# A Spotlight On:
# Corporate Bonds

October | 2019

## Introduction to Sector

The IA Sterling Corporate Bond sector is possibly one of the more straightforward sectors which the IA have put together. Funds must invest at least 80% of their assets in investment grade corporate bonds denominated in, or hedged back to, sterling. Nonetheless there is a range of funds in the sector, with more or less flexibility around duration and credit quality. This is a relatively large sector, encompassing close to 100 funds and some £85bn of assets, and therefore gives investors plenty of choice whether they wish to invest in a tracker fund or something more active.

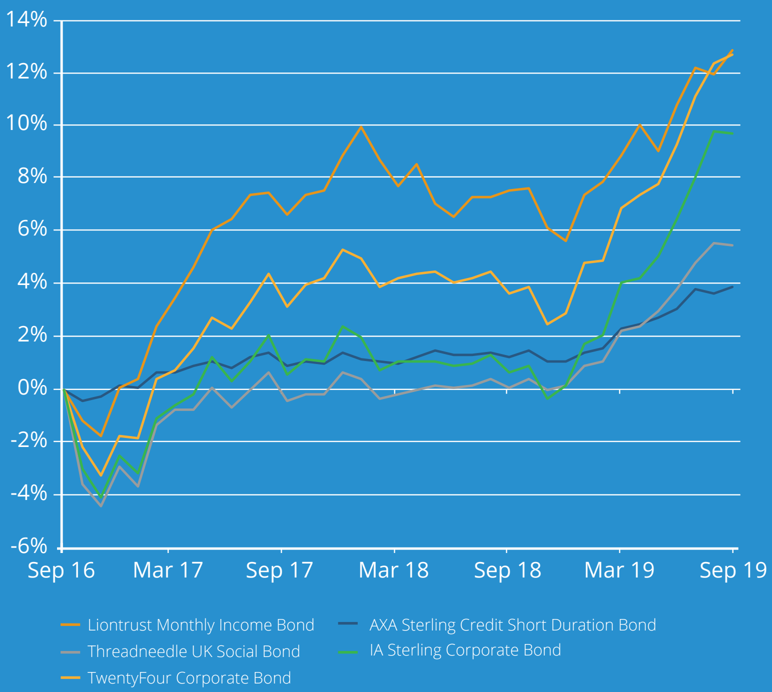
## Sector Nuance

People buy corporate bonds for different reasons, and the sector showcases this, with a range of funds offering different outcomes and investment results. Historically, corporate bonds have largely served two purposes. They have been a good source of income and, at the same time, provide diversification in a portfolio context because of their relatively low correlation with equities. Whilst yields have fallen across bond markets in the last 10 years or so, corporate bonds do still provide a source of income – this may be lower in absolute terms than it was, but nonetheless is useful as income from bonds is steady and predictable. The diversification potential of the sector is becoming more polarised. Diversification is largely due to the duration element of corporate bonds and, with yields having fallen and valuations having become more expensive in recent years, some managers who have the flexibility to do so have reduced duration quite significantly. Whilst the managers in question have good reasons for doing this, and believe that it should benefit investors in the longer term, it may also decrease the diversification potential of the funds in a risk-off environment.

## Recent Sector Performance

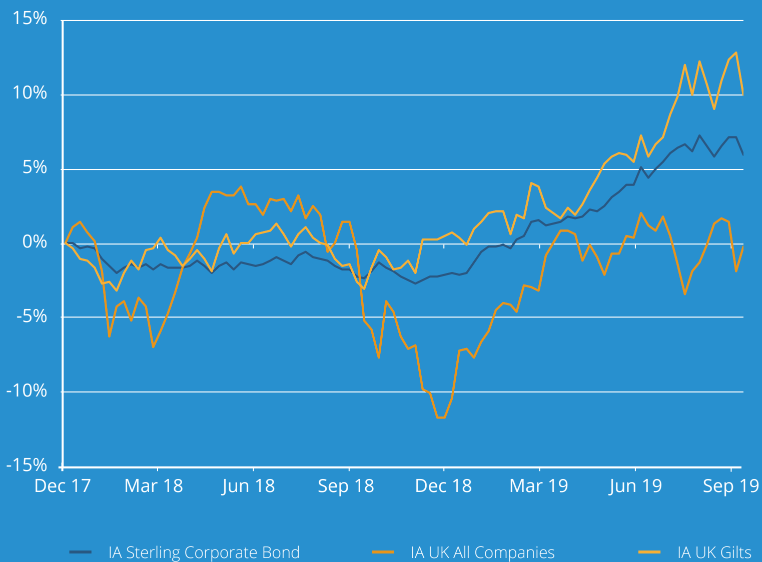
Performance in the sector over the year to date has been largely driven by duration. With gilts up 8.5% (over the year to date to 17th October 2019), a fantastic performance given the rally we have seen over the last 10 years or so, any corporate bond fund with a reasonable level of duration has performed well. The iBoxx UK Sterling Corporate All Maturities index is up 9.9% over this same period, and the IA Sterling Corporate Bond sector is up 8.4%. As well as a big duration rally over 2019 to date, corporate bond spreads have also tightened, giving a further boost to returns.

