

**Artemis Strategic Bond Fund**

Duration: 0:33:29

**Presenters**

- Richard Turpin
- James

**Operator**

Thank you for standing by and welcome to the Artemis Strategic Bond Fund conference call. At this time all participants are in a listen-only mode to eliminate any background noise. I must advise you that this conference is being recorded today. I would now like to hand the conference over to your host today, Richard Turpin, Managing Director of Artemis.

**Richard Turpin**

Thank you very much. Good morning ladies and gentlemen and welcome to the Artemis Strategic Bond Fund webcast conference which is a further conference call in our series that we've been conducting over the last couple of years. Thank you very much for waiting while we've gathered all the participants together. I'm very fortunate to have sitting next to me James.

Many of you know James, he joined us in April from Foreign & Colonial and Isis having been one of the key bond managers. We're very pleased to have been able to recruit James to join us and during the period of his time here, we've been in the process of getting ready and actually launching the Artemis Strategic Bond Fund which was launched at the end of June. The fund has raised some £14 million all from external investors with no C capital being used to actually launch the fund. James is going to speak with us today and talk through some of the macroeconomics that he is doing at the moment and how he sees the situation and how he's constructed a portfolio since the bonds have launched.

If I might just touch on a couple of small housekeeping issues. We will be taking you through a series of slides which will be shown on your screen in front of you. If you look to the bottom left hand corner of your screen you will see a small inset with a picture of James. Just below that are series of tabs, one of them has the word "questions" on it. Please feel free to click on that tab, type in a question as the conference call progresses and send it to us and we will interject during the conference call and answer as many questions as we possibly can.

So without further ado I'll hand over to James and we'll start the conference call. James, thank you very much.

**James Foster**

Thank you Dick. Good morning everybody, thank you very much for listening in. I thought I'd start today with just a sort of brief look at the economic background, and I thought I'd start with the GDP growth. Globally growth in the US has been actually coming off a little bit but at the start of the year it was going on with a cracking old pace and it's now as I say slowed a little bit. The very latest statistics are perhaps showing a slightly improving trend.

Moving onto Europe, Europe is as dismal as ever, low growth and the people are inevitably taking that out on the politicians, notice that the French referendum for instance. Dick has specifically told me that I'm not allowed to mention the Olympics, but of course I felt I had to bring that topic up when I talk about France. Germany is heading for elections as well this autumn and Schröder is no doubt getting due for a kicking as well. So it all makes for a bit of excitement out there.

The UK meanwhile, growth has been weaker. The latest numbers have actually been the weakest since Labour came to power. Meanwhile Gordon Brown's been doing the most incredible cooking of the books I've ever seen, with Lynn Cooke the Chairman of the Office of National Statistics must be going in for the most extraordinary number of peerages you can possibly get, if it is possible. Confidence clearly has been dented by the terrorism which has been taking place.

So I think if we look at what's going to happen towards interest rates, given that Gordon Brown has been quite so positive, given his cooked the books to such a degree, I'm sounding a bit like a vicar here. We're going to have to play catch up at some stage. On fiscal policy, he will have to tighten it up whether he does it at the next budget or a future budget I'm not sure, but clearly if he spends too much money now, he's got a fair bit of catch-up later.

Now if he does that then the fiscal policy being tightened up, monetary policy will actually take the strain. So interest rates in the UK are going to be on the way down. I'd be very surprised and I'm going to stick my neck out here, because it's a really dangerous thing to say, but I'd be very surprised if there's isn't a cut in interest rates on Thursday. That's not really actually being too brave, because I think most people are expecting that. But I would be very surprised if they don't cut. But I think more important is as we go into the next year or so, you'd expect interest rates to continue to fall, possibly down to 3% or so, as low as that. 3% over the course of the cycle which is probably two years, and that's primarily because the interest rates, because fiscal policy is going to have to be tightened up.

Now I can see Dick desperately asking the question...?

