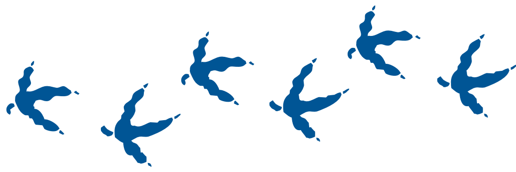

ARTEMIS
The PROFIT Hunter

James Foster – Strategic Bond Fund

Operator:

Thank you for standing by and welcome to the Artemis Strategic Bond Fund webcast. At this time all participants are on 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, Tony van Gool. Please go ahead, sir.

Tony van Gool:

Hello, thank you very much. Ladies and gentlemen, good morning and welcome to the second of our webcasts this year on the Artemis Strategic Bond Fund. Thank you very much also for the time you've been waiting whilst we've been linking all the registered callers on line. Joining us today is James Foster, who as you know, together with his colleague Alex Ralph, manages the Strategic Bond Fund.

The Fund passed its first anniversary some four months ago having been launched on the 1st June 2005. Now, before I introduce today's speaker, I would first like to touch on some housekeeping points. Apologies in advance to those of you who have used the system before but on the screen in front of you, if you look to the top left of the screen you will see a picture of James in the corner. To the right of his picture, there's a question tab, the second one along, if you click on that, a box will appear where you can type in your questions. Please don't hesitate to send us questions online at any time during the call and we'll answer them as we go along. Once you've typed in your question, click on the submit button just below the question box and I'll pass them on to James at appropriate times, as we progress through the webcast presentation.

Now, let me introduce to you today's speaker, James Foster. James' fund has had an excellent year and has outperformed the IMA UK Other Bond Sector, since launch in June last year, with a total return of 8.4% to the end of September compared to the sectors' 6%; making the Fund first quartile after its launch. The Fund is about £77 million in size with a current gross redemption yield of 4.6%. Now, James will be updating us today on the progress of the Fund and reflecting on his views for the near term future. James, thank you very much for joining us; tell us what's going on in the world of bonds.

James Foster:

Thank you very much, Tony. Thank you for tuning into the second bond webcast of the year. There is a lot going on in bond markets at the moment so it is difficult to know where to start but I thought I'd spend a little time on the interest rate debate which remains as crucial as ever, then move on to the investment grade market where, on the face of it, it is rather dull but looking at the detail, there's lots going on, and finally, just a few comments on the high yield market.

If I start with interest rates, all government bond markets are driven, as ever, by what is going on in the US. US interest rates which have been raised every meeting for seventeen consecutive occasions, are now finally on hold and they look as if they will stay on hold for some time. Some commentators fear a further increase to 5.5% but I believe the weakening housing market will be crucial here. There is no chance of any change today because it is directly ahead of mid-term elections and I don't believe that even Bernanke's commentary will be very hawkish for the same reason.

Now, if we look at the housing data, it has been very poor. And this is why I think the US economy will be so much weaker over the next year. The housing market has fallen by 1.5% or so, in the last year but inevitably people don't notice unless they have to move. Admittedly, that is a comparatively small amount, so pretty irrelevant in the whole scheme of things, however, there are some forced sellers around, from those people who were making speculative purchases made last year to generate a fast buck, they failed and are having to bail out.

The housing market situation looks like it's going to get much worse before it gets better. The wealth effects from falling house prices will be fairly horrendous leading to the consumer slowing their expenditure. I do not forecast a full-blown recession but the US will be posting growth numbers of 1% – something rather than the more usual 2, 3 or even 4%. So, in summary, the US interest rate cycle is at a peak and I do not expect any increase in the short term, though the market was getting a little too excited about a cut. I would anticipate no change for a long period possibly as long as a year. They will not come down sooner, only because the inflationary impact of oil prices have still not worked, still not fully worked their way through.

Tony van Gool:

James, could I just interject in there, if I could just remind our audience, please don't hesitate to send us through any questions, just fill in the dialogue box, click on the submit button and we'll gladly answer any questions you may have as we go along. Sorry James, carry on.

