you can see that impact on interest cover.

Now, post-pandemic, through 2022 and onwards, companies like other kinds of borrowers are contending with higher interest costs on their debt. So, that denominator of the interest cover ratio has been rising, and interest cover is falling, but it's falling from a fairly high starting level. We think that trend can continue for a while longer, but interest cover may continue to fall, as companies continue to refinance the low-cost debt that they took out several years ago, and that's a very active process that's happening just now.

That has a benefit, though, because most companies are exercising a greater degree of prudence in their planning and their spending, and many have a desire to reduce the total amount of debt they're carrying. So, higher interest rates are actually a disciplining factor for companies, which is also good news for bondholders. So, what does this mean for valuations?

This next chart shows the credit spread of the funds index over the last decade. This is a good measure of valuation in corporate bonds. This spread is the extra yield that corporate bonds pay, relative to government bonds, over and above the bond yields. It's a risk premium, because corporate bonds are slightly less liquid, and have a non-zero probability of not paying back the principal when it's due.

Now, that credit spread has historically significantly over-compensated investors for these risks, and that's why we think that harvesting this credit risk premium over the long term is a very sound investment proposition. Because credit spreads are a risk premium, they respond to how uncertain or worried investors are about the state of the world.

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

So, for example, during the pandemic credit spreads very understandably spiked to high levels, which temporarily drove bond prices much lower. As governments and central banks stepped in to save the economy, and as Covid vaccines were developed and rolled out, the risk premium fell, spreads fell, and bond prices recovered.

Now, where we are today, we have a backdrop of positive economic growth, inflation coming back down to manageable levels, central banks, therefore, starting to ease policy, thinking about cutting interest rates, and bond markets that are wide open to issuers to term out their borrowings. Now, that benign environment is reflected in credit spreads that are towards their cycle lows. Looking backward is all well and good, of course, but it's what happens next that's most interesting.

Today's benign environment goes hand in hand with low spreads, and low spreads are good news for borrowers, it reduces their cost of borrowing. So, there's a self-healing or self-reinforcing cycle at work. I think it will be either when borrowers start to take advantage of low borrowing costs, low spreads, to be more aggressive in their behaviour, or when some unexpected event jolts the market out of its good news mindset, and that’s when we might see a more persistent increase in credit spreads.

At the moment, we absolutely don't see that aggressive corporate behaviour and that typical late cycle behaviour. As I mentioned, I think the high all-in borrowing costs that are different to what companies have been used to over the last few years that is still having that disciplining effect. But it goes without saying that, by definition, we cannot foresee unexpected events.

Now, lower credit spreads, as we have at the moment, are leaving the market somewhat more vulnerable to unpredictable risks. So, what we're doing is preparing the portfolio for a potentially more volatile market ahead. So let's take a look at the shape of the portfolio today. We own a diversified portfolio of 75 best ideas from across the global credit spectrum, with ratings weighted towards triple B and double B in the middle of this distribution, the sweet spot of credit markets, as we see it.

And you can see that almost two thirds of portfolio assets were in that sweet spot at the end of June. The fund has a higher yield and a higher spread than its benchmark, while duration, as I mentioned, is in line with that benchmark level. We currently have no triple C rated highly speculative holdings, those at the bottom end of the credit risk scale, because that's the part of the market that will struggle most with rising borrowing costs.

We do though, have roughly a quarter of the portfolio in high quality assets with credit ratings of single A and above. As we've taken advantage of a number of attractive new issues in the single B category this year, we've begun to reduce our overweight position in the triple B and double B area, making sure that we are balancing attractive yield with resilience to whatever the market may throw at us next. The next slide gives a deeper insight into the balance of the portfolio.

Now, this is a busy slide. It is designed to explain how we add value in the Fund. The core return driver in our corporate bond portfolio is income generation, and that is how we have deployed the

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

bulk of the fund's assets. Some of our best ideas offer both income and capital upside. The holdings in our fund each fall into one of these four categories shown on the slide.

The detail in the boxes gives you a little insight into the risk and return profile of each category, and there is a couple of example holdings listed underneath each category box.

So, starting on the left, the steady category comprises assets with really defensive characteristics, such as high quality, high credit ratings, and deep liquidity. These form an important element of dry powder and balance in the portfolio.

The compounding category currently accounts for a clear majority of the fund's assets. These are bonds from resilient issuers with sound fundamental characteristics, offering above average yields. These companies are often a little bit more leveraged, and they will typically have credit ratings of triple B, double B, and single B.

