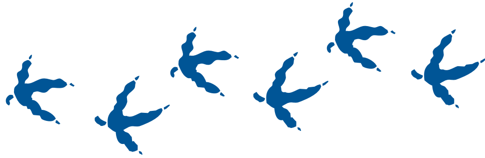

ARTEMIS
The PROFIT Hunter

James Foster – Strategic Bond Fund

Dick Turpin: Thank you very much indeed and welcome everybody.

As you are probably well aware, the Artemis Strategic Bond Fund has just passed its third anniversary and has an impressive track record going back to the point of launch turning over that period some 8.2%* against the benchmark of 1.9%* and indeed a sector average of 1.2%*. Also importantly, over the last three months which has clearly been a very difficult time for everybody in all aspects and all asset classes in the markets; James and Alex have delivered an impressive +3.8%* against their index measured -1.4%* putting them first in their sector*. It has been a fascinating time to watch what James and Alex have been doing in positioning the Fund. So without further ado, James good morning, thank you very much for joining us and well done on weathering the recent storm.

James Foster: Thank you, Dick. I have got lots to get through so I am going to get stuck in. Unfortunately since I last spoke, which I think was about six months ago, the economic situation has clearly got much worse. Inflation has risen more than I expected, and meanwhile the UK economy has fallen into a recession. Globally things are getting very difficult with inflation rising across the board, this is bad news, the authorities would love to cut rates, but they are constrained. In practice we all know that inflation is running away because of food and fuel, but what really worries these people, the central bankers of the world, is that if inflation gets stuck into the psyche that is a major concern.

I was taught at school that inflationary expectations are as important as inflation itself. The central bankers here are worried that inflationary expectations are actually getting ingrained. If so, it then becomes a real struggle to reduce those expectations again and if expectations of inflation rise then of course wage inflation increases, as the work force demand wage increases to compensate them for their loss of spending power. That is the reason we have seen Trichet acting quite so dogmatically by raising rates even though there is clear evidence the European economy is flat on its back and especially for the likes of Spain and Ireland.

Even in the US which has acted promptly, very sensibly, to reduce rates, they're making more hawkish comments about raising rates, though I see little prospect of that happening for a while. The UK has been somewhere in between; sensibly reducing rates earlier this year. Now with inflation up at 4%, I see little chance of them cutting rates further for now, and there's a potential – they may even have to go up. The deciding factor here is wage inflation, and by keeping rates relatively high, they are squeezing producers and preventing wages going up – that is not so true for the public sector. To be fair, the public sector finances are dire and that should prevent the Government handing out excessive wage demands, but I do remain very anxious that clearly the government is in desperate straits and they could resort to the old union bribery techniques; even worse, they may start raising the minimum wage – let's see.

Having said all of that, the economy has had a really severe kick from higher mortgage rates and more importantly the inability to get mortgages, which is squeezing the consumer on top of everything else at the moment, so in effect the monitory policy is much tighter than it was in the last year. This is also true in Europe and the US and I expect growth rates to fall sharply as a result. The US will probably avoid a recession given how far interest rates have been cut and the tax cuts that are part of Europe especially Spain and Ireland, look like they will suffer very badly. Even the latest data out of Germany is pretty poor and clearly one size of interest rates is not suiting all.

The UK looks like it is in recession already. Ultimately that means that interest rates will eventually fall quite sharply – not so much in the US where I expect no change for a long time, but in the UK, rates could be falling down towards 3% or so throughout the course of next year. Even Trichet might see the light, I don't know, but rates do need to come down; inflation should be being squeezed out by next summer. Remember assuming oil prices are unchanged in the next 12 months then the oil increases of this year will probably drop out next year. I just don't believe that inflation will be a long term problem; I think it is actually a bit of a side show compared with the real problem and that is the banks. They have got themselves into a complete pickle. They are losing vast amounts of money, and I mean vast amounts; so far the total losses are estimated to be $475 billion. The estimates for the total vary anything between $500 billion and $1.5 trillion, I find it very difficult to determine exactly how much they will lose, but it is clearly having very profound effects. These losses, as probably everybody knows, are all mortgage related sub-prime and the excesses of CDOs (Collateralised Debt Obligations) written over the last few years.