James Foster:

Moving on to European interest rates. The ECB remains neurotic and I think that two further rate rises are probable up to 3.75%. ECB policy seems to be more driven by what is going on in Germany than anywhere else. With Germany due to raise VAT in January, then the consumer will front-load expenditure in November and December and only abstain after that – expect the economy to slow down. The fact that Italy needs several rate cuts now, is irrelevant. Lastly, UK rates; well, I was just looking back at what I said last time. I have to admit I was wrong. I was not expecting any change. Very sorry for all of those of you with large mortgages, Tony. As a 0.25% in rates to 5% is now a given on the 9th November and the debate focuses on how many further rate increases are necessary. 5.25% in the new year, probably February, is also very likely and given that inflation is still surprisingly on the up side and the Bank of England is getting very worried about wage inflation, it may well be the case we have to go as high as 5.5%. I expect the slowing US economy to make that unlikely but I certainly don't rule it out. The market is discounting 5.5% rates already, so it's not something to get too worried about from a government yields perspective.

So overall, looking at government bond markets, they have got a little ahead of themselves recently but looking forward over the next twelve months, I think there is some good money to be made.

Tony van gool:

James, if can butt in here. We had a question. You mentioned a minute ago about the potential for falling house prices in the US, do you think this could happen in the UK and if so, would that dramatically change your interest rate predictions?

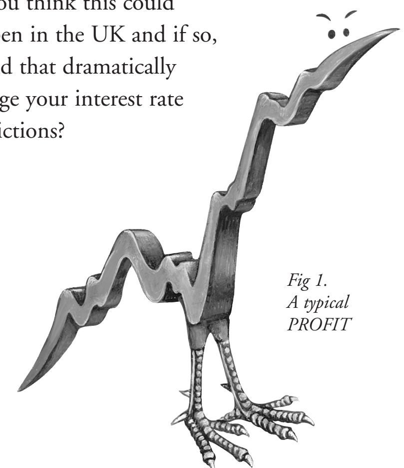

Fig 1. A typical PROFIT

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James Foster:

I think the difference is, in the US, the housing market is over supplied with property and so what we're seeing is now, with the pressure of frequent interest rates rises, this will lead to the potential for the market to come off. In the UK, I'd be surprised to see the housing market come off just because there's still so much pent up demand driven by a whole host of factors, whether it be immigration which is leading to lot's of demand at the lower end, various other factors as well, pent up demand there. So, I'd be surprised to see the UK housing market come off. Having said that, if the rates do go up to 5.5/6%, worst case scenario, then yes, I would think that the housing market might come off a bit but I don't think it's going to be a catastrophe like the 1990's.

Tony van Gool:

Right, so they have a lot to look forward to then. Thank you for that.

James Foster:

Let's look at the corporate cycle. The corporate cycle clicks on with companies generally looking to gear up their balance sheet. Shareholders are unfortunately winning the day. The number of new issues which are taking place at the moment for 'general corporate purposes', is never ending. What we do know is that this phrase, use of this phrase, as a euphemism for paying yet more distributions to the shareholders so for 'general corporate purposes', GCP, you should be reading, 'bribing the shareholders a bit more'. Or you could put it in another way, 'stuff the bond holders'. At the moment, I have to say, I don't consider this to be catastrophic news but however, I do feel concern that come a slowdown in the economy, with that dividend policy, the dividend will remain too generous and company balance sheets will inevitably take the strain.

Recently for instance, ITV did a new bond deal. A year ago, the management were targeting a good Triple B balance sheet. The company has not been doing well and within a year, they've changed the senior management and now they are targeting a weak Triple B balance sheet. Within a few months, I would not be surprised if they end up in high yield, clearly very bad news for your bond price.