About half of the fund is in this compounding category, and holdings with maturities between three and ten years from today, which I've called here 'the belly of the yield curve'. We're also currently exploiting an opportunity in short-dated bonds, so those with less than three years to maturity. Unusually, they, too, are offering above average yields, despite their very short duration, despite limited credit risk and low volatility. They make up roughly a quarter of the Fund's assets today.

As well as providing a great base of income, these bonds are a natural source of liquidity, because they will be maturing, or they will get redeemed early in the near future. So, they form another part of the dry powder in the Fund, which could be invested more aggressively, if we were to see market sell off. The excitement and value from our best ideas is most vividly demonstrated in our accelerated and event-driven opportunities under the 'capital appreciation' heading.

These are issues, which, we believe, have those clear milestones for de-risking, with improving sentiment, that could push bond prices higher. Accelerated investments are expected to show a gradual trajectory of continuous improvement. An example in that heading would be International Workplace Group. This was a recent issuer to the bond market, which has split opinion.

So, some people are looking at this, and seeing superficial similarities to WeWork, which is a troubled issuer. But we've looked, instead, at the long track record, the excellent founder leadership, a derisked business strategy, and very strong growth prospects, and those have impressed us. We expect that increasing cash generation, falling leverage, and continued growth will win round the sceptics in time, leading the bond price to rise, all else equal.

The final category after accelerated is event-driven investments. And these, really, I think, are the sleeper agents in the portfolio. They will tick along quietly, but there is some foreseeable event that could lead to significant upside. Naturally, these are fewer in number. They don't come along all the time, but they're really valuable additions for a patient investor. Annington is a great example.

It owns a very large property estate, which is leased to the MoD for the very long term, the UK's Ministry of Defence. That provides a super high-quality cashflow stream, which supports the company's triple B credit rating. The MoD is actually trying to buy this estate back, having sold it nearly 30 years ago. That process has already been running now for over two-and-a-half years.

We don't know exactly how much longer that process might take. So, there's an uncertainty here. We don't know how this will play out. We don't know a timeline, over which that happens. But in our view, the current bond prices are good value, and there's a possibility of meaningful upside, which we're paying nothing for.

So, in totality, the portfolio is working hard to capture the income and the capital opportunities that we see in the market today, but it also has a substantial amount of dry powder. Nearly 40% of the Fund's assets, those that are in steady and short-dated compounding categories, are expected to outperform, should the market turn down, and provide the source of funds to capitalise on valuation opportunities that might emerge.

So, to sum up, we're excited about the potential for very worthwhile returns from the corporate bond asset class and the Fund over the next few years, because we're starting from a position where yields are higher than they have been for more than a decade. Today's market backdrop is relatively benign, but we're not complacent.

The fund offers an attractive yield, and our best ideas have the potential for further capital upside. But balancing that, we have a significant amount of what we consider dry powder, preparing us well for whatever the future may hold.

SJ: Thank you very much, Robert. Are you happy to move on to Q&A?

RB: Absolutely.

SJ: So, in terms of questions, there is one nice one to start with here. I guess there are two parts to this. You talked a bit about dry powder there. What market conditions would lead you to deploy this dry powder? And what exactly would you be deploying that into?

RB: Sure. I think the natural thing to look for is that better valuation entry point, so spreads at higher levels than where we see them today. Now, what causes that to happen is inherently somewhat unpredictable, and the response, naturally, should depend on that. But if this were a broad-based market sell off, perhaps due to concerns around the economy, for example, and profitability of the growth outlook, and so on, what you would expect is to see a decompression of credit spreads.

So, if you think about the range of credit spreads among different borrowers as being a bit like a spring coil, when things are good and spreads are narrower, all kinds of different risks are closer together, and then when spreads widen, those gaps between different borrowers widen, as well. So, in that environment, you would rotate into areas, the so-called higher beta parts of the market, which would be bonds with lower credit ratings.

You'd expect our high yield weight to increase. You might also see us buying more subordinated bonds from both financial institutions and non-financial companies, so corporate hybrids might start to feature in greater size. But if this opportunity is more thematic, if it's more sector-driven, then sometimes, there can be really good opportunities, particularly in that scenario, where the baby is at risk of getting thrown out with the bathwater. People panic, and the good sell off with the weak.

So, we typically will not be racing to the bottom of the pile, hoping to pick up something in distress. We'll be looking for bonds which have been unfairly tarred with the brush of the day.

SJ: Thank you very much. Another quite good question here about new issuances. So new issuances are typically a good barometer of the health of the market. Can you give a sense of current market dynamics, in terms of new issuances? And also, how involved the fund has been recently in new issuances?