Merrill Lynch for instance this week wrote down its senior CDOs and sold them in effectively a fire sale, these are senior bonds essentially, at 22c on the dollar. That is a very hefty hit of another $5.7 billion, but at least it puts the floor under their CDO exposure; expect as a result of this, more banks to make significant write-downs over the coming months.

The extent of these losses is so great it is prohibiting banks from doing their day job of lending money. A particularly scary chart is this one which goes back to 1993 – as long as the data was ever taken for – the number of mortgages approved are now at record low levels, the average was around 90,000 per month, it is now down to 36,000 last month; and it's purely because banks have not only been careful who they lend their money to, but also they just don't have the available funds.

So it's no surprise to see the housing market down by around 10% or so from its peak. Expect it to fall at least by another 20% and the danger here, is it over shoots and falls even more. Now clearly you can't get a mortgage if house prices are going to fall, it is very simple. The Government may well be forced to intervene in some form to provide the banks with extra capital. They will probably allow them to swap their

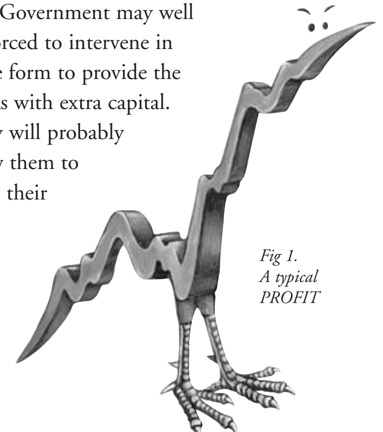

Fig 1. A typical PROFIT

* Source: Lipper Limited, bid to bid in sterling with net income reinvested to 30th June 2008. Sector is IMA UK Other Bond.

existing mortgage debt with the Bank of England. This gives the banks cash enabling them to lend again. This facility already exists but it looks like it is going to be extended; without it I would anticipate that mortgage lending will fall considerably further.

The same is happening with companies who are struggling to raise debt finance. Most have committed lines with banks, but if those have been used up, their alternatives really are becoming very constrained. Banks are loathed to loan them anymore money. Essentially banks are going through a significant belt tightening stage. I'm afraid really there's not a lot of good news there, I'm very sorry.

Dick Turpin: But with that overview, looking at the banks and the impact of banks on the economy at large, it is interesting to note their influence in the UK economy; is that greater than the likes of Europe or US, is that the sort of influences you are talking about there?

James Foster: It is. Clearly financial services is the major proportion of the total GDP in the UK; I once heard an American banker describing the UK as 'one big mortgage book', which essentially if it is one big housing market and that housing market a) is declining and b) on top of that you can't get any mortgages at the moment, it really is a pretty big influence on the UK economy. It is more extreme than it is necessarily in Europe and particularly in Germany and France. Where it is having the biggest impact of course is in Spain and Ireland where again the mortgage market is so important and that is why you are seeing the impact on those economies being so severe; as I think we have discussed before, Trichet probably isn't going on holiday to Spain this year.

The good news, and there is not much good news at the moment, but the good news is that the banks are at least recapitalising themselves and this is fantastic because this is new capital coming in at junior levels to me as the bondholder. Banks are essentially going to present a begging bowl to anybody who might be prepared to pay something. Good examples - look at RBS raising £12 billion** through a rights issue, plus some asset sales on top of that. Barclays have raised in total about £4.5 billion** through various share placements and mostly from sovereign wealth funds. We have also seen script dividends or even the cancellation of dividends from some banks. Asset sales will continue.

The chart highlights just quite how much fund raising has taken place. The total capital raised is approaching $360 billion**. There is going to be more. The danger of course is that the capital raised is not enough and we have even seen some examples where it is the case, the most dramatic was Northern Rock. Mostly because the Government made a complete hash of the situation, no surprise there of course.

Dick Turpin: Sorry, could I chip in with a question there on that subject that you have just touched on: Gary Duncan of Brewin Dolphin interestingly writes in and asks, 'what dangers do you see for the capital base and capital ratios of the major banks which you touched on? What would you anticipate the banks do to prevent any further deterioration?' Well you talked about recapitalisation...

