

Henderson's John Pattullo continues to see bonds as a compelling value proposition

"Last summer I stated that investment grade bonds were "a waste of time". Back then, investment grade bonds yielded 0.6% over Gilts, which would not even cover the charges on most bond funds. Today, the investment grade index yields 2% over Gilts.

We believe valuations are compelling and offer very attractive risk-adjusted returns for investors. At the moment, the bond market is offering equity-like returns for bond type risks. An example of this would be the HBOS bond issued last week. It now yields 9.75% (or 5.4% above Gilts).

Investment grade financial bond spreads are trading at levels implying that one in five UK banks will go bust in the next five years. Either this will happen or credit spreads are too cheap!

The great unwind

We are now moving into uncharted territory. The fate of Bear Sterns may one day be viewed as a pivotal moment in credit markets, an extreme example of what can happen when fear rather than fundamentals is the main market driver. Buying bonds into a crisis usually makes sense as you are getting paid for taking the risk. Of course the market does not trade on valuations alone; it is also driven by technicals and momentum – and those are lousy at present. The overshoot in valuation has been caused by the leveraged unwind of those investors who have been forced to become sellers. We now need new buyers to realise the value in the market. However, there are not enough of those around – nor do they have access to leverage – although there are rumours of 'smart money' investors starting up credit recovery funds to exploit the value available.

Portfolio positioning

We think we are about 65% of the way through the leveraged unwind, and we are now adding risk in our portfolios. We are currently taking profit on many of the short names we have held (**Kaupthing, ITV, British Airways, Dixons** and **Kingfisher**). Our credit derivative overlay has added over 4% to our funds, making a truly appalling market somewhat more bearable.

Further down the line we will start spending our "rainy day" cash (20% in the Henderson Strategic Bond Fund, 10% in Preference & Bond) on the most attractive assets – Banking Bonds. Back in 2002 the telecom industry was chastened by the bursting of the dotcom bubble and by excessive capital expenditure in the preceding years. The upshot was several forced rights issues, bond issues and the telecoms companies subsequently being run in a very conservative manner. We think the same thing will happen to the banks. They will be managed with a cautious, almost utility-like, approach, more to the benefit of bondholders than equity holders. We are not convinced that banks make a great equity story, but we think the bonds will prove a compelling value proposition.

We are in no doubt that investors should be averaging back into fixed income assets, but won't waste time trying to predict whether the bottom of the market is still to come or has already happened. We envisage investors can look forward to much more appealing returns from fixed income in the future".

John Pattullo, Director, Fixed Income

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John Pattullo is fund manager of the Henderson Preference & Bond and Strategic Bond Funds