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The PROFIT Hunter

James Foster – Strategic Bond Fund

Richard Turpin: Thank you very much. Ladies and gentlemen good morning, welcome to the continuing series of the Artemis webcast and today specifically the Artemis Strategic Bond Fund and as you know here sitting next to me I have James Foster. When we scheduled this webcast little did we know how apposite and appropriate it would be to actually host a conference, a web conference at this moment in time. Specifically as we sit here today, at this very moment the Governor of The Bank of England is defending his position in front of the Treasury Select Committee, so we clearly live in very interesting times.

James has been managing the Strategic Bond Fund since its launch on 30th June 2005 and normally I would do quite a long preamble, but this particular time there is a lot to get through; James has got some very interesting thoughts and comments and I'm sure you'll be relieved to hear that the majority of the time you will be able to listen to James rather than myself. Just one quick piece of housekeeping; forgive me for those of you who have listened to our conference calls before. Hopefully in front of you on your screens you will see a photograph of James, just to the right are some tabs and one of the tabs is a question tab. If you would like to pose any questions while the conference call progresses, please just click on the tab and a little box will appear where you can type in your question and then there is a submit button at the bottom of the box. Due to the time constraints and what we have to get through this morning, I will try and get as many questions that you pose answered but we will probably do that towards the end of the conference call. So without further ado, I'll hand you over to James for his thoughts on the interesting times that we currently live in; James.

James Foster: Thank you very much Dick. There is an awful lot to talk about over the next twenty minutes or so, so I will get stuck in, we will look at the agenda. Agenda is a fairly simple analysis of what's going on; where is the pain - which is an awful lot at the moment - when is this all going to get sorted out, a brief look at the fundamentals, though the markets are ignoring this, and then some fairly rash predictions about the future. Clearly you shouldn't believe any of them. So if we start with what caused all these problems, the issue essentially has been a liquidity crisis. It's been talked about as a credit crunch but in practice I would describe it more as a liquidly crisis. In hindsight it's always very easy to say that in hindsight interest rates have been kept too low for too long, particularly in the US and so too much leverage had built up into the system. The big liquid party of low rates is rather painfully coming to an end. Whilst low rates, low interest rates was encouraging, was a big increase in the level of gearing?. Surprisingly it has been financial gearing and not corporate leverage, or not corporate gearing. Clearly companies have learnt perhaps from their mistakes in the past. But what we had instead was private equity organisations, the likes of KKR buying up companies, massively increasing the level of gearing within the organisation and then selling off the debt in that organisation into the high yield market. On top of that we have also seen hedge funds borrowing vast amounts of cash to reinvest back into the market, the famous 'carry trade'. Furthermore, we have had in the last few years the establishment of a CDO market and other sort of geared, structured products.

So what started all the problems was actually the sub-prime market where defaults were starting to increase. The sub-prime mortgage markets was obviously famous for these NINJA mortgages i.e. no income, no job mortgages. Not surprisingly when interest rates went up the people with no income and no job struggled to pay their loans. The mortgages have been packaged up into these collateralised debt obligations, CDOs, and when the default increased, some investors who had believed the rating agencies that they were triple A investments suddenly realised that they had been sold a pup. Sub-prime is a problem, but in its own right, was actually perfectly manageable. But in practice it has acted as a catalyst to undermine confidence in the markets and led to this dramatic change in sentiment which we have seen in the last few months; this has been very dramatic. Private equity has also been one of the sufferers in this fallout. The collapse in confidence caused a dramatic re-pricing of this market and it means that private equity acquisitions are off the agenda for now. Quite simply they can't get access to their cheap capital any more so that makes it much more difficult to do those geared acquisitions.

The problem with private equity is the backlog of deals which still needs to be refinanced in the markets, so that they have made those acquisitions and they haven't managed to place those bonds back into the markets. There's a bit of a standoff taking place between the banks and end investors, with banks not prepared to take down their loans to say 80p in the Pound where investors are prepared to buy. The result is a bit of impasse at the moment. There was a backlog of about 400 billion of loans which need to be placed. The first of these should be done over the next week or so and that should help to boost confidence once it occurs, but at the moment the markets are still fairly jammed up in that area.

