GAM Investment Meeting Notes

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Long Only and Absolute Return Fixed Income

Tim Haywood, Investment Director, GAM Absolute Return Bond Fund, GAM Star Dynamic Global Bond

- November has proved an extraordinary – if treacherous – month, marking the demise of many traditional safe-haven markets. The ratings agency Fitch has placed the US on watch for a possible downgrade as well as warning the UK about its debt position. Accordingly, markets delivered some remarkable moves. Austrian bonds fell by five points over one month – an occurrence not seen in the past 40 years. Italian bonds also declined by the same amount, although this was regarded as a less spectacular occurrence since such a retreat had last occurred in August. Global bond markets have thus become treacherous. Spreads on European Investment Bank (EIB) bonds widened by 100 basis points, costing long-dated sterling bonds approximately 10 points.
- All of these moves impacted the performance of our absolute return portfolios. Conversely, many emerging market bonds displayed strong relative outperformance during November. Mexican and South African bonds were down 'just' two points, while five-year Indonesian bonds were down one point. Following such performance, we have begun to sell out of these markets, matching the modest reduction in emerging markets ex-Latin America risk with an incremental increase in Italian bonds, currently below 5%.
- At the moment, Italy is raising money at around 7.5%, which is also the price of its bonds in the secondary markets around the globe. To highlight the risk associated with holding Italian bonds we can look to Switzerland – which yesterday raised funds at a negative yield of -0.3%, charging a premium to the buyers of its bonds. This huge dispersion in the cost of sovereign funding is unstable – although when an equalisation will occur is difficult to predict.
- Regarding the European sovereign debt crisis, it now seems that the 'consensus outside Germany' solution is for the ECB to deliver a vast amount of quantitative easing to the market by buying up secondary bond issues to assist banks, and to buy new issues to support governments.
- Behind this, recent US economic data has been quite impressive. The Citigroup Economic Surprise index for the G10 has risen from -60 at the end of August to +17 (as at 30 November), highlighting that – away from financial markets – economic indicators are not all unhelpful; but the disconnect between market participants and wider actors remains as wide as ever. Pessimism levels in November did not reach the lows experienced on 22 September, which may mean that the subsequent bounce will be less impressive. As a result, we have been reducing overall risk of late.
- We have recently reduced our short euro position from -10% to -4%, as an example. This move is not the result of a new-found love for the euro per se, but reflects the fact that managers who admit to being long the currency are very few and far between. This increases the riskiness of being short the currency.
- We expect that future returns will most probably be driven by a regime change – either by a raft of defaults, which will benefit our credit default-buying strategies; or by a plausible resolution to the European crisis, driving yield convergence. Compare, by illustration, the Italian bond market yield at 7% versus that of the UK gilt market at 1% to 3%.
- Our largest long currency position is Mexico, which benefited from the news that the country is stopping the accumulation of foreign currency reserves at USD 600 million a month – a programme run for several years – with the current foreign reserves now standing at USD 140 billion. The country has committed to a programme where it will sell USD 400 million dollars and buy Mexican peso on any day that the peso falls by 2%. This means that on tough days the peso should outperform – giving us another reason to own the currency, particularly as valuations in relation to local and international stock market performances are very favourable.
- Our commercial mortgage holdings, which form another part of our protection strategy, have performed well during November. The month marked the biggest-ever auction of commercial real estate entities – both notes and actual properties – in Florida and other south-east states of the US. The average loss severity on the properties was 70%; the average loss severity on the notes was 50% – highlighting why our commercial mortgage protection has started to generate profits. Residential mortgages are performing a little better, so we are long these and short commercials.
- We have started to buy CDS on industrial names, such as Merck. Courtesy of excellent corporate results and strong balance sheets, the sector has outperformed to the point where covered bonds now trade flat to industrials and offer relatively cheap protection opportunities.
- For CDS protection, we will not use an entity as counterparty whose CDS trades wider than 400 basis points. We currently favour the principle names – Barclays, Deutsche Bank, JP Morgan and Credit Suisse. We stopped using French banks for a while, but change our counterparties in line with shifts in market sentiment. The great benefit of using CDS is that past profits are crystallised on a daily basis, meaning that these are not at risk, even in the event of a failure of the counterparty.
- Our portfolios are generally structured with approximately 50% of the assets invested in extremely liquid securities, which hitherto have been government bonds and treasury bills, mostly in Europe. Ironically, it is this structuring policy that has impacted performance this month, as countries such as Austria, Finland, Italy, the Netherlands and even Germany have performed poorly. Approximately 10% of portfolio assets are invested in convertible bonds with the balance in high-yield and investment-grade credit. On top of this there are foreign exchange, interest rate and credit default swap overlays.

- From peak to trough our funds have fallen between approximately 2% and 3% this year. At their peak, the average running yield on our bonds was around 2.6%. The yield has now risen to approximately 4.6% – so we have almost doubled our yield, while at the same time limiting our losses to 3% of the capital. This comes as a function of us owning fairly short-dated, AA-rated bonds. This sets up the absolute return bond funds for potentially better returns, courtesy of these higher yields.

Source: GAM