SVS Church House
Sterling Corporate Bond Webinar

Church House Investment Management

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Fund Manager

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Webinar transcript with Jeremy Wharton and Sam Liddle

[Sam Liddle] Good morning, everyone, and welcome to the Church House sterling corporate bond webinar. You can see us but we can't see you, so we do hope you can hear us all loud and clear. My name is Sam Liddle. I'm the sales director at Church House and in the other box on your screen I hope you can see Jeremy Wharton. He's the joint chief investment officer at Church House and manager of the Church House Investment Grade Fixed Interest Fund.

Jeremy also co-manages our Tenax Absolute Return Strategies Fund and, for his achievements on both Funds, has been awarded alpha manager status by Financial Express, ranking him in the top 10 per cent of active fund managers. Now, I'm afraid you'll be muted throughout this webinar, which I believe helps the sound quality. But if you would like to ask questions you can do so by typing them into the chat box and sending them through to us. We'll cover a lot of ground with the questions I already have in front of me, and the aim is not to present Jeremy's Fixed Interest Fund, but as we approach the half-year point we thought this would be a good moment to look at the opportunities and risks in the sterling corporate bond market.

As ever in a financial market crisis, the media emphasis has been on the performance of equity markets, but bond investors have endured a pretty turbulent few months as well. Now, Jeremy, let's turn to you, then. At the beginning of the year, you were concerned about the valuation of sterling credits, saying that spreads over ten-year gilts had come in to levels last seen in mid-2007. We all know what happened after that. To give some context then to what's happened this year, maybe you could expand a bit on the situation in the market at the end of last year; the end of 2019.

{Jeremy Wharton] Good morning, all. Yes, Sam, it was something that we'd written about and broadcast quite widely; that by the indices that we watch, monitoring overall levels of spreads, the main one that we monitor because it's the most liquid is the iTraxx main investment grade index, and that references the most liquid 125 names in sterling credit. Well, euro-denominated credit as well. It came into levels in the middle of last year that we hadn't seen since mid-2007. It does have quite a long track record, this index, and it does tend to reflect quite well the actual day-to-day, minute-to-minute movements actually in spreads because it's a constantly-traded index. This gave us great concern because the structured credit bid in mid-2007 pushed spread levels into artificial territory. So when we reached that territory ourselves, again we were concerned. We ended up staying at those levels until the 19th February, which is when things began to unwind. Ahead of that, we did de-risk quite considerably our holdings because when spreads get to those kind of levels, they can only really go one way.

We thought that will be a catalyst at some point that would come out of the woodwork - and one obviously did, and we won't remotely pretend that we thought it was going to be a pandemic, but that's what it was.

[Sam Liddle] Thanks, Jeremy. You have since cited 23rd March as a line in the sand for credit markets. What had occurred before that date to cause credit spreads to gap out so spectacularly?

{Jeremy Wharton] Well, volatility; the perception of risk within credit markets was intense. The prospect of many corporates not being able to fund themselves, not to be able to roll over existing funding, was very real. Spreads tend to widen out - we call it gapping out - so they basically hugely become much, much wider i.e. you're getting paid much more yield to own those credits. But that correspondingly means that the capital value of those bonds goes way down at the same time. We saw the culmination of the volatility - the levels of panic actually - in most markets and the worry about the viability of many corporates to have this dramatic effect. Then we also saw, especially towards the shorter end of the curve, some really very heavy forced selling with that across the whole curve of credits, but especially the short end, which is normally more liquid.

That caused the short end to seize up and if you were on the wrong side of that and people were selling to raise money for margin calls. There was quite a lot of forced selling and some highly-geared structures as well that had to fund redemptions. That caused the market-making side of the equation to get inundated with stock, and that pretty much seized everything up. We talk about the 23rd March as the line in the sand because that was the day that the Fed really stepped in with all its might and did their QE infinity, effectively.

[Sam Liddle] Thank you. I remember you were very quick to exploit the buying opportunities for your Fixed Interest Fund. What particular attractions were you seeing after 23rd March?