Investment grade, on the face of it, has been rather dull. I have put in here the chart of Triple B bonds. These are meant to be the most volatile but in practice they haven't been very exciting. What is interesting though is looking at some of the sectors; financials for instance, have been quite volatile. In June, everybody was getting terribly worked up that the banks were going to issue junior bonds for ever. The bonds fell out of bed and were offering genuine value. We bought lots of them, subsequently I was able to breathe a sigh of relief as they have rallied. Included within the financial category, were insurance bonds. We have just spent the last year terrified they're about to suffer the same problems as last year with Hurricane Katrina and four others in America, costing them loads of money. Undue panic did provide a good buying opportunity. The insurance sector is now much more profitable and can afford the odd disaster. We have bought the bonds and feel they are likely to be upgraded soon.

Furthermore, financials tend to be immune from the LBO Private Equity bid. I discussed this last time and it is the most important factor at present for why bond holders can lose money. Briefly, when private equity takes a company over, they gear it up in existing bonds which may have been rated say, Single A, pull down the rating scales and subsequently rate it as say, Single B. The loss to your capital could be as much as 25%. No company is safe from the threat unless firstly, if they're a very high yield company already, or they cannot gear themselves up anymore. Or secondly, could be a financial company. Financials are safe because if people feel they're unlikely to survive then nobody's going to deposit their hard earned cash in a dodgy bank. The LBO model just doesn't suit these sorts of organisations and for this reason we do retain a large weighting in financial bonds. Currently our weighting is nearly 40%.

Covenants remain crucial to protect you from an IPO. Nearly all the non-financial investment grade bonds we own have protection with covenants against takeover by an LBO operator.

Tony van Gool:

So would there be any circumstances in which you would own bonds without a protective covenant?

James Foster:

Yes, if the bonds already discount the fact that an LBO is going to happen, then they're already that much cheaper and therefore maybe offering good value and recently, for instance, we've seen some Telco bonds which have been. They've had speculation that they would be taken over by these LBO operators. The bonds have already fallen in price to reflect that and are now looking comparatively cheap and there maybe the opportunity in those takeovers that they re-finance these bonds and restructure them and you can get a good potential profit out of it. So, yes, the Telco sector, tends to be the one area which is the prime one for the LBO bid, or one of the prime areas for an LBO bid of late. And sometimes you can see some opportunities out of that, sometimes.

Tony van Gool:

Right, thank you.

James Foster:

Moving on to the high yield market. This has had a very good run. It surprised us quite how well it has performed but it has been quite selective. Distressed debt has performed very poorly and there have been some distressed situations over the summer months. In European high yield for instance, we had the default of GAL Finance in May and subsequently Schete Naclear, Damovo, Focus are all on the cusp of default. Distressed debt has performed badly in anticipation of more defaults next year. If the US economy does slow down then this will be the driver which will cause high yield to under perform.

Tony van Gool:

Again, James, can I just interject there, if I can just remind you all, ladies and gentlemen, if you do have any further questions, please do email them through to us now, type in your question in the dialogue box, press the submit button and I'm sure James will be happy to answer any relevant questions during the webcast. Thank you, James, sorry.

James Foster:

Further, the high yield market does look quite expensive as the last chart shows. For every extra level of gearing, you are not getting as much reward for your cash and for this reason we've been gradually reducing our percentage in high yield. Furthermore within the asset class, we've increased into less volatile names and floating red notes where we can take advantage of the extra yield but they don't have quite the same sort of volatility.

So, in conclusion, I remain comfortable with bonds as an asset class and mostly it is because I'm concerned about the economy, especially the US economy. With the trend in interest rates having been up for so long now it has reached a peak and should potentially fall over the next twelve months. That is positive for bonds, especially investment grade and government bonds.

Tony van Gool:

So James, you're positive on bonds. We had a question earlier on, what your feelings were on other similar asset classes for example, commercial property.

James Foster:

Commercial property, should be treated in the same vein as looking at say high yield bonds in that, if you're going to get an increase in defaults then naturally you're going to get an increase in voids in your commercial properties. And therefore your returns out of commercial property won't be as good as they have been historically. Government rental contracts continue to look very safe but they're yielding similar levels to gilts, so you might as well take the risk with earning gilts. More risky ones, as I say, are then subject to an increase in potential defaults. I have to say commercial property has done extremely well.