James Foster: That's all they can do; the only thing they can do is recapitalise themselves because if they don't… What historically has happened, particularly in the States, was the central bankers marched down short term interest rates, down to 1% and then longer rates were a little bit more than that, then they were able to roll. So they would borrow at 1% and invest it at 1.5%, and that was the cheats method of refinancing the banks and that's what they did as I say back in the early part of this decade.

Dick Turpin: Quite successfully.

James Foster: Very successfully. They can't do that this time because inflation is too high and so the banks have got to get recapitalised on sales from you and I through rights issues and from the City and from bond issues and any form of financing they can find. Essentially I think it is going to come mostly from the sovereign wealth funds. There is little else they can do, apart from actually clear some of the rubbish off their books. The measure which Merrill Lynch took I felt was particularly good, it doesn't sound very logical, but actually you would get it off your balance sheet and take that risk away, they can then move on. It is no longer a festering sore. It becomes somebody else's problem. There is a debate actually about how much risk they have passed on, but that is a separate issue.

In the extreme situations like Northern Rock as I said, the Government ended up bailing them out. You can argue about the moral hazard of this, but ultimately the Government is stuck, they are forced to bail the bigger banks out and if they didn't, the systemic risk for the rest of the economy is clearly just catastrophic. The 'last one out turn the lights out' scenario and whether it would be Northern Rock here or the organised take over of Bear Sterns by JP Morgan in the US, the Government felt obliged to step in. To be fair, Bear Sterns was bought by JP Morgan, but the funding for that was provided by the US Government/US Fed. Shareholders essentially took the pain whilst bond holders in both scenarios have been kept okay, not in Northern Rock's situation with preference shares, but bond holders have all been kept current. More recently in the States, we've seen the big US mortgage providers Fannie Mae and Freddie Mac being bailed out; so this trend is continuing. These bail outs are only true for the biggest banks, the biggest organisations, smaller banks are struggling and will continue to struggle in this environment as, by definition, they're not too big to fail and at the weekend we saw a number of smaller banks in the US disappear and last weekend two disappeared for instance.

Dick Turpin: It is quite remarkable.

James Foster: Still, bond holders are actually cock-a-hoop when share holders help bond holders out, marvellous. We've actually seen a very diverse performance between bonds and equities. Equities have been going through the floor, financial bonds have actually been doing reasonably well; they have been volatile, but they have been doing reasonably well. Especially the biggest banks. To be fair they had an absolutely awful first few months – I was crying – but now as each new capital rating comes along, they're starting to outperform. Small banks are still struggling, but for instance Merrill Lynch bonds, went up this week after they announced their latest rights issue; clearly more capital, junior to me means there is less chance that they will default and so that was good news for the bonds.

The next stage of all of this is further bank consolidation, there just isn't enough profit to keep the existing number of banks in the system in existence. We've already seen some. Alliance and Leicester being swallowed up by Santander for instance. I mean that was glorious, great news as our Alliance and Leicester Bonds shot up by 10% on the back of that. We sold them having made a good 10%† profit. More of this bank consolidation will occur; and I wouldn't be surprised to see HSBC ending up owning a couple of weaker banks over the next couple of years. 10% for a bond holder is very exciting; again all very good news for bond holders. So being acquired by an enormous parent like HSBC or Santander, your bonds shoot up the rating scale and the prices go up.

Dick Turpin: So a lot of it really boils down to bond selection?

James Foster: It is yes, and you've got to be very wary about which banks you own and their position and their status and all the rest of it. I haven't got any Irish banks for instance or any Spanish banks, apart from Abbey/Santander.

** Source: Bloomberg, 28/7/08

† Source: Internal

Dick Turpin: Santander seems to have been the model?

James Foster: Emilio Botin Sanz III walks on water. And that's why I've got 50% of the Fund in banks. It's quite a bold position and inevitably it's going to continue to be a bit of a bumpy ride, but I'm very comfortable that it will be profitable as banks eventually sort their balance sheets out and partly because of these moral hazard issues, which I've discussed before.
If I look at pure and corporate bonds, i.e. bonds issued by your average company, they tend not to be my favourite. They're likely to go down the rating scales. Furthermore they have not been issuing recently. Partly because the market has been closed and partly because they're not prepared to pay the current yield. They don't like the coupon, what it is going to cost them. Eventually the companies will be forced to do so, they've got no alternative places in which to raise capital. When they do, the issue here is that the existing bonds will be marked out significantly wider. Further, the companies issuing the bonds will have to offer lots of covenants which at the moment they really don't like doing and that may well have to be a good buying opportunity, but for now hang on, wait there is going to be better opportunities in the future.