Other problems from this excess liquidity was also in some hedge funds that had been forced to sell positions. Some that took on the dodgy sub-prime mortgages are now having to fund those losses. They have tended to do this by selling their profitable positions leading to a general rout of all bonds. Further there have been some pretty high profile defaults and that's led to forced selling of all of their underlying positions. The net result is that there has been a deluge of forced selling and that has exacerbated an already uncomfortable market over the summer.

Another area of interest which has caused a whole pile of problems has been these SIVs and conduits. I don't want to spend too long on these because they are extremely complicated, but essentially they are off balance sheet instruments used by banks and in the simplest form they borrow short using the commercial paper market and they lend long. The crisis has meant they can't borrow short and that has forced the banks to take these structures onto their own balance sheets. The net result of that is their balance sheet is clogged up with all these assets which they have had to take onto their balance sheet. And lastly and perhaps one of the most important factors in all of this is the banks don't trust each other. Banks have moved into the unusual position of not lending money. Banks balance sheets have been clogged up with all this commercial paper, private equity loans, various other rubbish and it has meant that they can't lend to each other. Furthermore they don't trust the collateral which they have been given back from other banks in the first place, so it's undermining confidence even further. And this is where the Bank of England has now been helping, belatedly, in the last couple of days. They are now providing liquidity to this market to stop this crisis getting any worse.

So what has this meant for the underlying assets, where is all the pain being

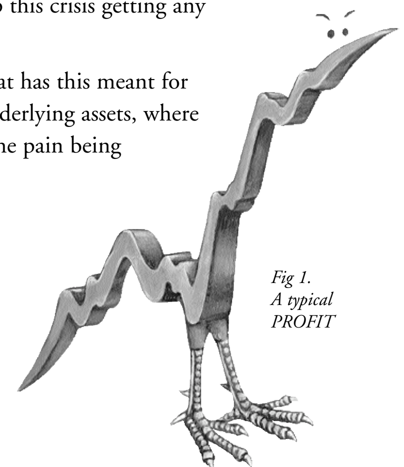

Fig 1.
A typical PROFIT

felt? Well, firstly in the loans market - and this has been hit really badly. This backlog of 400 billion of loans which I was talking about is naturally unsettling the market. Examples of this include Boots and S&M Corp which are sitting on the bank books and they'd really rather not have them, and it is expected to take some time before they can offload all of this and for the banks to argue with investors about a fair price for these assets. Net result is that the loans market will still be suffering probably for some time to come. The high yield market also suffered and that was purely a function of this greater risk aversion. It's not a function of actual default rates going up because they are not; they are still extremely low. But the chart demonstrates the extra yield available for investing in high yield bonds. So in May you were getting 200 basis points over Government Bonds. Now you are getting more than double that with 415 or so. That is now in line with fair value over the longer term as it as compensates you for the average level of defaults. So you wouldn't describe it as fundamentally cheap, but it is considerably more attractive than it was three months ago. This is one of the more interesting markets this chart shows. And this is where, this chart demonstrates base rates and three month LIBOR, and really sort of demonstrates the agony the banks have been suffering. LIBOR is the rate at which banks lend to each other, so it stands for London Interbank Offer Rate and normally LIBOR closely follows interest rates. If LIBOR was to stay at those higher levels then it would seep through to mortgage rates which did go up slightly last week. If LIBOR doesn't come down, and it is beginning to come down in the last day or so, then mortgage rates would have to go up again and this is where the Bank of England has got egg all over its face, and is now having to provide liquidity here to unclog the system. Clearly I think it is going to be embarrassing questions for Mervin King this afternoon. This extra liquidity should help but if it doesn't then they will have to cut rates otherwise this liquidity crisis will become a full blown banking crisis. At the moment I think the Bank of England is doing enough so I think we are alright but as I say, if we don't see this LIBOR rate fall then expect more panic.