Tony van Gool:

Dramatic, yes.

James Foster:

It depends how soon the level of defaults increases though.

Tony van Gool:

Right, we've had a question here, not to do with the presentation but just whether questions could be asked later on the telephone. No, they'll have to be typed into the dialogue box through the webcasts and we'll be able to then address them as they appear on my screen. We have had a further question here, what do you think will happen in terms of bond defaults and will this introduce a little more volatility into the market?

James Foster:

Yes, good question actually, because what we've seen in the last year to date in particular is defaults surprisingly on the down side. There was a lot of expectation that defaults would be that much higher and certainly Moody's forecast for defaults have turned out to be under estimated, i.e. they've undershot, they've always been lower than forecast.
My expectation is that defaults will increase and I think that's driven particularly in the States where the slowing consumer will have a knock-on impact on to defaults, ultimately over the next twelve months or so. So, and ultimately for the high yield market, it's going to make it much more exciting because your stock selection becomes ever more important. Previously it's all been about asset class selection and in the future when you start to see that increase in defaults, it's going to become less associated with that and more stock selection. As I say, it could be quite, potentially quite dangerous.

Tony van Gool:

What areas are more prone to this threat, do you feel?

James Foster:

There's more consumer led sectors, which are consumer driven sectors …

Tony van Gool:

Just those?

James Foster:

Yes, they have the most concerns.

Tony van Gool:

Right, right. We had a question earlier on, how is the Fund positioned to take advantage of the scenario for the global economic outlook in your view?

James Foster:

We, it's actually a very good question, because we haven't yet positioned the portfolio in anticipation of an increase or a slowing of the US economy. The current numbers, as I say, have been reasonably good. We are gradually shifting at the moment but we still have some reasonable risk positions within the portfolio which we will be running for the next month or so, possibly up until Christmas, before we take those positions off. And take some of the risk off within the portfolio and shift the duration that much longer to reflect the potential for government bonds – government bond yields to come down. So ironically, yes, it is a good question because the portfolio is relatively small, very flexible and we will shift as we see the trends in the market change.

Tony van Gool:

Right, thank you. You had a wonderful phrase earlier actually, just following on from shifting economic outlook but you had a wonderful phrase earlier, 'stuffing the bond holders', would you be referring, by any chance, to equity managers doing this or just equities in general and if so, what are your views on equities?

James Foster:

Being next door to Adrian Frost and Adrian Gosden, I am never going to be rude about equities managers, of course, because that would be unfair of me, but yes, clearly they're encouraging shareholders to hand out dividends hand over fist and I wouldn't accuse them of doing it at the expense of bond holders but clearly it is. Their concerns are less about the quality of the balance sheet, more about making sure they get as much money out of the company as possible. And that's fair enough, that's how we know that, that's true, what will be interesting is when the economy slows down, will the shareholders continue to demand substantial payments which may well be at the expense of the quality of the balance sheet and in the longer term, that is bad news. In the shorter term, the shareholders have to do what I suppose is appropriate but actually appropriate at the time. What that means for equities is that, because shareholders are being essentially bribed with my money, with bond holder's money, then they should continue to perform reasonably well for now. I do get a little bit worried that the quality of the balance sheet will start to come under pressure over, let's say twelve months time and that could ultimately affect the valuation of equities but I don't think that's a concern at the moment.

Tony van Gool:

James, we have had a question here, what are your current views on the main currencies and are you hedging any currency risk at the moment?

James Foster:

That's a good question, because I wish I could answer it. In that I wish I could tell you where currencies are going. I suppose I am a perennial dollar bull; I have to say probably less so for the moment just because of where the dollar is. But we do hedge out all currency exposure because I am so awful at predicting where currencies go. And secondly it sort of fails the "Mrs Miggins" test in that currencies are a very volatile asset class in its own right and people, I think, invest in this Fund partly because of its low volatility characteristics. And if you don't hedge currencies then you end up taking on quite a lot of volatility through the currency haze which you have, and generally I think that's a bad thing to do. So I mean, our policy is normally to hedge out all currency risk.
We don't, it may even be 95% or so at any one time just because we haven't quite hedged something for a particular reason, but normally we hedge 100%.