Dick Turpin: It's an unfair question, but in terms of the banks going forward and clearly from your position as a bond holder this is all very exciting, but as an investor in the equity then presumably their performance is going to be pedestrian at best as they go through this period of unrest?

James Foster: The difficulty I had with this is how much it discounted in the price; because when the yields on equity yields are up at 18%, 19% or whatever that is quite ridiculously high and what you know is that dividends will be cut and that you won't get that sort of return.
I'm not an equity expert, but I tend to feel that actually over the next few years they will have been shot to pieces, as this consolidation takes place and they start to restore their profitabilities. Banks are normally quite good at doing so, they'll start to make some profit again and then you'll see a stunning performance from them. So actually I think they're discounting too much bad news at the moment because the market is running scared, but don't quote me.

Dick Turpin: Sorry to ask an equity question of a bond fund manager.

James Foster: Having said that, I think it highlights the issue that I'd much rather take the risk through the bonds rather than taking it through the equity, I think it's a good question in that regard. Because actually, what's the chances of the equity going to 0? Well distinctly possible. What's the chances of the bonds going to 0? Very unlikely because the Government will bail you out. And so I think actually it highlights the issues very well; so if you think a bit bolder than, 'buy some equity', well it depends on how brave you're feeling. And the volatility of it at the moment and that All Share price is up and down 12% every other day, or every day this week – it's just ridiculous. So getting on the wrong side of that is very easy whereas through the bonds you're getting a yield of 10% or whatever, 9% that is far more attractive.

Dick Turpin: Well thank you I hope you didn't mind me asking that.

James Foster: Just moving on then, we've hardly got any of these investment grade bonds at the moment it will be some normal corporate bonds. The only ones we own are tobacco which luckily tends to be pretty immune to the economic cycle. Now if we look at the chart which shows the extra yields you were getting from owning an investment grade bond.
The brown line is Financials, the extra yield you now get is the 300 basis points on average.
So for example if Government bonds are yielding 5% it's a bit less than that, but say 5%, then add on your 3% for your average finance we've come up with yield of 8% in total.
Your typical corporate bonds yielding more like 220 basis points, so again at only 5% that gives you about 7.2%. So there is plenty of extra yield which you're getting for owning a bank bond and this chart highlights that.

I think it also highlights quite how dramatic the credit crunch has actually been. It is my favourite chart as it highlights the values we had and how far we are from the norm. High yield remains difficult, defaults are increasing; and will continue to rise for the next year. Having said that we still have 35%† in high yields, mostly in Defence and Telcos and they have done us extremely well, short dated ones or dated bonds, they have done extremely well. It's been a bit of a bumpy ride, but that's life at the moment.
We remain very careful about our high yield positions and it's an area where you have to be aware of the risks, but there are still some fantastic yields available, and selectively we're very happy to own them; a good example is something like Rexam. Rexam yields are 12%. Now Rexem's results only the other day were excellent, so there are some great opportunities. Good bonds are being thrown out – babies being thrown out with the bath water.

Dick Turpin: Phillip Hilton actually asks about default rates and clearly you've already answered the question partly in saying that you expect them to rise. Do you want to put any number on the level of default rates that are going to rise too?

James Foster: Good question, because in the last year, defaults were about 2% or so. We would anticipate that they should rise somewhere around 5%. Now the real issue with high yields is that a lot of these companies were very sensible and re-financed themselves in the good times. It can take a long time to go bust, it tends to be an in-cycle thing, that companies go bust anyway, because banks try and keep them going if they possibly can, because if they do and things start to improve, then when the economy improves they can get better value for the assets. So it tends to be a late cycle thing rather than an early cycle.

Dick Turpin: Following on from that if I may, another question, 'do current spreads actually reflect the expected default rate?'

James Foster: They do actually, and if you look at the differential, with current yields, the pick up which you're getting is now as wide – not quite as wide as it's ever been – not quite as wide as back in 2001, 2002, when the defaults were running at 10%, but yields have risen to reflect a lot of that risk. I still wouldn't sit there and say because we've got a rising default rate environment it's outstandingly cheap. You do have to be very selective, but I actually would rather take more risk with the investment grade market than I would through the high yield market at this stage of a cycle.

