

# Strategic Bond Q3 investment update

October 2023

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**Investment manager Torcail Stewart and investment specialist Sandy Jones give an update on the Strategic Bond and Global Strategic Bond strategies covering Q3 2023.**

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Your capital is at risk. Past performance is not a guide to future returns.

**Sandy Jones (SJ):** Welcome to the Baillie Gifford Strategic Bond Q3 update. My name is Sandy Jones. I'm an investment specialist in the income team here at Baillie Gifford, and I'm joined by Torcail Stewart, co-manager of the Strategic Bond strategies.

As a reminder, these are global best ideas portfolios. We seek to add value through bond selection and active management of portfolio credit risk. We're going to talk about performance, rates markets and positioning. Torcail, let's start with performance. How have the strategies performed over the last quarter?

**Torcail Stewart (TS):** The Strategic Bond strategy is behind benchmark, and the Global Strategic Bond strategy is ahead of benchmark over this last quarter. Both strategies are running with a low level of high yield corporate bonds relative to the historic amount that we traditionally run with.

**SJ:** Can you give us a bit of an insight into some of the contributors to performance?

**TS:** Yes. So, on our last quarter's call, we spoke about the importance of having patience in companies that may be going through a more challenging cyclical time. We spoke about ams-OSRAM for example, and positively with ams-OSRAM, we've had the patience, and actually, it's now starting to play out. It's been one of our top performers over this last quarter.

What we've seen is that there's a new chief executive at the helm and a recently appointed CFO, and they've taken decisive action to really focus upon the most profitable segments of that business. They've also managed to source a €300mn grant from the German state. This is to fund a research and development optoelectronics plants in Bavaria. They are also looking into doing a €300mn sale and leaseback transaction. And, importantly, they've managed to line up an €800mn rights issue being underwritten by HSBC, Morgan Stanley and UBS.

Some really positive developments there from that management team. And it's important to show you that if you see the fundamentals of a business having long-term potential, then typically, businesses will find a way to get there, to get that liquidity because shareholders will also see the long-term potential of it.

Now, looking through other performers within the strategies. We've seen there's been quite strong performance from longer-dated financial bonds, in particular that of Investec. I'm sure you'll be aware that Investec is combining just now with Rathbones, and that has been positively received by the broader market and has been positive for our Investec bonds as a consequence.

**SJ:** And what about detractors, Torcail? Can you give some insight into positions that haven't performed as expected over the last three months?

**TS:** Yes. As we've been quite defensively positioned within our portfolios, what we've found is some of the longer-dated most defensive credits, those from AAA-rated supranational organisations like the European Investment Bank, they have not kept pace, as we might expect, with the market rally that we've seen, because such high-calibre, high-quality credits tend not to have the same market risks or market beta.

And so they will provide a more muted performance in a rallying market, as we've seen. But that doesn't mean that markets are going to rally forever.

**SJ:** So overall, a solid quarter. Risk levels in the portfolios have been lower than normal. The strategies have broadly kept pace even as the markets have risen. Let's move on to talk about portfolio positioning, and in particular, the market environment. There's been an emerging narrative around interest rates being higher for longer, but also a lot of talk about us having reached peak rates. What is the outcome for interest rates?

**SJ:** So really, Sandy, it depends upon which side of the pond you reside on, because we're seeing quite a differentiation between the US and Europe in terms of the speeds of their relative economies.

What we've seen in the US is really quite strong exceptionalism. What is driving that is, really, organic onshoring. We've seen a lot of companies bringing their factories and supply chains back to the US. We've also seen some government stimulus there as well, through the US Chips Act, that's really encouraged a number of businesses, resulting in about \$200bn worth of investment flowing towards semiconductor manufacturing plants in the US.

In addition, the US also has the advantage of being a net energy exporter. As we've seen in Europe, we've seen them redirecting that demand for energy away from Russian oil and gas, and the US has been a strong beneficiary of that. So, the combination of those factors is actually resulting in quite a strong economy out there and people pushing back the likelihood of recession in that geography to mid-2024, so mid-next year.

Rate hikes have been coming through, and inflation has been trending down, and at the last Fed meeting, it was termed a hawkish pause by the market. Why is that? Because many think the strength of the US economy is going to result in further rate hikes from here.

Now, if we look across the pond to Europe, very, very different. Europe is a net exporter to the global economy. It really is impacted by the winds of change that are happening. What we're seeing in China just now; we're seeing a slowdown in that property market, which is really affecting their overall growth.

Europe has also been a beneficiary of globalisation. So, as we see some protectionist moves bubbling up around the globe, that is to the detriment of European growth. Europe, if we look at the German industrial model, is also strongly based upon energy prices, and again, it's suffered a bit from the higher energy costs that we're seeing coming through. And you also have to contend with high debt levels in the likes of Italy.

So overall, when you put all of that together, we think we're going to see rates biting harder and faster in Europe than they will do elsewhere.