{Jeremy Wharton] Well, we were seeing them before the 23rd March as well. We were fortunate that we, as I mentioned, had been very worried about the levels of spreads, so we had de-risked ourselves to the least risky that we've ever been, from a credit perspective. What we held was very liquid and we raised - dare I say it, having seen this before but not in the same time frame - we wanted to have ready liquidity to hand. So we raised actual hard cash so we didn't just hold near-cash assets; we had hard cash. We were able to take advantage of some very mis-priced credits before the 23rd March. The kind of things that we bought were big bank credit. When the Federal Reserve gave explicit support for some of its largest financial institutions, we felt that was an opportunity that we couldn't ignore. We were able to buy sterling credits at very, very significant discounts - sorry, sterling denominated credits - from the likes of Bank of America, Goldman Sachs, the big names that were being supported. They were offering fantastic value at the time, so we scooped up some of that value. Then that continued to

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[cont'd] be the case for quite some time after the 23rd March. This is the secondary market pricing and we bought the whole market side of buying credits then and so the opportunity diminished but there still are plenty of credits out there offering good value.

[Sam Liddle] Would you like to say a bit about your VW purchase that you made around that time?

{Jeremy Wharton] Yes, we were fortunate with US, but also we weren't left, thankfully, holding the sectors that were the hardest hit. That was partly by design but partly by chance, to be perfectly honest. We didn't have any hotel leisure-type/related credit. We had no airline-related credit. We had no hospitality pub credit and we didn't have any auto credit either and we didn't have any oil energy-related credit. Auto credit for us was something that we've tended to avoid and before things unravelled, say a short-dated Volkswagen bond would pay you below one per cent in terms of credit spread to own it, which is just not enough in our book. So we didn't have any of those credits. When the market reopened to primary issuance post the 23rd March, we saw several issuers come to market and then VW came to market at the very beginning of April. To give you an idea of how far things have moved, they had to offer investors 450 basis points over gilts as opposed to 90 basis points over gilts previously, to sell those bonds.

We couldn't turn down the opportunity so we took a fair old chunk and they priced - and this is only a five-year bond - they've priced paying four-and-a-quarter per cent coupon. Before they're the best-performing sterling corporate bonds issued since the middle of - well, since things reopened. They're now paying you I think it's about 240 basis points over gilts today. They've come back out of it because there's a bit of volatility in the market today. That means what we call spread compression, so that tightening, that narrowing of the credit spreads so the less yield you get means that the capital value of the bond has gone up. That means that we have a 12 per cent uplift on that bond. It's trading at about 111 and a half, and we got it at 99.50, so we're being paid four-and-a-quarter per cent to own it. But we've also made 12 per cent of capital on that bond. I would like to think we've done that with all our bonds, but we haven't because that's the top-performing bond, so there you go!

[Sam Liddle] I was about to ask whether that's untypical, but there we go! Just turning to some of maybe the headwinds that might come, we've had ten years of QE really almost, but they have had little effect on inflation so far. Does QE infinity and the enormous sum of money pumped into the system this year raise the prospect of higher inflation? As a bond fund manager, how would you address that?

{Jeremy Wharton] Well, we've never seen asset purchases on this scale before and this level of QE, and the idea that somewhere down the road there isn't going to be some inflationary effect. It is bound to happen. You're right in saying that we have had ten years of QE, but we have also seen the Federal Reserve taper its asset purchases and raise rates as well, and try and shrink its balance sheet [unclear words 0:12:48.0]. Now, in the past, they were trying to remove some of the accommodation that they had provided. It is a topic that's discussed more and more at the moment amongst investors; where is the inflation? When might it appear? Our view would be that it's not an immediate danger but we want to be - we don't want to be complacent about it and we would not be surprised, and we'll take steps to insulate ourselves from the worst effects for the inflation that we think is probably likely to reappear. To what level, I don't know. There's some wild speculation about whether this might lead to hyperinflation and God knows what. The answer is we don't really know at this time.