**Richard Turpin**

We have had one, I'll put it more as a comment from Richard Philbin, he's commenting on what a nice photograph we've got of you James. I don't really think we need an answer to that question, but I just thought I might let you know.

**James Foster**

No surprise, welcome Richard to the call. Well I can see Dick's asking desperately asking the question about inflation today. Clearly surely interest rates are coming down this far would be surprising given the fact we've got so much potential inflation coming through the system because of what's happened to oil prices. Yes, but remember what happened to oil prices in the last couple of years. They've more than doubled and we haven't seen much inflation coming through to the system, since rising oil prices isn't actually inflationary because it slows the economy.

That is also true for the US as well as Europe. So whilst US monetary policy is being tightened up as we can see to a neutral level from clearly an expansionary level, we'd expect interest rates in the US to be about 4-4.5% or so, I don't fear it going much higher, because the impact of oil prices is not particularly inflationary at the moment. Essentially that's because of China. China are producing goods at half the price of anybody else so that means no domestic producers are able to increase their price books.

In Europe looking at interest rates, we may even see a cut, but I think that's unlikely in the short term. The latest German numbers have been a little bit more positive. If we move onto the next slide, the European government bond markets, this scenario is actually just pure nirvana; low growth, good dose of unemployment. They always like that in bonds, they just love to see lots of people being made unemployed because that clearly keeps the wage inflation down and so low inflation generally. Politicians in trouble, actually they quite like that because it tends to mean that the safe haven of bonds is a good place to be. But if we look at the yellow line on there, on the chart, you can see the problem with that is it's all priced in and I don't think it necessarily demonstrates there's much value to be held in European government bonds. They have performed extremely well.

**Richard Turpin**

Can I just chip in there? Just a second, you mentioned unemployment, there's that's a question from an anonymous listener saying "how concerned are you about the potential rising unemployment in the UK". You actually see that as deflationary in certain aspects?

**James Foster**

Rising unemployment for bond fund managers is jolly good news. It's just what we like to see because it keeps wage inflation under control and actually will be positive.

**Richard Turpin**

You're not seeing any evidence are you?

**James Foster**

There is just the initial evidence of unemployment starting to creep up. Most of the people who've been employed in the last couple of years have been on Gordon Brown's books, not in the private sector's books, and clearly with the cuts and government expenditure coming through, particularly coming down, I have to say Gordon Brown's cuts in government expenditure is just an anathema, but perhaps his attitude towards trying to control public expenditure will lead to unemployment perhaps starting to increase and that must be good news when you're looking at it from the point of view of inflation and wage inflation. So I think that's actually a positive scenario.

**Richard Turpin**

From the bond manager's point of view. Thank you for that. You're actually just talking about Europe and the decline in bond yields in the European arena.

**James Foster**

I sort of...if we move from Europe and to looking at the US, I have to say there, rising interest rates generally isn't particularly good news. A slightly improved growth doesn't bode quite so well for the bond market now. My favourite actually is the UK market at the moment. It offers prospects of quite significant cuts in interest rates which really isn't priced into the market at the moment. Gordon's profligacy is a problem and I accept that, but the yield curve will steepen as a result. So I'm very wary of long dated bonds and much happier with shorter dated UK bonds. In fact the longest bond I've got in the portfolio is 2026 and that's for specific reasons because I think there are specific reasons for that company.

**Richard Turpin**

Talking of Gordon Brown, just before we move on if I may. A question here from an anonymous gentlemen or lady asking about Gordon Brown's cuisine, will the market suffer indigestion? I presume he's referring to excessive borrowing and growing borrowings and the potential for indigestion in the gilt market do you...?

**James Foster**

Yeah, I think it's a very good point there, and I'm very glad that you brought that one up because I think it is inevitable that the requirements that are being talked about is in the order of 60 billion next year. Now that's not going to be a fundamental problem, it's not going to cause, we're not going to have a sort of IMF crisis as in 1976. But it is going to cause a little bit of indigestion within the bond markets. Where that will really demonstrated is in the long end and what we saw last month, was the 2055 auction coming up.