Now the most exciting, most interesting chart of the lot and by far the most important chart I am showing you today, this on the left hand side is investment grade bonds which have suffered the most. The extra yield you are getting for any investment grades is just about as high as it has ever been. The last three months have been the worst ever; yields are now genuinely attractive. They are compensating you for defaults, recession, every other problem under the sun, so if you really think that things are going to get much worse, then you should be buying defendable land because that is the only thing that is worth having.

The area which is really offering even better value is bank spreads, and this as I put here senior bank spreads which demonstrates they are genuinely, extremely cheap, and the high spread on record; this goes back to 2000 but you could take the chart back as far as you can find it and they have never been cheaper, and it is a direct result of what has been going on in the LIBOR markets and the banking markets which has led to these spreads being so incredibly attractive. The chart here demonstrates senior banks; these rank pari passau with depositors, in other words as far up the food chain as you can get. They offer fantastic value, we have been buying some and I will give you a good example as Alliance and Leicester which we bought last week at a ridiculous yield of 8.5%, admittedly only an 18 month bond but that is just fantastic value and it is a remarkable scenario.

Richard Turpin: James this might be an interesting point to start, there is a question here from Simon Braite which is a simple question but it is a very important one. Will high yield spreads narrow again? Discuss. Joking apart, clearly they will but what do you see, do you see a protracted period of confidence needing to return before we will see any spread compression?

James Foster: I think where you are going to get the most spread compression is actually investment grade. High yield spread is a bit more selective, you have to be looking at…generally we're looking at more shorter dated and slightly higher quality. What this liquidity crisis inevitably means is that banks are going to be a little more conservative in their lending policy, which means that the weakest companies, the CCC's and perhaps some of the weaker single B rated companies may well find it difficult to gain access to funds and as we all know if they can't get cash, they go bust. So we would expect an increase in defaults in high yield companies and the furthest down the spectrum i.e. the CCC's. I would expect to actually not see much spread compression at all, but I would expect to see some spread compression in investment grade and better quality high yield companies, say double B's and that sort of thing.

Richard Turpin: I know there is a corollary question here from Gordon Lynes about a recent event brought about by a revision in the perceived merits of sub-investment grade bonds, presumably on the short term yes, but what do you feel overall?

James Foster: I don't discount the asset class entirely just because we have had a little bit of a setback; in fact it still offers some fantastic opportunities there and we have been digging up some bonds which are in the order of 10% yields or so which we can see may well be bought back in the not too distant future. In the meantime giving us 10% yield for a high yield bond, 10% for any bond is fantastic, so it is not an asset class which should be discounted just because we have seen a slight setback. And you wouldn't say that about the equity market when they had a slight setback, therefore we shouldn't be investing in it, on exactly the same basis. There are ebbs and flows in this market; it has come back a little bit. As I say I think in the weakest part of the high yield market yes, I would still be very cautious in the CCC area, but in the better quality area I am actually very confident that we will see some good returns over the next few years.

Richard Turpin: Thank you.

James Foster: If we look at the total returns for this year in bonds, they have been dreadful. Gilts are just positive; whilst our returns have been around 0% for the year which is very depressing, but it is a little bit better than investment grade and high yield which basically fell by 1.5% and 1.4% respectively. It is very rare to see such an underperformance of the investment grade market especially compared with the gilt market. They generally tend to move very much in tandem and so to see this level of underperformance highlights again the opportunities which are available in that market, we have seen distressed seller's which are creating good opportunities. It's really a very exciting time, I am very enthusiastic about the potential returns out of that market.

Let's have a look at the solutions to this crisis. In the US there was a clear justification for a rate cut given what had been going on in the economy and given the housing market, I would expect more. I don't actually expect much from the Bank of England or the European Central Bank yet. It might get a bit more if the prices get a bit worse but at the moment I think that is unlikely.