We still have to remind ourselves that this situation isn't over and as Jerome Powell, the Federal Reserve chairman, reminded Senate last week, to remove the measures put in place too early would probably prejudice the nascent recovery that we're seeing certainly in the US economy.

[Sam Liddle] You've used to date in the last few years AAA floating rate notes as the principle insulation against rising rates or hedge against rising rates. Is that what you would envisage building up again if inflation did become more of a problem?

{Jeremy Wharton] Very much so. These are regarded and are very, very strong from a credit perspective. We've always used them. They have been issued in quite a continuous way since '07, '08 but the difference is that most of them are covered bonds so they're seen as secured and they have a cover pool of mortgage assets that is the security that secures the bond. As the owner of them, you have dual recourse through that cover pool to a security and to the issuer, so the big banks; let's say the likes of RBS or Barclays, whatever they issue them. That's why they're so well rated and so well regarded, but for us we use them, as you say, as an inflation - sorry, as a hedge against rising rates because they have a floating rate coupon. So the coupon resets over the money market benchmark, which is just changing from LIBOR to Sterling Overnight Index Average. That means that the coupon goes up as rates go up, and it goes down as rates go down. The key thing is that because of the size of the issues, the fact that they're used as a money market instrument, they did not freeze up in the way that other credits did in the worst of the volatility. We were able, when we needed cash, to raise cash from them and we put cash back into them. We took in fact quite a lot of cash out of them to put to work in some of the bashed-up credits that we were talking about earlier.

Just going back to some of this new issuance this year; the yield on the ten-year gilts is at 0.2 per cent, thereabouts. The base rate is 0.1 per cent. There seems to be an insatiable appetite for new issuance of credit, so why do companies feel that they need to offer such attractive yields at the moment?

Well, the yields aren't that attractive because normally a yield is constructed of a credit spread, which is the risk that you're prepared to accept, but owning the liabilities of that issuer. Then you have - and normally the yields over the benchmark then construct the overall yield of that bond. If you're not getting anything at all from the [?risk-free rate 0:17:07.2], from the benchmark, which you're not out to five years in the [cont'd] gilt, so the gilt curve at the moment is negative out of five years. Say, one year are just positive but two, three, four-year, five-year gilts are all at this moment pricing negative yields. So you're not actually getting in terms of proper yield from that bond anything spectacular. Also we're still in an environment where we are - where there is a heightened awareness of credit risk overall. Things have come a long way back from the darkest moments of March, but still the issuers have to pay investors the going rate, effectively. So you look at the rest of their curve and you can get an indication of where they should be pricing a new issue, which tends to be wider to the existing curve. Otherwise no one will buy it.

The indications of all these new issues come, and have been initially quite attractive and then because of this huge demand and we've seen issues over-subscribed five, ten times again and again, more than that, means that the final spread tightens in. So the final yield isn't quite as generous as it might be. I can bung a few examples at you, but some longer-dated stuff: from utilities, you can take some 20-year risks from United Utilities and that's paying you 1.875 per cent coupon. It's not setting the world alight in terms of you're getting, in comparison to rates where they are, as you say, base and gilts, you're getting a pick-up but it's not exactly shooting the lights out in terms of yield.

[Sam Liddle] I guess a downside of all the new issuance might be that companies are taking on an ever-greater level of debt at a difficult time for the global economy. How important is credit risk analysis? How careful have you had to be when picking up new issues?

{Jeremy Wharton] Well, credit risk analysis is absolutely vital. You certainly don't rely on a rating agency. You might get an indication of what they think but you don't necessarily agree with them. You have to do your own analysis. It depends what the bond is, who it's issued by, where it sits in that capital structure. It is paramount that you have a very, very developed idea of where a bond sits within the capital structure of the issuer, but also the financial health of that issuer. There are all sorts of credit metrics you can look at and unfortunately, I can probably go on for days about which ones you would prefer to look at. I think it's been a worry that people have rushed to issue, but on the other hand I fully applaud them for doing it because to take out some kind of insurance by having a healthy amount of cash on your balance sheet, or cash to meet future maturities of bonds, is obviously a good thing.

