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Bonds have more fun

FUND FOCUS

The prospect of interest rate falls means it is time to look at bonds again and the Artemis strategic bond fund is a good one-stop shop for those who do not want to have to make the decision between gilts, high yield and investment grade

One sector that has seen considerable outflows over the last few months has been corporate bonds. We have experienced a period of rising interest rates, so naturally their performance over the past few years is uninspiring, especially compared with the bull market in equities.

Recently, however, we have seen investment-grade spreads bloom out to levels last seen in the Russian default crisis, close to 140 basis points over gilts. In the year to date, gilts have risen by 3.89 per cent, investment grade by 0.72 per cent while high yield is down by 1.96 per cent. Yields are back to where they were around six years ago.

There are not many things we can predict with any confidence for 2008 but I believe one of them is that there will be interest rate cuts in the US and UK. This should provide a supportive environment for corporate bonds.

One fund which I think is very much on top of things is the Artemis strategic bond fund, managed by James Foster and Alex Ralph. Foster was on top form when I met him recently. In his view, the cause of the present credit problem was an excess of leverage, resulting from interest rates being left too low for too long. Banks were particularly caught up with this but are now being forced to bring low quality assets back on the books because they cannot borrow commercial money.

The upshot is that their balance sheets are being strained. They cannot lend money and are running out of cash. What follows this is deflation (or at least disinflation) which has a dramatic impact on the economy as banks start to offer uncompetitive rates. This is the reason why Libor rates are so high.

The ultimate consequences of the present problems are obvious. It really does not matter what level interest rates fall to if the banks themselves are not profitable and cannot lend money. To see the worst of this, you only have to visit Japan which has interest rates at 0.5 per cent and where for many years banks have not been able to lend money.

However, the central banks in the UK and US are aware of this problem and will be trying not to make the same mistakes as the Bank of Japan. I am less sure of the European Central Bank which in my opinion spends far too much time battling inflation and will often be the last to move rates down.

Where does this leave the Artemis strategic bond fund? Foster expects more defaults in the high-yield space and this is beginning to be priced into the market. He does not expect spreads to go as wide as they were a few years ago and is still seeing some good bargains. Spreads on financials have been blown out and he feels he can take advantage of the present panic.

He has topped up his holdings and now holds 40 per cent of the fund in the financials, giving the fund an attractive yield after costs of around 6.5 per cent.

What I like about the fund is that it is a true managed bond fund. For many brokers and clients, this is a superb one-stop shop for your bond portfolio. The majority of investors really do not want to be trading between gilts, high yield and investment grade so what better than to leave it to a high quality outfit like Foster and Ralph?

Foster has always been professionally blunt with his views. Those who saw him in 2001-02 will remember his extremely bearish dance on equities. What I found interesting this time was that he was not entirely negative on equities. In fact, he believes they could make good returns over the next year.

I, like Foster, am not entirely bearish on equities. Remember that next year is a presidential election year in the US, which is usually good news for markets. However, I am in no doubt that the overall outlook for 2008 is cloudier than we have seen in recent years. It seems a good idea to have some bond exposure in client portfolios, especially given the background of falling interest rates.