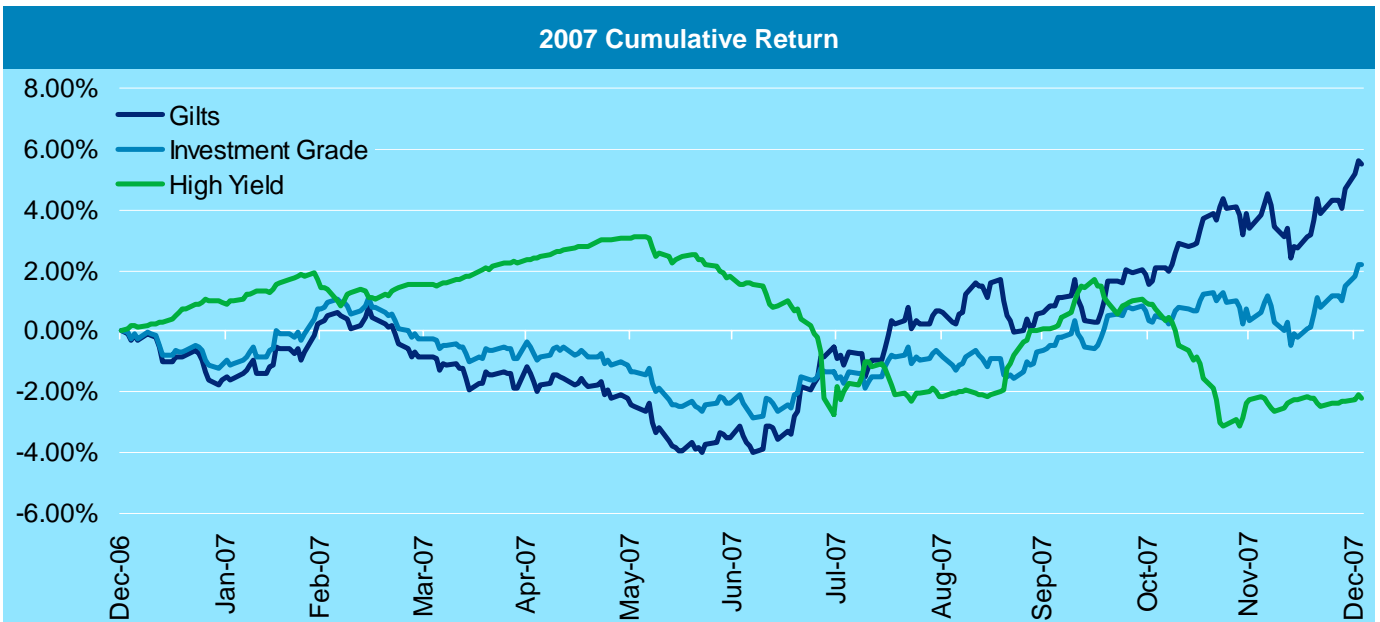


Flight to quality brings long-awaited cheer to bond investors

By John Pattullo, Director of Fixed Income

As a fixed income manager I feel that when markets are against you, sometimes honesty is the only policy. Over the course of the past year I have been brutally honest about where we are in the economic cycle, and the relative merits of cash versus bonds. Indeed, as far back as autumn 2006 I had been telling the investors in my funds that cash returns would outperform the returns to be made from bonds. In 2007 holding cash proved to be a smart decision. However, this year, after the US Federal Reserve announced a whopping 75 basis point interest cut, the biggest single cut in over two decades, the outlook is looking decidedly more positive for fixed income as an asset class.

Last year came in two distinct halves: the first half was characterised by strong equity markets, very tight credit spreads and rising bond yields. The latter half was the complete opposite: weak and volatile equities, credit implosion and a major flight to quality. Although the credit boom seemed to be getting a bit long in the tooth, nobody expected the severity or duration of the credit crunch that followed. Nor the way negative sentiment would travel between previously unrelated asset classes: from asset backed securities to loans through to high yield, investment grade and equities, and now on to monoline bond insurers.