Richard Turpin: There is just a quick question James, I must admit it comes from myself. Do you feel that he is walking a tight rope between pushing the Dollar even further down? I mean you talk about potential further US rate cuts but clearly the crises in the economy are probably demanding those, but on the other hand the Dollar has all sorts of problems.

James Foster: Yes, I don't think they worry too much. Trade for the US economy is at a relatively low percentage, so the fact that the Dollar is weak tends to upset their trading partners more than it upsets them.

Richard Turpin: And they are all saying it is our Dollar but your problem.

James Foster: Yes, it is absolutely, still very valid. It is clearly much more relevant in the UK if the Pound is weak, then it has a direct inflationary impact. In the US because more assets are priced in Dollars anyway, it tends not to have that sort of impact. So it is less significant there.

Richard Turpin: Thanks for that. Sorry to interrupt.

James Foster: In the UK where - talking about interest rates, sorry yes - in the UK where inflation is only just coming off the boil and yes, it's banks were below the target level, there is some justification for an interest rate cut but I don't think that Mervin King will be pushed into it yet. If we hadn't had this turmoil in the last few weeks, they would have put us through

another rate increase so at the moment I think the economics just does not justify a cut in UK interest rates. Having said that, if LIBOR was to stay at very high levels then they would have to cut rates, but at the moment I don't think that they will. Perhaps later into next year the economics will probably justify an interest rate cut, but that is not the case at the moment. The ECB will doggedly do nothing of course for the rest of the year which if is anything good. Actually they'd probably like to increase rates because that is how they tend to think; if in doubt, increase rates.

Richard Turpin: But conversely they are suffering from a strong Euro versus a weak Dollar and…

James Foster: Yes, but that doesn't worry them, they think that is a good control of monetary policy and going to keep inflation under control. Remember the only thing which ever worries the ECB is inflation. The last thing which they are concerned about is growth; in fact growth equals inflation.

Richard Turpin: There is no mention of growth in their charter I think.

James Foster: No they are totally besotted about inflation and given the rigidity within the labour markets and the rest of it, they do suffer, they struggle.

Expect further injections of liquidity by all the central banks; and the Bank of England rather belatedly, as I said, started yesterday. The ECB have been pouring liquidity in for some time and there is no doubt that this has helped. Other important solutions were clearly US banks. We need to know whether there is any black holes in their balance sheets. If there are, then it would continue to upset the markets, but we need them to get through their reporting season. So far there haven't been any major black holes with both Lehman's and Morgan Stanley reporting numbers which were slightly better and slightly worse respectively, but nothing too dramatic.

I did a speech last week in which we talked about potential for some smaller banks and the odd hedge fund to disappear. We had seen the odd hedge fund going and I said last week I thought the only bank which really worried me was Northern Rock, which was a bit of a fortuitous statement given that that evening they then announced that they were in trouble. It actually helps ironically, you would not think it, but it does help because it clears away some of the potential uncertainties within the system. People were concerned that they were going to go into trouble; when they do actually announce that they are in trouble, it actually improves confidence because people know where they stand and so it then sorts out all the others. They sort the men from the boys because all the others the stand up and say well we are not in trouble, and the rest of it, and we know that we are not in the same sort of scenario as Northern Rock, and so therefore we are fine. This is a hangover from this liquid party and that is what the repercussions of that will be. The odd institutions will disappear and we have seen it with some hedge funds which are going and no great surprise there.

I am going to flick past these charts, which just highlights US growth next year. I just want to highlight that US growth next year will come under further pressure as the housing market out there takes further pain. UK and European growth rates will slow from their current levels, which are probably a little too high for the Bank of England's comfort anyway, so move on.

This is probably one of the more interesting charts; it's the House Builder's Index which is a good indicator of future retail sales. The housing market as we all know in the States is really in trouble and that is why I envisage that interest rates will have to come down further here. The fear is about higher oil prices and whether that will reignite inflation. I just don't think that is a problem at the moment; I think the Fed is much more focused on getting the housing market going again and therefore will continue to cut interest rates.