It might be a drag on the balance sheet of a company, but the key thing is that initially a lot of these entities, they use commercial paper to fund short-term operations that that market throws up. The Fed had [unclear words 0:21:02.8] there and the same thing happened with the Bank of England. That was short-term funding and then a lot of companies had in place credit facilities with banks, so revolving credit facilities in place. There was a concern that those might not be honoured because the banks are not - might not be able to afford it. That was actually not the case because banks going into this were actually in a very strong position, which is a good thing. I would say that most companies have done the right thing and if they need to raise cash then they haven't. You look at how well insulated some issuers were, so a good example is Heathrow Funding, which is obviously a funding vehicle for Heathrow Airport, and that was completely taken apart in terms of as a credit.

They then came out recently with their results and in fact before that and said that without flying a single passenger, they had enough cash on hand to keep things going for over a year, which is obviously a good thing. In the midst of this - which gave me a little bit of cause for wondering - we had a short-dated, it was the 16th March 2020 maturity of a Heathrow Funding bond, which they of course got redeemed in full, without even questioning. We did have a little moment of wondering whether they might be able to do it because that was the worst of the volatility in some ways. Of course they were absolutely fine and I did, annoyingly, send a valuation to an investor who has a direct portfolio. I didn't point out that that bond had been redeemed but it was marked at zero and so he quite rightly thought that it had just gone to nothing, whereas he'd actually been repaid in full! Bit of an error.

[Sam Liddle] Any concerns over the default rate, whether that would pick up?

{Jeremy Wharton] I think it's bound to. We said this last time and it hardly picked up. It's bound to because unfortunately, the whole nature of this situation is that it has accelerated change and certainly change in different industries. We can see that, take the airline industry and the likes, and associated with it, some corporates will just not make it, sadly. If you look at a lot of the smaller energy-related credits, they will probably not make it so they will - they're bound to default. We've already seen a few defaults already, but these things don't happen straightaway. It's probably likely to arise, I wouldn't want to hazard a guess to what number, but you're going to see it in the lower ends of high yields, certainly, some people going under.

[Sam Liddle] Looking at the other concerns, I guess, there were concerns at the end of last year that most of the BBB minus rated credits, so the bottom end of investment grade, were in fact junk, as turned out to be the case in 2007. Do those concerns still exist today, and do you have any worries about high-yield bonds generally? I know we don't invest in them in your Fund, but others do.

{Jeremy Wharton] Well, I'm not sure that most BBB minus credits are regarded as junk. There were quite a few, which is fair enough, but we hadn't seen in fact the levels of downgrade moves by ratings agencies that one might have expected - which I, in fact, thoroughly applaud because they cannot always be quite as… What's the word I'm after? They're not quite as aware of the situation in some ways. They might exacerbate what's a difficult time for markets in general, and so they shouldn't be in a rush to downgrade corporates. This time, to be fair, they haven't really. There has been some action and we've traded out of some credits ahead of that action, but going down the rating spectrum to the lower ends of high yield, we're not interested in that. It simply is bumping around on the bottom of the credit spectrum and some of those, as I say, will survive and many won't. We don't think that, certainly from a private client perspective, our clients are expecting us to invest in credits that might go to zero or might go to recovery or might go to recovery rates of 40 per cent.

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[cont'd] They're not expecting that level of risk to be taken on because it's not quite binary but when things go wrong in a credit, they can go wrong quite quickly. It can be pretty brutal from a valuation perspective, so the one at the moment is wildcard, which is subject to an accounting fraud scandal. They don't have much credit but they have a commercial bond and a straight bond, and they're both trading at next to nothing. That's happened very quickly.

[Sam Liddle] Thanks. We've had a question that has come in here, which you might've covered anyway but we'll go back on it. I don't know. It says; do you think that SONIA - so Sterling Overnight Index Average - will become more dislocated from CPI and therefore are they still going to be an attractive hedge against inflation? I'm guessing this is on floating rate notes.