Tony van Gool:

And what do you think would be a reasonable return that investors could expect your fund to generate over the next twelve months? Putting you on the spot here, I'm afraid.

James Foster:

Yes, again I hate that question too. But it is a good question, it's perfectly reasonable.
I certainly think you are going get the coupon which is around the 5% yield or so, which is where we are at the moment. And I actually think there is a potential to get a bit more than that. The advantage of the strategic nature does mean that you can move between the asset classes, you can try and pick up the cheaper bonds when there is the opportunity to so I would like to think that you'd get more towards a bit more than that 5% and hopefully six or seven, but please don't hold me to that.

Tony van Gool:

We'll be back in a year's time. Actually, I think you said that rates of 5.5% in the UK may already be reflected in bond prices. Is that a judgemental or is that a science? How does one know that?

James Foster:

Yes, there is an element of the science in that. You can look at the futures market and what the futures market is discounting, and in fact the futures market is discounting by 5.4%, I believe, so essentially it has discounted most of that increase or any expected increase over the next few months. I suppose the uncertain element is how much do we expect yields to – the ten-year yields or the thirty-year yields – to react to that 5% short-term rate, and that is certainly not a science; it is purely a value investment. What you would expect is the yield curve to flatten, i.e. when you get short rates going up you tend to get long rates coming down, and we would continue to expect that

trend to occur. It is, the UK has always tended to have a downward sloping yield curve and even more steepward downward sloping yield curve because rates at 5.5% would not be surprising, would not surprise me at all.

Tony van Gool:

All right, we have had two questions here that are sort of interrelated, but let's address the US first and pop back to the UK. Do you think it's possible that the Fed may not raise rates sufficiently to prevent inflation becoming entrenched in the US economy and, if so, do you think it will lead to stagflation?

James Foster:

Good question actually. I mean, I perhaps I don't think the US economy is not a command economy, it's not a European-style interventionist economy. It's still a pretty free market and it has its elements where it's not, I accept, but generally it is a pretty free market economy. And the reason that inflation would get entrenched is because you have essentially socialism coming into the State. At the moment that doesn't look particularly likely. Admittedly, the elections next week may vote in a more democratic government, but still you would not consider them to be anything like the left wing in economic terms, as Europe is broadly. So no, stagflation tends to be associated with economies where you have inefficiencies built in, particularly in the labour market.

Tony van Gool:

Right.

James Foster:

And Europe is a prime example of that where you tend to get social legislation which creates more stagflation in the system, and I just don't think that within the US that, that is likely because ultimately (a) interest rates will go up but (b) you tend to get an increase in unemployment pretty quickly. You get an increase in unemployment which slows the economy down, which takes inflation out of the system. I think it very unlikely.

Tony van Gool:

On a sort of related topic, and very topical, last night Charles Bean (who is Chief Economist to the Bank of England) said that because of globalisation central bankers may find it more difficult to control inflation through the raising of interest rates. Do you see interest rates staying higher for longer as a result of that?

James Foster:

I think what he is referring to, Charles Bean there, is it works both ways in that, if they raise interest rates or reduce interest rates, it can sometimes – because globalisation is so powerful, such a powerful trend – that it almost becomes irrelevant. And at the moment we have still got the deflationary consequences of China still feeding through the system and admittedly they are not as pronounced as they were let's say five years ago or three years ago but they are still an important factor in keeping inflation under control. And I can't see that changing, and I can't see it changing with India and a lot of the other Asian economies, which is providing to us a whole pile of cheaper products.

Now, the factor which would get me concerned is global protectionism and more protection is measured, which would be a disaster. But yes, I appreciate where Charles Bean is coming from but I think it is actually almost the other way round, in that globalisation is leading to deflation within the system and that sometimes they may want to reduce interest rates and it takes longer, as we have seen in the States, for the impact of that to work.

