

# benefiting from falling rates

November 2008

**Jim Leaviss**, head of M&G Retail Fixed Income, comments on the outlook for bonds.



We are very positive on bonds as an asset class, because both drivers of bond performance – duration (interest rate risk) and credit risk – are now very attractive. We think bonds should perform much better than cash over the next one to two years.

In an economic downturn interest rates tend to fall, which is when bonds really come into their own. We have long believed that we are heading towards a recession and have positioned our bond funds to benefit from falling interest rates.

Until recently, investors were worried about a return to the stagflation of the 1970s, but markets are now coming around to our long-held view that there is a greater risk of deflation than inflation. Inflation fell in the aftermath of past banking crises (eg the Wall Street Crash,

the US savings and loans crisis, Japan in the 1990s, the Scandinavian banking crisis and the Asian financial crisis) because liquidity was withdrawn from the system and excess capacity created as economic growth stuttered. We don't believe this time will be any different, and central banks are more likely to worry about the prospect of deflation than inflation in 2009. Interest rates have been slashed in the past couple of months, and we believe more cuts are on the way.

## performance driver

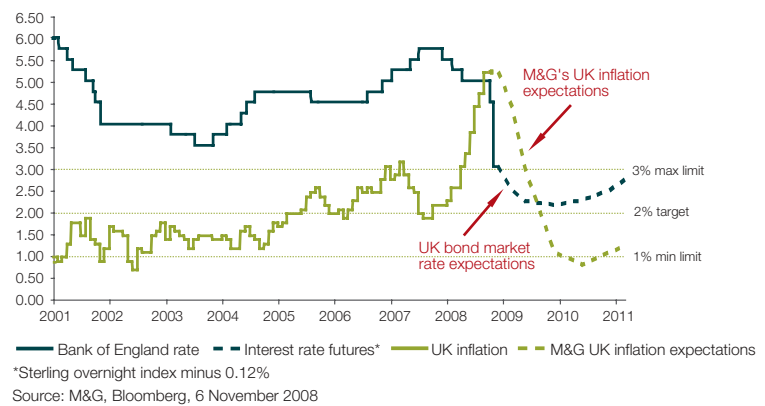
The other key driver of bond performance, credit risk, refers to the extra yield that comes from owning a corporate bond rather than a government bond. Corporate bond 'spreads' (the excess in yield over government bonds) have reached unprecedented highs, and are now fully compensating investors for a

wave of defaults that eclipses even that seen in the Great Depression. We have held a bearish economic outlook for a long time, but we believe that corporate bonds are more than compensating for the risk of default.

For example, M&S bonds maturing in 2012 currently pay a yield of over 10% per year. In other words, assuming M&S does not default, the investor would receive a total return of 10% a year until 2012. M&S is rated BBB (which is investment grade) so the risk of default is small, but even in the unlikely scenario of default investors could expect to get around a third of their money back, as bond investors are near the front of the queue in laying claim to a company's assets. Investment-grade corporate bonds are more attractive than they have been in living memory.

High yield is also becoming much more

## M&G's inflation/rate expectations compared with those of the UK bond market



attractive. European high-yield corporate bond spreads recently widened out to nearly 2,000 basis points over government bonds, meaning that the average high-yield corporate bond was yielding around 20% more than government bonds. At such heightened levels a number of attractive opportunities are emerging, although credit work is absolutely essential in an area of the market that will inevitably see a number of defaults.

### key factor

In current conditions, a key factor in driving returns is choosing the right sector.

Our bond funds have benefited enormously from our largely underweight position in financials. Over the past year, we have argued that the market badly misunderstood both the risk of banks defaulting and that subordinated bank bonds could end up worthless – even where banks didn't default. We have particularly disliked so-called 'Tier 1' subordinated bank bonds; investors are beginning to realise that these are nearly worthless in the event of default, and are likely to be worthless even when banks are bailed out by their government.

Although the effective nationalisation of

the banking system has made us slightly more positive on financials, there are many details of the package that are yet to be ironed out and we think that on the whole non-financials are much better value right now. Where we do own bank bonds we own the 'national champions', and we lend to them in the senior part of their capital structure. ☺

**The M&G High Interest and M&G Optimal Income Funds are available through Skandia's Life, Pensions and MultiFUNDS fund ranges and the Selestia Investment Solutions investment platform.**

## adoption of UCITS III wider powers

Following overwhelming investor approval, we have recently adopted the wider powers granted by UCITS III across our retail bond range. We believe this will improve our funds' performance potential without changing their risk profiles.

A key advantage of adopting these 'wider powers' is an increase in efficiency as managers are able to more accurately implement their investment views and adapt quickly to changing market conditions. For example, if a manager believes that interest rates will fall, he or she can buy interest rate futures instead of buying longer-dated bonds, where longer-dated bonds may be affected by other forces. Derivatives can also be used to position portfolios to benefit from falling as well as rising bond values. Another advantage is that dealing costs are often lower, and better liquidity means they can be easier to trade than physical bonds.

The use of wider investment powers is likely to vary from fund to fund, depending on their objectives and strategies. Government bond funds will generally use only interest rate futures or gilt

futures. High-yield corporate bond funds will generally use only credit derivatives. Investment-grade corporate bond funds are likely to use a combination of these strategies. Money market funds such as the M&G High Interest Fund are, however, unlikely to use derivatives to any significant extent.

Richard Woolnough has already been using 'wider powers' in the M&G Optimal Income Fund, the most flexible of our bond funds, and this has proved highly successful. In the current environment Richard has used 'wider powers' to go short on credits he does not like, such as US banks Wachovia and Citigroup and UK banks HBOS and RBS, enabling him to profit from the deterioration in their credit profiles.

The performance of the M&G Optimal Income Fund has been exceptional, looking at its peer group: from launch (8 December 2006) to 7 November 2008 the Fund has returned -5.1%, more than 10% ahead of the -15.5% average fund return in the IMA Sterling Strategic Bond sector, placing the Fund in the top decile.\*

\*The source of fund performance data is Morningstar, Inc., as at 7 November 2008. Sterling class A shares, net income reinvested, price to price basis.

The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process. Past performance is not a guide to the future.

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