{Jeremy Wharton] Well, CPI is subject to questions as to whether it's a valid indicator anyway. I think I'm fully in favour of SONIA as an alternative to LIBOR. Having worked with LIBOR for rather a long time, unfortunately it did lose its credibility. It also really lost its validity in pricing, so the fact that Elixir say that they're - and there's consultation still at the moment as to whether the end of 2021 will actually be - whether it will become unsupported or whether that will actually be the line in the sand for LIBOR, whether that will actually be outlawed out to the end of 2021, which would make life an awful lot simpler. Although there has been talk about that being delayed because of the present situation, but SONIA does have the advantage of being based on real transactions. It is monitored and published by the Bank of England so it has all the credibility that LIBOR has lost, sadly. As a money market rate to reference floating rate paper over, I think it's a good one - and it works. There's a little bit of straightforward…

[Sam Liddle] Just looking back at other comments that you've made in the past, you've mentioned last year that if you add duration, all you are adding is risk. Has that sentiment changed a bit? Are you finding opportunities further along the curve?

{Jeremy Wharton] Yes, and we have added quite a lot of duration, so we felt at the time, you weren't being compensated for taking on as much duration as people were prepared to. We're now in a different environment and so we have added duration in a way that we didn't have at the end of last year. You've got to remember that it is volatility so if you have a 30-year bond it's a lot more volatile than a three-year bond. That's fine when it's working in your favour, but when it's going against you, then the capital value of that bond is a much more volatile thing.

[Sam Liddle] There's been some talking over recent years that bonds no longer fill their place or sit in the same place on the risk scale any more with rates so low. Given the base rate is now at an all-time low, why do you think it would still be important at the moment to have an allocation to fixed income in a low-risk or income-biased portfolio?

{Jeremy Wharton] Because they provide an income stream that is quite hard to find in equities at the moment! If you look at our banks, they've been told to suspend dividends - and they have. So have other corporates, and so that means that you're not getting an income stream from them. If you're an income-hungry investor - which most investors are, most private clients certainly are - in order to replace the income stream that you might've got in dividends from all these shareholdings to replace that, you go up the capital structure. A fine example of that is, well, recently we had two issues from both Barclays and RBS, who've both been lent on and told to stop paying dividends. But they issued two bonds; one is paying - so the Barclays one is paying three-and-three-quarter per cent and the RBS one is paying 2.6 or something. They do have slightly different characteristics from the credit perspective, but they are paying you a coupon. They will continue to do that. You don't have them being lent on and told not to pay coupons on their bonds, because that's a rather different matter altogether.

[Sam Liddle] Really finally then, it'd just maybe help to tie the session all together if you could just summarise what the opportunity is at the moment maybe some people are missing or commentators are missing when they're constantly talking about equities. You clearly feel they should be looking more over at your sector.

{Jeremy Wharton] Well, yes, not entirely. As you were pointing out if you look at a normal portfolio, there's a need for income from part of that portfolio so bonds have a place within a portfolio and so do equities. There is still the opportunity to add credit risk into portfolios, as long as it's the right credit risk. You'll have gathered that I'm not advocating most parts of high yields or emerging market debt or whatever because most of it is much more risky than it has been for quite some time. In decent investment-grade credits you are being paid a predictable income stream and there has been, and there will continue to be, in certain credits the potential for capital upside. You don't have to go too far out; you don't have to take on too much volatility to do that. There isn't as much volatility down the short - sorry, as much coupon available down the short end of the curve, but there's an awful lot more than you're getting from many other sources.

[Sam Liddle] Thank you very much, Jeremy. I think that about wraps things up, then, for today but before we close, I'd just like to urge you all to consider the Church House Investment Grade Fixed Interest Fund, when you're investing for your client portfolios. As the name suggests, it is always 100 per cent invested in investment-grade bonds. All the risk controls are aimed at creating a low-volatility fund with real risk diversification from other asset classes, while providing a competitive income. If you'd like to arrange a call with Jeremy to discuss the Fund in greater detail, then please do get in touch with me, but thank you again for joining the call today. We'll send you an email tomorrow with your CPD certificate and a link to Jeremy's Fund on our website.

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