The other way round: do I see interest rate increases having an impact in making inflation take longer to come down? Well, only if you wrap your economy up in protectionist measures and I don't think that that is happening generally. In fact, you probably still classify the world as being as globally capitalist "as it has ever been".

Tony van Gool:

Still very open?

James Foster:

It's still very open, yes.

Tony van Gool:

Right. We had a final question here which I think I am going to squeeze in before we call it a day. What is the yield currently on, and what yield is reasonable to expect going forward, and in fact, three-pronged question here: would you expect capital to be maintained at this level?

James Foster:

The yield of the Fund is currently at, well I sort of tend to look in pre-charges say, but the yield is about 6%, just over 6.1%. So lop off 1% charges, it is 5% or so.

Tony van Gool:

And what do you expect capital to be, and where do you expect capital to be maintained at this level with a yield of around 5%?

James Foster:

Yes, clearly there's two components to it in this Fund: income and capital – and we do try to protect capital as much as we possibly can. But there is not much we can do except if you have a global round of stagflation and it's difficult for us to hedge out that risk. We can use futures, we can use CDS or we can use cross-over, all of those things can give us protection. But if we get an unexpected shock which we just don't forecast then, yes, clearly we are going to lose capital. There's two elements producing returns within bonds, one of which is income and one of which is capital growth. I do consider capital protection a very important part of the management of this Fund.

Tony van Gool:

All right. And what is the current split between high yield and investment grading, and do you see that changing in the next 12-18 months?

James foster:

Current split is roughly 47% investment rate – yes. It's 47% investment grade, 47% high yield and the rest is in cash, so it's pretty even between the two.

Tony van Gool:

Right.

James foster:

And over the next twelve months I would expect high yield percentage to come down and the investment grade percentage to increase. I wouldn't be surprised to see 60% in investment grade over the next year or so. And it could even be higher than that; it could easily be 70% if we start to see the economy, US economy slowing down as I expect it to.

Tony van Gool:

Actually you mentioned, very finally, you mentioned the use the CDS there; is it something that you do use as an investment tool in your Fund?

James Foster:

CDS, the best way for it is as a liquidity management tool. So we have got a lot of cash coming in, then we could use CDS if we can't use the cash market, because CDS market tends to be more liquid. Having said that, the scale of the cash which we have had in so far, it's just not necessary to use CDS. We have got sufficient flexibility just to continue to use cash markets.

Having said that, we would use it for hedging tool again if we needed some particular credit which we don't like, suddenly don't like. I don't know whether it's BAA, or some other particular credit, and we can't sell the cash bonds for any particular reason then the alternative is to use CDS because that gives you a hedging tool.
We haven't needed to do that because we usually just sell the underlying bonds. The cash market is pretty liquid at the moment – but it does give us options there if we need it.

James Foster:

Right, ok. Thank you very much for that, James. Thank you.

Tony van Gool:

Right, thank you for that. Ladies and gentlemen, I'm very conscious of time so I will now draw the conference call to a close. Thank you very much indeed for taking the time out of your busy schedules to listen to this conference call with James. I hope you found it useful and interesting and indeed thought provoking. Thank you also to those of you who

have sent in questions, it is most helpful in moving the whole process along. If there are any further questions which we haven't been able to answer today, or if you'd like to discuss anything further, please don't hesitate to send them through to us. You can either email them through to us at brokersupport@artermisfunds.com or indeed phone the questions through to us on our, Free Phone, Broker Support line, 0800 092 2090.

Before I end this call, may I take this opportunity to remind the audience that the next webcast will be on the Artemis Capital Fund and this will be taking place on the 29th November at 11 am. Please do register your interest through the normal means on our website, www.artemisonline,co.uk.

Ladies and gentlemen, thank you all very much for your time. I look forward to a future conference call with you all and James, thank you very much indeed for your time and interesting comments. Thank you all and have a very good day.

Operator:

That concludes our conference today. Thank you for participating, you may all disconnect.

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