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Conference call highlights



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HIGH YIELD & CREDIT OPPORTUNITIES UPDATE OCTOBER 2011

Spreads offer good value

The spread offered by high yield over government bonds widened substantially over the summer and now stands at levels typically seen during a recession. These spreads imply a far higher default rate than we believe is likely. Our forecast for the default rate in 2012 is in the 2-3% range, whereas spreads are discounting defaults closer to 10%. We therefore think that a very interesting value opportunity has developed.

Companies in good shape

One of the reasons why we believe defaults will not rise significantly is that companies are in very good shape, particularly in terms of leverage. Companies have not used the last two or three years to increase leverage, because of the uncertain economic environment and the fresh memory of the financial crisis. Businesses have looked after their liquidity and raised a lot of cash and, with the market trading reasonably well, they have also had plenty of time to optimise their balance sheet structure. At the same time, earnings have been growing. So with the cost of debt relatively low, interest coverage ratios are unusually high. All in all, companies are in good condition to weather what is likely to be a period of anaemic economic growth.

Better quality index

Another factor supporting our sanguine view on defaults is the credit rating breakdown of the European high yield market. Around 63% of the index is rated BB with a further 31% rated single B. This leaves less than 6% in the CCC category, a part of the market that carries significantly higher default risk. By way of comparison, the US high yield market has a higher weighting in CCC and B and a lower weighting in BB. The European high yield market is therefore characterised by higher average credit quality than its US counterpart, leaving it better-equipped to prosper in the economic conditions we foresee.

Low growth is not a problem

For sensibly managed high yield issuers, the lacklustre growth background that we are forecasting does not represent a significant problem. High yield companies do not need robust economic growth to be able to repay their debt – indeed, when growth accelerates too far there can be a tendency for companies to become over confident and increase leverage. Low growth gives well managed companies with appropriately structured balance sheets the chance to generate cash flows and pay down debt.

A different market compared with 2008

The first half of 2011 was characterised by high levels of supply, as companies sought to refinance and manage their balance sheets, combined with high levels of demand given the scarcity of alternative income options

available. In the third quarter, risk aversion drove significant outflows from the asset class, but the nature of these outflows was very different to that seen at the height of the financial crisis. At that time, the lurch wider in spreads was driven by forced selling by leveraged investors including hedge funds and proprietary trading desks. Now, leverage in the system is much lower and cash investors are more prevalent. These real money investors are rational and have now started to identify value at current spread levels.

A wide range of buyers

Flows have stabilised over the past few weeks and the market has regained its poise. We have started to see buyers returning to the market and these have come from a variety of sources, including retail and institutional investors from the UK and Europe. There is also evidence of US high yield investors turning to Europe as a result of the attractive relative valuations and better credit quality on offer.

Fund positioning

We have been maintaining a relatively defensive stance in terms of sector exposure and position in the capital structure, but we do not believe it is appropriate to be overly defensive at the credit rating level. Therefore, we are underweight in BB rated bonds and are focusing the portfolios on more defensive B rated issues, with a lot of senior secured exposure in the portfolio and a bias away from cyclicals. As a result of this approach, our average rating is similar to the index, but our average spread is somewhat higher. Recent activity has been focused on reducing cyclical exposure further at the margin, with new purchases skewed towards BB rated bonds.

Event-heavy environment continues

Although conditions obviously became more difficult over the summer, the market remains open for high yield issuers and refinancing and takeover events continue. Anticipating and seeking to benefit from these events has been a key strategy in our funds in 2011. We have seen a number of prominent issuers taken over, with deals often resulting in bonds being upgraded or tendered at a premium. Nevertheless, given the uncertainties facing markets, some anticipated events may take longer than previously expected to occur.

More cautiously positioned in Credit Opportunities

We have adjusted the positioning of the Credit Opportunities Fund - our absolute return offering focusing on high yield and investment grade - over the summer to reflect the more volatile conditions. The fund has five main strategies: carry, directional, relative value, basis and event. We have reduced exposure in the event book in light of the likely delays to some anticipated events. We have also cut exposure in the directional book, which is where the fund takes its longer-dated, higher-risk credit exposure. Meanwhile, the carry book has grown as we have refocused the portfolio on the shorter-dated yield opportunities on offer. We will continue to monitor market conditions and to adjust these strategies accordingly.

Conclusion

The high yield market has had a difficult summer but spreads at current levels imply a far higher default rate than we foresee. As such, we believe that the market offers good value. Outflows seen in August and September have stabilised as investors have returned to the market. Interest has come from a range of sources, including US high yield investors. We have been relatively defensively positioned in terms of sectors, with limited cyclical exposure, but remain overweight in B rated bonds relative to BB issues in our high yield portfolios. We believe that this part of the market continues to offer the best long-term risk-adjusted return potential.

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