

Europe – Corporate bonds look good value

By Emma Du Haney, Investment Director

Corporate bonds, particularly the higher quality investment grade ones, look cheap on any historical measure. In the UK, investment grade financial sector bonds are trading at levels that indicate that one in five banks will go bust in the next five years. If this really happens then the financial world is set to become a much scarier place. But if not, then surely financial bonds represent good value. Indeed, following the rescue of Bear Stearns in the US and Northern Rock in the UK, one could take the view that governments are effectively guaranteeing financial institutions.

In terms of value, take the example of the UK bank HBOS: it recently issued a bond that is yielding more than 5% over UK gilts; a yield of around 9.5%. This represents equity like return for bond type risk. Moreover, even if the banks have had huge problems, the future is likely to see them managed with a cautious, almost utility type approach, which is likely to benefit bond holders at the expense of the equity investor.

However, just because corporate bonds look cheap does not mean that they cannot get cheaper still; there are still a large number of forced sellers around and risk aversion remains high. However, we believe that investors with a medium term view will be well rewarded by starting to rebuild their corporate bond exposures.

Investors should also consider allocating funds to credit alpha strategies as a way of taking exposure to both the positive and negative stories within the corporate market. Credit default swaps allow you to put in place a negative view on a company, which can be done outright or as part of a relative value strategy. An example of the latter would be to prefer British Telecom over Vodafone. This type of low risk strategy is not affected by the direction of the overall market or even the telecoms sector; it is just a play on one company having a relatively better performance than the other. Having these types of strategies within your portfolio allows you to profit from opportunities in the credit market without increasing your exposure to overall market direction.

Pension funds are by their nature long term investors and have for many years enjoyed the additional yield available to those prepared to tie some of their capital into less liquid assets, the most obvious of which is property. There are also a number of fixed income asset classes that fall into this category such as asset backed securities and secured loans. The recent crisis has increased their illiquidity and led them to trade at much higher yields. For an investor prepared to overlook the possibility of some further near term volatility and willing to take a 3-4 year view, opportunities exist in these areas.

So, while UK pension funds might have suffered from the credit crunch, now may be the time to start to take advantage of the attractive valuations that have been created.

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