JAMES GLEDHILL INTERVIEW

NEW STAR HIGH YIELD BOND FUND

James Gledhill
Head of Fixed Interest

BC: (Ben Cherrington) Good afternoon, a warm welcome. Firstly, a few introductions, my name is Ben Cherrington, Sales Manager at New Star on the Partnerships Team, delighted to be joined by James Gledhill, Head of Fixed Interest at New Star and also Manager of the High Yield Bond Fund which, as of July, enjoys a double-A rating from OBSR and a triple star rating from Morningstar. James, very quickly, firstly, can you just talk me through the investment process of the Fund?

JG: (James Gledhill) Yes sure. The investment process really starts from a top-down perspective. We're trying to generate a kind of macro picture of the world we live in so we're looking at a fairly big picture economic statistics, things like GDP and inflation and things of that nature, really for the G7, most of the developed markets but I guess more with a concentration on Europe and the US since that's where we're invested in. And we're really trying to decide really whether GDP is positive, whether inflation is growing, whether it's a good environment for investment, whether we want to be invested in more cyclical companies or more defensive companies, and what we think of interest rate risk as well as credit risk. So we're trying to take a view on government bonds as well as on corporate bonds. And, having developed that view, we can then move down into the individual sectors.

So, if our view on GDP is very positive, then we might have a more positive view on more cyclical sectors and vice versa. So we can decide which sectors we want to expose the Fund to. And then, as a kind of third level, we then get into which company specifically we want to invest the Fund in. Now, clearly, if we're very negative on some sectors, we might not look at any companies in that sector or we might certainly be very wary of a sector; other areas, if we're in favour of those sectors, we might spend a lot of time looking at a range of companies in that sector and possibly own quite a number of companies in the same sector.

We are, however, very keen on diversification. It's one of the key things we do in the portfolios. So we'll own a wide range of holdings that are diversified both by number of holdings but also by the sectors they're invested in. So we may choose to ignore a sector pretty much but we won't have a situation where we've got all of our funds invested in a single sector because then the companies would be highly correlated and there would be a big default risk.

And then I guess, finally, as a policy, we are concentrating on the cashflow. It's typically more of a bond investor, credit investor focus as against an equity investor. Cash is king to bond holders, rather more so than accounting profitability, so we're keen on cashflow, we're keen on quality of cashflow and we're keen on businesses which have assets. Typically, though, we'll be more biased towards a company which has high quality predictable cashflow and yet is somewhat leveraged rather than a company which maybe has less leverage, less borrowing but is much less predictable. So we'll go with the predictability of cashflow rather than the more cyclical less predictable choppy sort of business as a bias.

BC: So, with regards to the macro situation, what are your current thoughts on the interest rate environment?

JG: Clearly, it's pretty ugly. I mean they have tin hats on in the City at the moment. Life is particularly tough in the banking sector but also in consumer focus sectors. So things like retailers, clearly the house builders, areas of that part of the market are in great difficulty. This has come from the US. I mean it started from the US with the subprime market but I think it's very much moved past that, to be honest. I think that's like yesterday's story and today's story now is very much that we're in a slowing economic environment, possibly tipping into recession. Whether we're slightly negative GDP, slightly positive GDP seems to me to be frankly neither here nor there. I don't think we're going into a really negative GDP market.

But we're also in a world where there's quite a few contradictions. We've got slowing GDP in developed markets and yet, until recently, we've had very strong oil prices. We've got the contradiction of very weak developed markets and relatively strong emerging markets. So we sort of have a tug of war going on. And we've seen really very aggressive increases in inflation, particularly quite strong numbers on inflation in the UK today. So you've had central banks trying to deal with both a weakening GDP situation but an increasing inflation situation. Which is almost their kind of nightmare; central bankers wake up in a sweat thinking about these situations. So that's very difficult.

We, as a house, have been very negative or really quite negative on government bonds for quite some time, and that's because we have been concerned about the inflation that's been building up in the markets, and when I say quite some time, I'm going back really four or five years. And it's really only in the last six months or so that that's really come to fruition and the inflation numbers have come through. That's beginning to push up government bonds, increase their yields; clearly inflation is the enemy of a government bond. And it's really only in the last three or four months that we've started to feel rather more positively about government bonds that people can now see the inflation in the market, the yields on government bonds have come back up, and looking forward, strange as it may seem, we're starting to think that the inflation situation may gradually be getting more under control now because slowing GDP will ultimately bring down the oil prices and the commodity prices and such like.

So, actually, for the first time in a while we're feeling somewhat more positive about government bond risk, and we will be increasing the duration on the funds gently to add a little bit more government bond risk, and on the high yield fund we now have a small weighting in government bonds which we haven't done before.

BC: Okay, so that's the gilt side covered and what about our credit?