Now that did struggle a bit and it failed to find a proper home and the result of that was that there was a few weeks of indigestion in the long end and that the long end

underperformed and I – inevitably we've got 60 billion of issuance coming along, it's going to come, and some of it's going to have to be at the long end again and so I would expect further potential underperformance of the long end of the gilt market as a result of that.

**Richard Turpin**

Yeah, thank you for that.

**James Foster**

If we move onto investment grade, I am very wary and I'm still very way, [divided payment] and I put that old chart in there, which is my favourite chart, but I have to say it is...you've all seen it probably many times. But what we are moving into is an environment where dividend payments to shareholders are generally going up, that's good for equities and that's why you're seeing a good performance, I think one of the reasons we're getting a good performance from the equity market of late. But as we all know dividend payments are essentially based on last year's performance, depends on how well the company did in the previous year. And with the economy slowing, not dramatically slowing but it is a little bit slower, and given where we'll be in the cycle, that means that the investment grade companies are having to borrow more to pay out that dividend. Inevitably the result of that will be that they will tend to fall down the rating scales. Now there are some exceptions, but the general trend is for ratings to be falling.

Leverage buy-outs are a threat, they're still a threat. Actually that's not entirely true, there are some companies with good, healthy pension fund deficits where that's perhaps not so true, but generally leverage buy-outs are still a threat, and to avoid those leverage buy-outs, companies are doing exactly the same measures themselves, so they're deliberately gearing up their own balance sheet to avoid being taken over. Within investment grade I have to say I struggle to find many situations, many companies which I like. I like the financials and that's because they cannot go down the rating scales and they're restricted – essentially they're restricted in their ability to fall.

Industrials are one area which give me the real concern, because I think this is where we're seeing most of its ratings moves, and so that's the area in which concerns me the most. Especially so, I really find it a struggle to find much value there. It is a difficult area.

**Richard Turpin**

Talking of value, James if I may, Richard Philbin sent us another question saying what do you think about index linked bonds, do you feel they offer better value at the moment?

**James Foster**

No, I don't. The issue there with index linked is it's essentially a pension fund tool being driven by...the pension funds they're being forced by index linked, continue to be forced by index linked bonds. They're pushing into levels which really are just I think unrealistic. They're...I mean obviously a good hedge if you think that interest rates are going to rise, sorry, that inflation is going to rise in the future, but I have to say my personal prediction for inflation is it that it won't rise much in the future. So no, I don't think they are a good hedge, they've been...if you've got artificial buyers it means the prices are too high and the regulations are forcing people to buy index linked, not necessarily [I have to say].

**Richard Turpin**

One further question while I've interrupted you. Richard Scott asked that do you see gains in UK gilts versus other global markets being offset by weaknesses in sterling, or do you feel that falling UK rates are already priced into sterling's value at the moment on the currency market?

**James Foster**

It's a good question that because no, I don't think that the falls in interest rates which I anticipate are fully priced into the currency markets, but please be very wary in my prediction about currencies because they're normally wrong. As a result of that, I normally hedge – well I do hedge – all our overseas currency exposures, because I do think currencies are a very volatile asset class in their own right and therefore I just take out that volatility, it is a bond fund which is meant to be more stable than not. And if you add the volatility of currencies then you increase volatility of total returns of performance, increase this volatility performance.

So, it is a good question and as I say, given that the fundamentals should tell me that falling interest rates are not priced in, the degree of falling interest rate is not priced in, that should have an impact on the currency. But as we all know with currencies, they never do what logic expects.

**Richard Turpin**

Thank you for that. Please don't hesitate to send us any questions through the system I described, but moving on to the next slide I think.

**James Foster**

If we move onto the high yield slide, what's interesting here, the most recent data is demonstrating a very low level of defaults. So if you factor in that level of defaults, the current spreads which you're receiving on high yield is actually fair value.