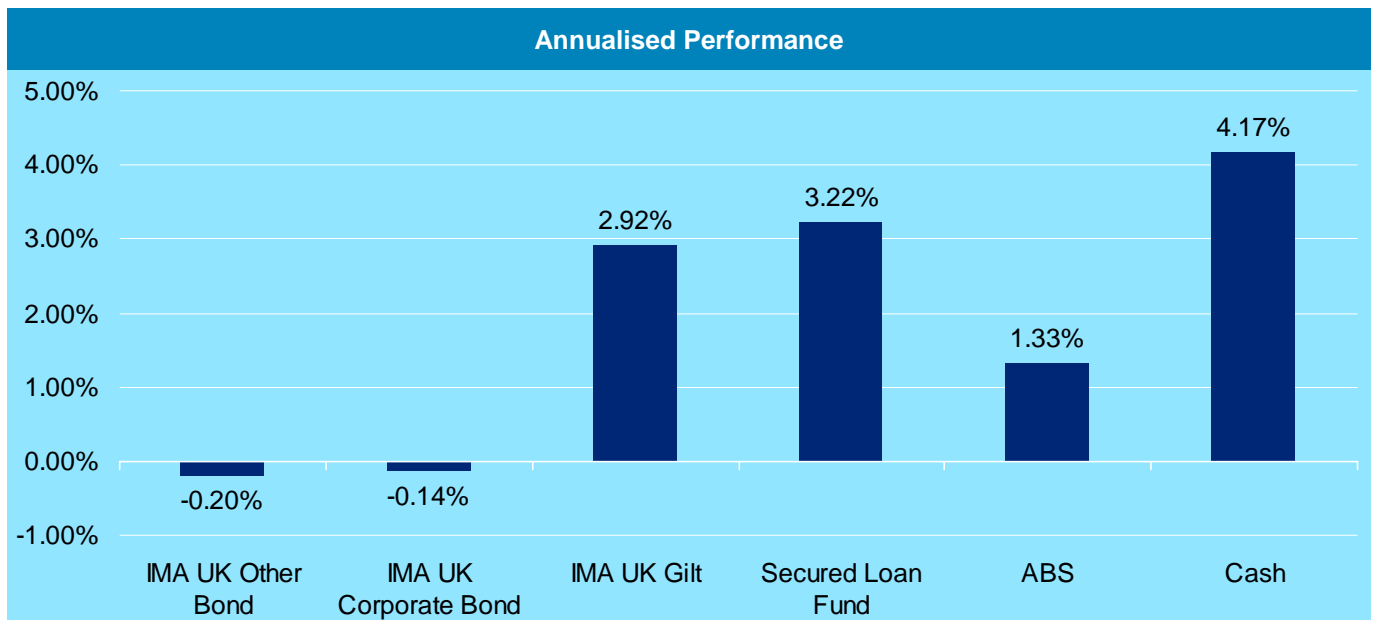


Source: Merrill Lynch, data at 31 December 2007.

Making money in this sort of environment has been tough because fund managers have little choice but to operate within the parameters of the market. Liquidity dried up in all asset classes, making asset allocation difficult and implementation tricky. Ironically almost all fixed income assets classes were poor over the year – languishing in a range of plus or minus 2%. So it was not really a big asset allocation year, which is unusual given the large historical deviations between different types of fixed interest assets. Cash won out against all, including equity and property, but investors should remember that it is called an economic cycle for a reason; if cash did not dominate occasionally monetary policy would not function correctly.

Are bonds looking better value?

Last September we underwent a material change in our view. We believed that the shake-up and repricing of risk to more rational and even cheap levels represented a good buying opportunity for bond investors, a view we stick with. A general rule of thumb is that you want to buy bond funds just before interest rates peak. Well, rates have peaked. Secondly, corporate bond spreads have blown out to five year highs and the market is currently trading at levels discounting a recession. In fact BBB-rated companies are trading at levels discounting five year cumulative default rates of 10%; the worst ever five year period since 1970 is 5.4%, and the average is 1.9%!



Source: IMA, Henderson Global Investors, performance figures to 31 December 2007 (funds quoted net of charges).

Strong upside to financials

Financials are trading at levels implying 14% default rates over a five year cumulative period. This is cheap on any risk-adjusted basis. Everybody thinks investment grade financials are cheap but few are brave enough to buy them now, as most expect them to get cheaper as new supply hits the market over the rest of the quarter. However, virtually all the strategists believe that on a 12 month view this is trade of the decade.

We believe the current financial crisis is being contained by equity support by sovereign wealth funds from players such as UBS, Citigroup and of course significant central bank action from the European Central Bank, and most recently, the Fed. The crisis is – in large part – of the banks' own creation and is not dissimilar to the one the incumbent telecoms companies found themselves in post the 3G license misadventure in 2002. To put it simply, banks need to de-lever, recapitalise and hunker down. Running banks for creditors is good for bond holders, but does not make a good equity story at all. As a bond manager I'm not too troubled by this.

So in times like this, how can a bond fund manager add value? By using a strategic approach that allows for greater flexibility than traditional bond portfolios. For example, around Christmas and New Year we implemented a hedging strategy by using credit default swaps (CDS) to short several investment grade industrials, airlines, cyclicals, and consumer names (such as Tomkins, BA, Dixons and Clariant), given the market's concerns over recession. This type of trade is vital when market sentiment is weak as it presents opportunities to turn a negative outlook on a company into returns for clients.

There is much to be concerned about with such an uncertain economic outlook but portfolio flexibility will be key to steering through the murky waters. Our current view is that bonds are cheap and should outperform cash in 2008.

John Pattullo manages the Henderson Strategic Bond and Preference and Bond Funds

4 February 2008

This article first appeared in Fund Strategy