JG: Well, I guess, splitting the credit up into the kind of two crude rating agency sectors, we're talking about investment grade and high yield bonds. Much the biggest sector actually within investment grade is bank debt, and it's also I guess the most topical conversation at the moment. Bank debt has performed really very badly over the last year or so, as we've already mentioned, starting with the subprime losses. We've had significant writedowns, really in pretty much all forms of banks, pretty much everywhere in the world. The Japanese banks have been better protected than many but really the European banks have actually done no better than the US banks despite this really being a US problem initially. And, as I said before, I think we've now moved past subprime and we're getting into the general cyclical downturn that banks have as the economy turns down. So we're starting to get into typical credit losses. We're seeing the increase in normal mortgages. Defaulting is the wrong term but people missing payments on normal mortgages. We're starting to see people worrying about companies and just bad loans in general in the ordinary course of an economic slowdown.

The other thing that's going on is that banks clearly are need of capital. They've been really quite a considerable number of rights issues in various forms. In this country the most obvious being RBS and HBOS, but really across the world banks have been having rights issues. I think this is very important to understand from a bond perspective rather than an equity perspective. On the whole these rights issues are very dilutive to equity holders. They're really quite negative in many ways. They're having to stump up capital to support the banks and, I guess, in a sense, good money following bad in that they're doing that in order to support their existing investments. From a bond perspective, this is equity being injected below the bond holders, so it's protective of the bond holders. So it's actually very supportive to bonds. So rights issues are actually very good for bond holders and rather less good for equity holders. So when we see a rights issue, as equity investors, we're very happy about it.

So, given that, we're a little bit surprised, to be honest, how weak the corporate bonds and corporate bank debt remains and, actually, we think it's probably the sweet spot of the credit market at the moment. We think bank debt offers the best value. You're being paid, depending on seniority of the bank debt, anywhere from 300 to 500 basis points over for the too big to fail sort of banks, the RBSs, the Barclays of this world, which to be honest are both protected by equity shareholders who are prepared to put in capital required but, ultimately, also by governments. So we think the chance of default of these sorts of pieces of debt is actually remarkably low and yet you're being paid pretty much twice the government bond yield for holding this debt. Now it will be choppy over time, people are clearly very uncertain about banks over the short and even sort of medium term, but over the next two or three years I feel pretty comfortable that bank debt will be a very good investment for people.

On the high yield side, the high yield market is also being difficult, as you would expect going into a downturn. It's very much our view that you're overpaid for the default risk within high yield. There are lots of statistics that kind of fly around on this, I'm talking about default risk, but to try and simplify it, the average high yield bond now is probably paying you 700 or 800 basis points more than a government bond. That is implying somewhere, you know, 7 or 8% default rate, broadly speaking, and we don't think defaults will come anywhere close to that in this cycle. Now, in bank debt, where you're being paid 300-400-500 over, we think there's no way that the bank defaults will come anywhere close to justifying those sorts of spreads. In high yield, it is possible, in the weakest environments in high yield you do see default rates reach 8-9-10%. But we don't see that in this current environment, certainly not in Europe.

And, actually, it's as much because of what the high yield markets in Europe are made up of, what sort of companies have issued as anything else. We don't really have retailers in Europe. We don't have house builders. We don't typically have weak airlines. We have Air France and their like but we don't have really weak airlines. And those sort of areas are where the defaults are coming from in the US. And actually Moody's have been improving their outlook for default rates as well. They've slightly upgraded, ie reduced the number of defaults they expect over the next year or so. But I think it's particularly interesting that Moody's are talking about 6% defaults in the US but about 3% defaults in Europe. So when you read headlines of global default rate is about 6%, that's typically reflecting the US market and not the European market, and our funds are principally invested in European bonds.

So we think again that you're being overpaid, you're being paid too much for the default risk that we'll actually see, even in a relatively negative economic environment. So we still think that there's significant value in high yield. We still have approximately a neutral weighting on the Fund in high yield so we've got about 55% in high yield which, as I say, is about the neutral weighting. We think the best area, the best kind of bang for your buck is bank debt but we also think high yield is offering you a very good rate. The worst area then, almost by definition having gone through those areas, is the non-bank investment grade areas, and that continues to trade relatively tight because, to be honest, the balance sheets of those corporates are actually in quite good shape going into this downturn. A lot of companies didn't borrow too aggressively, so actually those companies go into this weak market actually quite well capitalised. So it's not that they're bad value, it's just that we think there's better value in other areas.

That said, we think it's going to be quite a difficult time for bonds for the next six months or so. It is plain that markets are jittery. It's plain that markets are not functioning particularly well, to be honest. The liquidity of markets is poor. So bond prices are moving up and down more sharply than you would typically see. Typically these sorts of bonds move in relatively small increments; we're seeing relatively big increments. Exactly the same thing you're seeing in the equity markets; there are bigger swings going on. So it would be wrong to say that we think that the capital of these assets will be as stable as it has been over the two or three years a year ago when life was simple. But you are being paid now on the high yield fund something like 10%. So we do think that you're being paid to wait, you're being paid to absorb that capital volatility, lower than equity but high for a bond fund. So you're being paid to absorb that capital volatility with the high income stream and, if you've got a sensible timeframe, you'll get a decent return out of these assets.

BC: Marvellous. Hugely informative as ever. James, many thanks for your time.

2009/08.08cy