So in conclusion, as the world economy is slowing, especially the US, interest rates are generally on their way down. That is fundamentally good for bond markets. Furthermore, investment grade bonds are cheap, really cheap. I mean I haven't seen them this cheap for a long, long time. Rarely do you get the prospect of getting a situation of both good bond spreads and the potential for interest rate cuts. This is nirvana for bond investors. The market may take some time to recover from the turmoil, I accept that, and there is a backlog of deals to be done. But now is the time to be taking advantage of that. Investment grade bonds in particular are looking stunningly cheap, especially financials. We have been increasing our exposure to these financials and will continue to do so especially as the new deals come to the market over the next few weeks and we are expecting a lot of deals over the next few weeks. I really have to say that I am quite enthusiastic for returns over the next year. In fact that is wrong; I am very enthusiastic for returns over the next year or so and it is rare for a bond fund manager to say that sort of thing because we are normally a miserable bunch.

We had a big shock to the market with a number of forced sellers; I like forced sellers because they are selling them at the wrong price. To me; that's good news. And that's created genuine opportunity to pick up some really good value and I can give you examples of that; Alliance and Leister bond is 8.5%, and even Boots is at 11% yield. There are some amazing deals out there and its now time to reap the benefits.

Richard Turpin: A very exciting time coming up then for bonds fund management. I've got a few questions then if we can, we've still got a bit of time. Simon Brett; one thing you haven't touched upon in your presentation is where the credit rating agencies stand and clearly they have come in for a bit of flack. Simon was asking have they done a good job in the light of the sub-prime crisis and then added some thoughts about how they are going to operate going forward.

James Foster: I would love to set up a business called James Forster PLC which would rate anybody's debt and I would, if you give me enough money, rate you triple A. And I'll say, Dick Turpin give me £100,000 and I will rate you triple A and then you can sell your debt on to anybody else. To me there is no regulation, no control over what I am doing, nobody can stop me doing that as a business and that's what the rating agency has been doing. Taking fat fees particularly off these structured products as a result giving them an inflated rating and I…

Richard Turpin: Could you ever see as an extreme example of say Gove rnment or even the regulators coming in and forcing them, maybe by funding them centrally from the tax payers, so sort of make them wholly independent and get away with the difficulty of that ve ry conflict of interest you just mentioned in terms of basically buying ratings. Or is that too extreme?

James Foster: It won't happen that way because the governments won't want to pay the fees and they won't want to nationalise that industry which is effectively what that's doing.

Richard Turpin: Could you see more regulation?

James Foster: I could see more regulation coming through, but ultimately it comes down to us doing our jobs in terms of doing our own credit analysis of these individual organisations and making our own assessment. And if you don't understand it, don't trust it, then you shouldn't buy it and that's always been my precept on which I work. A rating agency is a helpful contributor to your own thought about an individual organisation, but it is not the be all and end all. Where the real dangers have come is actually the fact that people have been believing the rating agencies. We've seen the, particularly triple A bonds which they have been rating, and they have obviously come under a lot of pressure and had to change them, and that's had a dramatic impact.

Richard Turpin: Robin Davies is asking where you see bonds as an asset class for the next 12 to 24 months. I mean clearly you are excited, but you could argue that equities haven't really got going either in the last couple of years, unless it was sort of commodity or prope rty related. Do you see bonds as an asset class coming back into their own?

James Foster: I do, and I think if you look at the yield of our fund, after charges it's around 7% now, which compared with when we started was around 5% or so. That is a very attractive yield compared with the way we were before. I know even if we just own the coupon over the

next year you are going to get 7% yield. That to me is a very good return without taking that much risk. We are not talking about the more volatile areas of equities which clearly one day it is up 10% and the next day it is down 10% as we all know.