Especially if you consider over the summer months we're not really expecting an awful lot to happen, it tends to be a quieter period, so earning the extra yield on high yield seems to be a very sensible move.

And even on a month-by-month basis, looking at those support rate numbers, they're still very, very low. The forecast continues to be low for a long, long time yet. There has been a lot of Triple C issuance and Triple C companies generally go bust after a couple of years or so, but we didn't have any Triple C issuance two years ago, so there's no Triple C's now going bust if that makes sense. So we would expect these numbers to remain at this sort of...we expect the default rate numbers to remain at this sort of level for at least another six months and potentially as long as a year. The results which we're seeing and we're in results season at the moment are generally equal or better than expectations and that's acting as a continued good prop to the high yield market, so we're continuing to see all these companies coming up with marvellous statistics and that's acting as a very good prop.

Clearly the biggest concern earlier this year was the GM and Ford downgrades and that did put the wobbles in the market, but that's now been priced in and bonds have actually been performing very well recently, unfortunately I have to say, because we don't [unclear], but mostly they've been performing well because the sales numbers have been performing well, but they've been bribing people to buy their cars and if you give them away at a substantial discount less the cost of building them, then eventually that's going to come through the underlying numbers, but that will...the markets at the moment are looking at the positives of the better sales numbers rather than the negatives of what they actually sold them for...and let's wait for six months and see what the results of those...what the actual cost of those sales are. So in overall positioning, this fund is a go anywhere fund, as strategic means and in this sort of environment we're going to keep duration relatively low. We are concerned - we're more focused towards the UK where we think that the UK gilt market is offering the best value, but to demonstrate those positions we exercise that through the investment grade market, but actually we don't really like many of those either and so we're more focused towards the high yield market which is currently about 60%, just under 60% of portfolio. Of the investment grade proportion, predominantly that is in financials, or there are a few companies in there which have got very healthy pension deficits which means they're unlikely to get taken over and people are scared that they might be taken over, but we don't think that that's going to happen because of this pension fund deficit, Mr [Norgroves], the pension regulator means that they are unlikely to be taken over.

So, a few, so essentially within investment grade it's financials and a few industrial stocks but only those with big pension fund deficits. Within high yield it is much more stock specific but we do have a good proportion of industrial companies there, and the reason we like those is we don't...we feel that with the results coming though which are generally better than the expectations than worse, they are actually performing quite well. Further, they're not distributing back to the shareholders, they're distributing to us, the bondholders through their interest payments and that

makes us very happy.

**Richard Turpin**

One question James, I'm going to test your knowledge of the car industry here, with the advent of new fuel technology, for example hydrogen fuelled vehicles, do you feel that a company like GM or Ford could sort of turn the corner that one implicitly understands that there's an awful lot of R&D costs that would go into developing new sort of vehicle ranges and that at this point in time with their level of indebtedness, presumably it wouldn't be an easy thing for them to do.

**James**

It's a good question that because ultimately if somebody like Ford or GM was to invent a car which runs on water or the equivalent of something equally available then they will be rescued, but unless something like that happens, they're not going to be rescued. These companies will go into default. Now that's a long way off, it could take three, four, possibly even five years. I wouldn't be surprised if that long, I think it's more likely to be earlier than that just because they're burning up cash. If you give your cars away at less than the cost of production then clearly you're going to go bust one day. They are still saddled with these long term pension liabilities and healthcare costs which is an insurmountable problem unless the unions agree to a restructuring of those liabilities, and history in the US is unfortunately pretty bad on this one. If we were to look at the airlines for instance, they have spent most of their lives on chapter 11 because they cannot renegotiate their liabilities, the pension liabilities, and so I think it's inevitable that GM and Ford will end up there unless, as I've said they spend a vast amount of money on developing new cars, but it's the Japanese who are making the real progress there. Toyota's triple A rated and Honda's, I think they're double A rated but I'm not sure, they are doing much better there so if perhaps some genius comes along with a fantastic new model then perhaps it might happen, but I'm certainly not counting on it. I consider it a bit of gamble I'd have to say.