Dick Turpin: So your asset allocation has moved towards investment grade then?

James Foster: It shifted more towards investment grade to reflect this.

Dick Turpin: Which was a question from Brian O'Neil actually which you've now answered.

James Foster: Yes and to put that into context, when we launched three years ago we were at 70%† in high yields. We're now down to 35%† or so and this is continuing to fall and mostly because as I say, we're still expecting the economy to struggle and also because we've got a lot of the shorter dated ones and as they redeem they come off the books. I have been waffling for a long time but these are interesting times, fascinating times, probably some of the most fascinating in my career. It feels like bond volatility is as great as equity volatility, which is not what I'm paid for, but still. So with things winging around all over the place, there are some great opportunities being thrown up. Markets do remain very illiquid, very difficult, however gradually the market is starting to get inured to this bad news. I'd love to say we've hit the bottom, but unfortunately I just can't say that. And even then when I think we've hit the bottom I'll be wrong, inevitably you are. But, however, if the bank starts to get to grips with their problems, then these bonds will continue

† Source: Internal, 28/7/08

to perform or will start to perform very well. However the yields I now pick up I find extremely attractive. 9.5% yield in a junior Royal Bank of Scotland Bond is just fantastic and it gives you a good cushion against any further weakness.

Dick Turpin: So it's better to buy the bond than put money on deposit with RBS?

James Foster: It certainly is, it generally is a very attractive time to be buying into these markets. I mean Government yields will be kept low with the recession and falling interest rates help pull the yields down. I don't think inflation is really the major story here. Investment grade yields are so attractive we should definitely be taking advantage of it. And even selectively in the high yield markets there are pockets of great value, it's just rude not to take advantage of them.

Dick Turpin: Can I pick up another one? Graham O'Neil from Ireland, given away by his email address, he actually asks, 'as Irish Banks don't have sub-prime or presumably a relatively limited exposure to sub-prime and other leverage alone problems, why are you avoiding them? Is that more a reflection of the Irish economic situation?'

James Foster: The Irish economy has been, Graham, you must know, well it's in difficult straits at the moment. Despite the CDOs and the sub-prime and all the rest of it. In the States, they have taken some pretty extraordinary positions on their own book. They have been gearing up very, very aggressively and in fact there's just been an issue today from the Bank of Ireland and it's not one which I would take. Yes, I don't trust it. Some of the projects which I have seen them investing in and I'd say they are one of the only people who do it – only the Irish banks would do it – none of the other banks would look at it and this was last year. Quite clearly there are problems coming and it worries me, I could be wrong, but you know…

Dick Turpin: On that subject David Thornton from Premier is asking about Tier 1 financials. 'Where do you and Alex stand on Tier 1 financials?'

James Foster: Yes, good question actually, now I don't want to spend too long on explaining Tier 1 financials, but Tier 1 is just junior bank debt. There are whole tierings of bank debt and I could go into that forever but with junior bank debt Tier 1 is the most junior. I tend to think that if you look at the Northern Rock situation, even the Tier 1 there is still being kept current by the Government, they are still paying them. They don't have to, it's a voluntary payment for them. But because they want to keep the credibility of the organisation in future years they feel obliged to pay that. They are attractive; where we tend to buy them is in the biggest and strongest banks, so the likes of Royal Bank of Scotland or Barclays. We have got a small amount of Lloyds. It is where we have got exposure to Tier 1s and I would not have the exposure to Tier 1s in the slightly weaker ones and for instance UBS. Not that it is a weaker bank, but it has got its own set of problems at the moment. It is newspapers everyday; there I have got exposure to the senior bonds.
With Merrill Lynch, I've got exposure to senior bonds because I think that is a better place to be. It really depends on the quality of the bank so the lower the quality – perceived quality – the higher up we are on the food chain in terms of the level of banks. To be fair, in Alliance and Leicester, we did own the junior ones because we felt that there was a distinct chance they would be taken over and I was very happy when they were.

Dick Turpin: There are a lot of questions coming in, we'll try and answer as many as we can, obviously we are conscious of the time. David Creighton is asking about the demand for corporate bonds and particularly relevant to the declining collateralised products and bank trading activity. What do you see out there?