**SJ:** We may have seen peak rates in Europe, but probably a bit further to go in America.

**TS:** Yes. Although even in America, it's quite intriguing because you are starting to see some signs that those rates are starting to have an impact. We are seeing that credit card delinquencies have been trending upwards. But the challenge for the US is really the tightness of that labour market, and that is the element where we think the US is going to have to continue to do a bit more on the rate side to temper that.

**SJ:** Okay, I'm going to ask you the most important question: what does this backdrop mean for portfolio positioning in Strategic Bond?

**TS:** So, this last quarter, what we've seen is corporate bond spreads, ie that extra yield premium that you receive for lending to a corporate over and above the government bond yield, we've seen that that spread come down through this last quarter as the markets have rallied.

And that really is why we are running with a lower level of risk than we traditionally would in these strategies just now because high yield is more susceptible to tougher macroeconomic conditions. And if you look back in time, whenever we've seen rate hikes, not even rate hikes of the magnitude we've recently seen, within one to two years of that, you generally end up with recessionary conditions.

We think it's prudent to run with a low level of high yield just now in the portfolio, which in the goodness of time, I think, will be beneficial to the performance of the strategy.

**SJ:** Any other movements or adjustments you're making within the portfolios?

**TS:** Yes, Sandy. So, other elements that we've looked at include some of our dry powder, our shorter-dated dry powder, some of that being in European investment banks, etc. And what we thought is, how can we make that work a little bit harder without moving the risk dial too much? And so, we've looked around quite vigorously to find corporate bonds where the business effectively has enough cash on the balance sheet, or is sufficiently cash generative, such that it can meet the maturity of that upcoming bond we've been purchasing. So effectively you're upping your yield a bit without moving the risk dial materially, i.e. keeping it working harder for you without moving that risk.

The other aspect we're looking at is some of our longer-dated bonds in the portfolio and identifying those where we think there's some market beta in there; they might move with the market more than we would like. Moving some out into shorter-dated bonds, but also into some of the really good ideas coming through from the team that have that balance sheet improving angle that we think will give a differentiated return to that of the broader market.

So effectively, we've been trying to up the yield a little bit, improve the potential of the portfolio overall for the long term without moving that risk dial to ensure the strategies are well-positioned for tougher macroeconomic conditions ahead.

**SJ:** I'd like to delve a bit more into the balance sheet improvement angle. Can you give an example of a new idea that's made its way into the portfolio in the last quarter that has these characteristics?

**TS:** So, an eclectic new issuer to our markets has been that of Veritext. This is a company that operates in litigation support solutions in the US. It's the leader within its field, and effectively what it provides is deposition testimony recordings of witness testimonies. What we've found is that, because the legal industry has been outsourcing that, you've got quite a fragmented market of mom-and-pop companies.

And so Veritext has been hoovering these up, moving them onto their larger platform, which is more efficient. But it also is a platform that has some budding proprietary AI technology that they're looking to deploy, and we think that could be very beneficial for their margins in the long term. So, this is quite a nice niche, growing business where we think the ratings are likely to rise on this company through time, and that should be positive for the bonds that we've purchased. So, we think it's quite an exciting play for your strategies.

**SJ:** So, in summary, if we reflect on the quarter and the outlook, the strategies have performed broadly in line with their respective indices despite being underweight high yield, and we continue to favour investment grade over high yield because high yield is much more sensitive to weaker macroeconomic conditions.

Thank you very much for your time, Torcail, and thank you for joining us.

## Strategic Bond (including Strategic Bond and Global Strategic Bond strategies)

### Annual past performance to 30 September each year (net %)

	2019	2020	2021	2022	2023
Strategic Bonds Composite - GBP	9.8	2.1	4.0	-20.6	7.9
Strategic Bond Benchmark* - GBP	9.1	2.9	2.8	-20.0	9.1
Fixed Interest Global Strategic Bond Composite - USD	10.8	6.9	5.3	-18.5	5.9
Global Strategic Bond Benchmark** - USD	10.8	5.3	3.4	-16.4	6.7

### Annualised returns to 30 September 2023 (net %)

	1 year	5 years	10 years
Strategic Bonds Composite - GBP	7.9	0.0	3.0
Strategic Bond Benchmark* - GBP	9.1	0.1	2.7
Fixed Interest Global Strategic Bond Composite - USD	5.9	1.5	2.9
Global Strategic Bond Benchmark** - USD	6.7	1.5	2.7

\*The composite's benchmark is composed of the following: 70% ICE BofA Sterling Non-Gilt Index, 30% ICE BofA European Currency High Yield Constrained Index (Hedged to GBP). The benchmark is re-balanced quarterly.

\*\*The composite's benchmark is composed of the following: 70% ICE BofA Global Corporate (Hedged to USD), 30% ICE BofA Global High Yield (Hedged to USD). The benchmark is rebalanced daily. Prior to 15/01/21 the composite's benchmark was Bloomberg Barclays Credit (Hedged to USD).

Source: Baillie Gifford & Co and ICE. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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