**Richard Turpin**

Thank you. I've got a couple more questions coming in. I know you've mentioned that you're wary of investment grade bonds at the moment, but the question here from an anonymous listener, you don't have any triple A or double A holdings currently in your fund positioning. Is this a deliberate policy reflecting your wariness of investment grades?

**James**

It is a deliberate policy and I...this is not a permanent policy either; it could easily change as circumstances change. Certainly the current overall weightings within high yield reflects our viewpoint for the summer and perhaps getting into the early autumn, but we are expecting a lot of issuance coming in later in the year and that may put that may put the high yield market under a little bit of pressure.

My real concern is when defaults start to pick up, because that's the real issue for undermining the high yield market, so I would anticipate that we will be reducing that high yield position over the summer, but we're not going to go short...we're not going to get massively underweight, i.e. in terms of 10-20% or so until we perceive that the default rate is likely to increase, but when we do that then the natural place we will be going is into gilts and triple As and double As.

**Richard Turpin**

Picking up on your comments there, Meera Patel has sent us a question reflecting the fact that yields on high yield bonds have fallen. Do you feel that at times you're being forced to the drunk end of the market to search for yields?

**James**

That's a very dangerous thing to do and that's something which I'm very wary of. The whole point of a strategic fund is to try and generate the best returns throughout the bond spectrum. Chasing yields is a very dangerous game as you end up buying lower and lower quality bonds as the economic cycle, the bond cycle moves on and eventually when the economy hits a brick wall which we all know it will do one day, you end up with a whole clump of bonds which go bust. So no, it's not a policy which we're going to go about chasing yields. Yield is an important contributor to total returns, yes, and so it's important to be prepared to take the risks when you think it's appropriate, but you have to also be prepared to take that bet off the table when you think it's appropriate.

**Richard Turpin**

Thank you. Talking about defaults, there's a question come in here, do you have a provision to defaults – clearly you can't provide for defaults, but in terms of percentages do you expect to see a percentage within the portfolio or very much reflects the market as a whole I presume?

**James**

Yes. We would hope to be moving out of the market before defaults start increasing dramatically, but it is inevitable that we're going to pick a bond at some stage which defaults. History has shown that we're not going to be so good at recording all of them. It's often...in some situations it's a good to pick up more than if they had defaulted ironically because the price falls too much.

So it's an interesting one, the recovery rates on bonds can be pretty good. What happened with the telco situation was recovery rates was absolutely appalling but in the more recent past the recovery rates have been pretty good and the market's actually over discounted for it. So sometimes it can be an actually good idea to buy in that scenario, but no, we're not sort of staying we would anticipate x percent per year, but it's inevitable we will have some.

**Richard Turpin**

Thanks for that. As we're drawing to the end of the presentation, I've got a couple more questions from Richard Philbin who clearly wins the award for the most questions, Richard thank you very much indeed. The cheque's in the post. Richard's asked how actively we use cash as an asset class or to manage durations?

**James**

Yes, cash is a very important tool and yes we will use it. It will be either cash or quasi-cash instruments will be done within a [USIT 3] portfolio like this we have quite a lot more flexibility than historically and so I would expect a time that we really were concerned that the cash percentages could rise as much as 20%, and even higher in sort of alternate cash instruments is appropriate.

**Richard Turpin**

Richard was also asking how many issues, how many assurers as well, if there are specific targets for that?

**James**

There aren't specific targets and it tends to be if we have a greater percentage in high yield then we're going to have a greater diversification because clearly the potential to get it wrong is still there, whereas with investment grades you tend to have less diversification, so when we've got a greater weighting in high yield, we'd expect up to a maximum of about 80 holdings. When we've got more in investment grade I would expect it to be more concentrated and to put that into context, our average position is between 1-2% of the fund. If they fall below 0.5%, then our inclination is to sell them and to get rid of the holdings, mostly because they're never really going to contribute significantly to performance of that smaller level and they're more likely to be a problem. So on average our aim is to have a percentage of between 1-2%, but if we had a greater percentage at investment grade then I'd be prepared to raise that up to 3%, possibly even 4%.