2018 was a much more difficult year for corporate bond markets. Whilst the asset class fared well in comparison to equities, it still finished the year in negative territory. There were two notable periods of volatility over the year, the first in January and February, and the second in the fourth quarter. Whilst corporate bonds rallied a little in the interim period, it was not enough to offset the poor performance in the periods of risk aversion, and the sector finished the year down 2.2%. This compares to a return from gilts of +0.6%.




*Source: FE, 18th October 2019*

*Figure 1: 3 Year Cumulative Return*




*Source: FE, 18th October 2019*

*Figure 2: IA Sectors 2018 & 2019 YTD Cumulative Return*

## Funds in Focus

A core offering in this sector is the TwentyFour Corporate Bond fund. The fund is managed by Chris Bowie and Gordon Shannon, a pair of experienced managers, and backed by a well-regarded team at TwentyFour Asset Management, a specialist fixed income boutique. The fund is run in a sensible manner, with a focus on delivering attractive risk-adjusted returns, whilst retaining the basic characteristics of the corporate bond universe. The fund will thus always retain a healthy degree of interest rate risk, which could prove to be an attractive diversifier in a balanced portfolio, as well as exposing investors to credit risk and the extra returns above government bonds which this should generate over time.

For investors who prefer a more flexible approach, the Liontrust Monthly Income Bond fund may be worthy of consideration. The managers of this fund have considerable investment flexibility around both interest rate risk management and in how much credit risk they choose to take. Thus far they have used this flexibility to reduce the volatility of the fund's returns. A core part of the investment process is a belief that sustainability matters, and that companies which produce goods or services which are of benefit to the society or the environment, and who do so in a way which manages environmental, social and governance (ESG) risks and impacts will, in the long run, be the best investments. Thus the fund combines a flexible approach with sustainability considerations.

Those who are concerned about valuations in corporate bond markets, and would prefer to reduce the duration of their corporate bond holdings may be interested in the AXA Sterling Credit Short Duration Bond fund. This is a relatively simple corporate bond fund that invests in short-dated bonds which produce an income, but which tend to have less volatility than the wider market. The fund is managed using a laddered approach, with about 20% of the portfolio maturing each year. This gives some protection against any future possible rises in interest rates, as the manager should be able to reinvest maturing bonds at higher yields, and also provides a natural source of liquidity in the fund.

For investors who are serious about monitoring and measuring the impact of their investments on society, the Threadneedle UK Social Bond fund would be a good choice. This fund combines sound financial analysis with a genuine desire to improve social outcomes. Investing in investment grade corporate bonds, the fund should provide everything one would expect from a standard corporate bond fund, including income and diversification from equities. At the same time, the focus on social outcomes provides significant non-monetary benefits. For a bond to be held in the fund, the proceeds of the bonds must be evidenced to be contributing to some form of social goal, mainly in the UK. From a social perspective, the fund's philosophy and process are highly credible and the manager is evidently extremely passionate about the role that capital markets should play in generating a positive social impact.

## Sector Outlook

2019 has been a strong year for corporate bond markets, and fixed income markets more generally, and valuations are now looking quite full on an absolute basis. On a relative basis, however (looking at spreads), investment grade bonds are one of the more attractive areas of the fixed income market, both compared to UK government bonds and sub-investment grade bonds. Spreads relative to UK government bonds were around their long term average as at the end of September 2019.
It should also be noted that, as we write, sterling corporate bonds are trading at fairly significant discounts (on a spread basis) to their US and European counterparts. The reason for this is obvious – the high levels of uncertainty around Brexit. Should Brexit be resolved in a manner agreeable to markets, and if we get a greater level of clarity around the future for UK corporations, the sector may enjoy another rally.

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