RB: Absolutely. So, we've seen a real resurgence in new bond issuances in 2024. So, companies have really held off throughout 2022, and through most of 2023, as well, in what have been quite rocky conditions. Companies weren't willing to take the risk of refinancing into a difficult market backdrop. But since the end of the year, we've seen that stability in people's confidence that we are at or moving past peak interest rates.

Government bond yields have stabilised, credit spreads have come down, so companies of all stripes are coming back to the bond market. As I said, there's that self-healing process going on, so companies, which maybe have debt coming due in two or three years' time, are able to refinance that early, and push that maturity back to, let's say, five, seven, or ten years into the future, and they will be paying a higher borrowing cost to do that, but typically that is affordable.

So there are a few pockets of distress that mention triple C rated borrowers, an area where the Fund is not exposed. Those are companies which will have that same pressure to refinance, but are finding it quite a challenge to make a deal work, and we're seeing that companies have to be quite inventive there. And inventive doesn't necessarily mean good for bondholders, unfortunately.

SJ: Thank you very much. Another question here. You've presented quite a positive picture for bonds. So, what tail risks are you worried about? What keeps you up at night? And how would this change on the positioning? I think there is probably a bit of crossover with the first question there a bit.

RB: Well, without getting too existential about things, I mentioned that if we see a slowdown in economic growth, if the outlook for corporate profitability diminishes, or maybe if the current gauge that rates are slowly set to fall from here, I think if some of those core tenets were to change, for whatever reason, that, I think, would put the market in quite a different mood, and that's a possibility.

That's not our prediction, but that would be a big market-moving event, and quite negative. There are some understandably concerning tail risks that we will think about and worry about, whether its geopolitical risks between the US and China, for example, that affect trade, or heaven forbid, even conflict. Or, as we saw recently, a small flare-up around the French election.

Any concerns around government solvency, any failure of confidence in government debt, is very serious for bond markets, generally, and would definitely reverberate in the credit markets, too. In that particular case, in France, that proved to be fairly short lived, but it gives a little taste or a reminder, if we're going back to the future, we've been there before in the Euro crisis that was an aftershock of the financial crisis.

SJ: Thank you very much, Robert. I think that's probably a good point on which to finish the Q&A. If we haven't answered any of your questions today, we will get in touch with you, following the webinar, and respond.

Before we finish, I want to quickly re-emphasise some of the key takeaways. So, back to the future corporate bond yields are currently attractive. The Fund yields around 6%. In this context, history shows that we can expect healthy returns from the Fund over the next five years. Looking ahead, we're very confident that the portfolio provides a platform for success. So, it out-yields the index and it's built on a defensive foundation of steady and short-dated bonds, that provide dry powder in the event of future market volatility.

Finally, the portfolio is full of potential. We've run through our return categories today. Talked about some examples, for example, IWG. This is just one position in the portfolio that holds the potential to add significant value for the Fund through bond selection.

Thank you very much for joining us, and if you do have any follow-up questions, please get in touch with your Baillie Gifford contact. Thank you.

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

Baillie Gifford Strategic Bond Fund

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

	2020	2021	2022	2023	2024
Baillie Gifford Strategic Bond Fund B Inc	3.4	6.7	-15.5	-1.1	11.3
Index*	4.3	4.9	-13.2	-2.2	10.5
Sector Average**	3.8	6.1	-10.2	-0.2	8.8

Source: FE, Revolution, ICE Data Indices. Total return net of charges, in sterling. Share class returns calculated using 10am prices, while the Index is calculated close-to-close.

*70% ICE BofA Sterling Non Gilts Index / 30% ICE BofA European Currency High Yield Constrained Index (Hedged to GBP).

**IA £ Strategic Bond Sector

Past performance is not a guide to future returns.

The manager believes that appropriate comparisons for this Fund are the Investment Association Sterling Strategic Bond sector average, given the investment policy of the Fund and the approach taken by the manager when investing and a composite index comprising 70%: ICE BofA Sterling Non-Gilt Index and 30%: ICE BofA European Currency High Yield Constrained Index (hedged to GBP) being representative of the strategic asset allocation of the Fund.

Important information and risk factors

This recording was produced and approved in July 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, and Baillie Gifford and its staff may have dealt in the investments concerned.

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.

Investment markets can go down as well as up and market conditions can change rapidly. 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.

The Fund's share price can be volatile due to movements in the prices of the underlying holdings and the basis on which the Fund is priced.

Further details of the risks associated with investing in the Fund can be found in the Key Investor Information Document or the Prospectus, copies of which are available at **bailliegifford.com**.

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