James Foster: What we're seeing there is demand from proper real money institutions and there seems to be a lot of switching by pension funds and by life companies from equities and into bonds. For the right issue at the right price there is genuine demand, but it is much more selective than it was a year ago when there was a general demand for everything, because the CDOs were just buying it up willy nilly. We're just not seeing that genuine demand across the entire curve as we did before. And it is pre-selective, so those companies if you feel that there is any doubt about their ability to finance in future years then they are just not getting the funding. The only way that they are able to do it is by offering extreme covenants. We're just not getting that at the moment, they are not prepared to offer those covenants, really strict financial covenants, so they are going to find other sources, but at the moment that is taking a bit of time.

The demand is there and actually it is quite interesting because we had last week one of the biggest deals that we had in a long time from Bank of America which was a £1.25 billion deal which for sterling was a big deal – a 20 year bond. So it tends to be the longer dated ones, which is a sign that again it is the life companies that have got the money, for the right bond and the right price they will pay up. I think weaker companies particularly retailers that sort of thing, we have not got any retailers at the moment, they would just really struggle to raise funds at the moment because sentiment towards that sector is so poor.

Dick Turpin: Excellent question from Nigel Callaghan of Hargreaves Lansdown which I would like to ask myself. 'If the Government does break its borrowing rules and it's one of the few ways out, what do you think the impact will be on the bond market if that happens?'

James Foster: I think people know that is going to happen. It is in the price; it is inevitable because as the economy goes into recession, the automatic stabilisers step in. What I mean by that is unemployment benefit goes up and that costs more money, VAT receipts reduce because then corporation tax receipts go down just because they have not got the money. So the automatic stabilisers step in, they cost money and on the other side they are not getting the tax receipts. It is inevitable that Darling is going to break his rules and clearly he has already done it with the announcement of the 10p giveaway to compensate people for the loss associated with that.

Dick Turpin: Will there be more so called off balance sheet activity?

James Foster: Well there has to be. Rigging the figures or essentially they'll just have to increase the borrowings. The level could actually afford to go up a reasonable amount without upsetting the bond market too much. Historically it tends to be driven by the fundamentals of the economics rather than the scale of borrowing. That does not seem to appear to make sense, but that is what happened back in 1994 for instance. 1995, when the vast amount of extra borrowing took place, initially the market reaction was very negative, but subsequently as inflation came down those bonds got bought. In the short term I have a slightly negative reaction, but longer term it's quite positive.

Dick Turpin: I'm conscious of the time, maybe just one more question and we will try and get the answers to the other questions done over the phone separately. Ian Leperb asks about index linked bonds that have clearly performed quite well…

James Foster: Well actually that was my biggest mistake in the last year – not buying those, and it is a great question actually because clearly look at the index linked and they have done so well. I don't think they offer much value at the moment, they did not ever offer much value, but now we have got real yields down to effectively 0. They have done well just because inflation has picked up and they therefore had a fantastic hedge against rising inflationary environment. I feel that it is difficult to make predictions about oil prices and all the rest of it and I am not an oil expert, but I am relatively comfortable. The environment for oil is you get a five year shift in oil price and we've had that five year shift. We have moved to a higher level

and I would not be surprised if in 12 months time oil is not much different to where it is now, it might be $10 higher or $20 higher, but not significantly different from where we are now which means that over a 12 month period, the effects of oil price increases will drop out and then inflation falls back down again. Now the gas prices are going up aggressively, but again in a year that's dropped out again and so the inflation number starts to fall and once they start to fall the attractions of index linked disappear.

Then if you combine that with an economy recession you have got the disinflationary impact of that. So I think the inflation index linked, should I be buying it now? I am afraid I missed it yes, but I would not buy it now, it could be quite dangerous to buy it now.

Dick Turpin: A short party, but the party is over.

James Foster: I am afraid the party is over. It does not often have a party to be fair.

Dick Turpin: James, thank you very much and I am conscious of the time, ladies and gentlemen I think we'll draw it to a close because we have taken a lot of your time. If there is anything further that we can help you with please don't hesitate to call our support number on 0800 092 2090 or indeed send us an e-mail at brokersupport@artemisfunds.com. Thank you very much for listening.

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