**Richard Turpin**

Super. Following on from that actually there's a couple of questions, one from Gary Brindalter and one from Warren Perry relating to sort of running yield, gross redemption yield. Do you want to say anything touching on that? I think it's an interesting area.

**James**

It is, and running yield is important and what I'm wary of doing is buying lots of bonds which are priced over par because you end up trading income for capital which I think is a dangerous thing to do, so we have tried as much as possible to keep the running yield and redemption yields as close to each other as possible.

**Richard Turpin**

One other one from Gary: will you use credit default swaps which I believe you will

be using and then see the base default rates increasing?

**James**

Yes, we can and in practice credit default swaps we can use them to hedge out a particular position, but in practice it's probably easier just to sell the bond. Yes, we can use the credit default swaps to gain exposure if we think it is appropriate and we use them as liquidity management tools and much as anything else, but yes, if we couldn't sell a particular bond but we could use the credit default swap market and hedge our particular position we can do that. This is USIT 3 portfolio, we will be able to do that.

**Richard Turpin**

Let's just take one more question, there's one from Paul Warner here commenting on your comments regarding the economy possibly hitting a brick wall, Paul asks: does that mean you're in a deflationary, recessionary count in a year or so's time and would you possibly elaborate?

**James**

No...I think the cuts in interest rates will work and I think that if they...seeing interest rates down some 3% at level or so will maintain the growth levels in broadly the 1.5% range, perhaps 2% range over the next sort of two years or so. No, I'm not talking about the economy hitting a brick wall, we will sustain growth. It just won't perhaps be as exciting as we've seen in the last couple of years and part of that will be driven by the increases in taxation which will slow the economy down inevitably.

**Richard Turpin**

Let's just take one final question, we said the last one was the final question. Forgive me, but you did mention the Olympic Games in your opening remarks and Tony Catt has sent us an email question here relating to the need for the bond markets to effectively participate. Do you see the bond markets being used to raise capital for a lot of the investment work and the infrastructure work that need to be put in place for the Olympics?

**James**

Yes, I think that's inevitable, but that's probably a few years away yet before they start running out of money and they'd have to come along and beg from bondholders. Yes, we always remember Montreal, and they call it the big owe, as in o-w-e, because they're still paying for it, and they had the Olympics in what, 1976? So there's every potential for it to cost as half as much money, but let's perhaps not be too negative in feeling that this government won't cock it up, but fingers crossed. You never know.

**Richard Turpin**

Ladies and gentlemen, let's draw it to a close now because I'm conscious we've taken more than half an hour of your time. I'm very grateful to you. Thank you in

particular most sincerely for all the questions you've sent through, it does liven up the presentation and it makes it hopefully interesting for everybody in and above what we were going to speak about anyway.

So James, thank you very much indeed, thank you to our listeners. If for any reason we haven't answered a question you have sent through, we will try and get hold of you either by phone or by email to answer the question but I think if I'm right, I think I've covered all the questions that have been sent through to us via email. Finally, if there is anything else that we can help you with please don't hesitate to call our broker support number, 0800 092 2090 or email us any further questions at [broker.support@artemisfunds.com](mailto:broker.support@artemisfunds.com) and you'll be able to pick up those telephone numbers and email addresses through our website.

So finally it remains for me to say thank you very much to James. Thank you to Bright Talk for hosting the conference call today and thank you for listening. I hope it's been worthy of your time and we very much look forward to hosting another conference call in the months to come. Thank you very much indeed.

**James**

Thank you very much everybody for listening.

**Operator**

That does conclude our conference for today. Thank you for participating. You may all disconnect.

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