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bonds: a licence to thrill?

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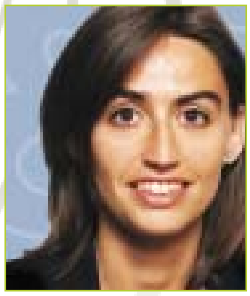

We asked Fatima Luis, Fund Manager at F&C Investments, for her thoughts on the key issues facing fixed income.

are there opportunities in financials?

Many have suggested that the beleaguered banking and financials sector represents the opportunity of a lifetime from a credit perspective. This is because spreads – the difference in yield between government and corporate bonds – have moved out and remain at previously unseen levels.

Fear over banks going bust and subsequent risk aversion means that, for many, valuations and yields are simply too good an opportunity to miss. For most bonds the current price presents a compelling case because their valuation more than compensates for the additional levels of risk currently being experienced. Of course there are times when wider spreads turn out to be well founded – a lesson learnt when the authorities chose not to rescue Lehman Brothers from bankruptcy.

Across the sector as a whole, however, financials do seem to offer compelling value, especially as the sector's senior names now effectively enjoy government backing and we have sizable exposure across our portfolios. Indeed, we have even introduced a sizable allocation within our Maximum Income Bond as a large proportion of related issues offer yields comparable with traditional high yield bonds.

you have mentioned the collapse of Lehman's – what about defaults more broadly?

Outside of the banking sector investment grade has, up until now, escaped relatively lightly from a default perspective. We do, however, believe that defaults are likely to pick up significantly from here. For example, more than half of the US sub-investment grade credits are offering yields in the range of 10-20% more than government bonds. This large number indicates the extreme stress in markets.

The economic backdrop continues to deteriorate and recession now looks to be well on the cards on both sides of the Atlantic. This obviously impacts on companies and corporate earnings have already begun to tick downwards – a sure fire signal that higher defaults are on the way. Problems in the financials sector will also make themselves felt more broadly as banks, keen to rebuild balance sheets and reduce risk, tighten lending standards. As companies find it harder to get short-term capital, a growing number will begin to default on their bond payments. The ability to differentiate between winners and losers will become even more important.

what's your outlook and which areas look attractive?

Things are going to remain pretty uncertain from here, in the near term at least. But it's not all doom and gloom – there are still plentiful opportunities out there. As we've already mentioned valuations and yields look attractive, especially among the distressed financials.

Selectivity is increasingly important whichever part of the bond markets you are looking at – both from an individual issue and asset allocation perspective. We currently prefer investment grade over high yield – valuations are attractive on a historical perspective and higher quality bonds should be the first to benefit in an environment of falling interest rates and when signs of economic improvement eventually emerge.

Fatima Luis manages F&C's A-rated* Strategic, Extra Income and Maximum Income Bond funds which are available through Skandia's Selestia Investment Solutions investment platform and Life and Pensions fund ranges.

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* Standard & Poor's.