Richard Turpin: Nick Lincoln from Wilson Dean Financial Se rvices asks that if inflation is a threat, could you envisage using index linked gilts in your fund?

James Foster: Yes, it's a very good question, because it highlights where we can go within the fund, in that we would go anywhere and do go anywhere. Whether it be investment grade, high yield, preference shares, government bonds, you name it, we have been using them and index linked is clearly a tool which is available to us. It tends to be a good tool actually for stagflation environments. So if I am wrong about the States and we do get a bit of inflation back into the system because of their cuts in interest rates and they perhaps cut them too early, then yes, the place to go would be index link because that would give you that protection in that environment. At the moment I tend not to like them because pension funds in particular have bought and are continuing to buy them and they are a slightly overbought asset and so they don't yield very much and don't give you much compensation. So, I don't think they're very cheap at the moment, so they're not my favourite. But yes definitely, if I thought circumstances were changing it would be an area I would go to.

Richard Turpin: Following on from that looking at which areas of the long markets you like, Thorfinn Rendall from Orkney sort of sent in a question regarding the potential increase in – or the p rospect if you prefer of defaults on some of the high yielding end and where do you see the sort of best p rospects for bond retu rns balanced against the risk that one is taking?

James Foster: I think what we are going to get over the next few weeks is, the Royal Bank of Scotland are doing a big deal at the moment to finance the acquisition of ABN. Now they are going to have to do that at distressed levels in a fairly distressed market. Now that is, I think, going to be one of the best opportunities to pick up cheap bank paper and I would anticipate that over the next 12 months you are going to see that as being the best – one of the best performing areas. The yield which they will be paying is three hundred, 350 over something like that, which is a very attractive yield in a bank – it might not be your absolute favourite bank but it won't go bust and you have seen what has happened with Northern Rock in that I think it seems that any problems with banks the government steps in. So you would be even more comfortable about the fact that with Royal Bank of Scotland they would step in. To be fair they would not step in on the preference shares which is what they are going to be issuing, more junior capital, tier one capital but I am very comfortable those sort of banks will be providing one of the best returns over the next 12 months.

Richard Turpin: There's a political question we have got here, in terms of the potential interfe rence and it is clearly not clear yet whether the u-turn we have witnessed is down to the gove rnment itself or whether he has had some political arm twisting. Do you think the events of the last couple of days have in any way brought the independence of the Bank of England into question? And if so is it material?

James Foster: Yes, if I was being very cynical. It gives Gordon Brown a great get out I suspect, I came in, I told the Bank of England what to do and it will cost Melvin King his job in the whole process. I think his contract is coming up relatively soon. I've not got the exact timetable but he is coming to the end of his term of office, it is five years in office and so I would guess that he won't be reappointed and he will be perceived to be taking the flack from a purely political point of view. Yes, I think the Bank of England did slightly misjudge this one and in particular the steps which they came out with last week where they said were not going to bail out the money markets. "We not going to provide ex-post insurance to excess risk takers" it is probably the line they said. That was a pretty stupid statement for them; within 24 hours they had to turn around and change their view, provide support to Northern Rock and then provide extra liquidity into the money markets, as they have done over the last couple days. So it looks very bad for the independence of the Bank of England in the future. And the blame will be assigned as I say to the Bank of England rather than to the politicians because clearly that is what they want to do.

Richard Turpin: Yes; well there is nothing new there then. Well I think conscious of the time James we might as well bring this to a close. Ladies and gentleman thank you very much for your questions. I do apologise if we have not answe red all the questions that have been sent in but thank you ve ry much for going to the effort of sending them in.

We would be delighted to take any further questions either through our broker support line which 0800 092 2090 or our email address brokersupport@artemisfunds.com. Please don't hesitate to send in any of these questions and indeed a transcript of this presentation will be posted on our website in the next few days so if there is anything you want to follow up on please visit the website. James, thank you very much indeed and thank you again to all of you for listening in and we look forward to getting together again in the next few weeks. Thank you very much indeed.

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