HIGH YIELD BOND FUND – MANAGER INSIGHTS

Lucy Isles, investment manager, gives an update on the High Yield Bond Fund and how the team are not only offering support to companies in the short term, but also looking to the future and thinking about how companies will operate sustainably longer term.

The value of an investment in the fund, and any income from it, can fall as well as rise and investors may not get back the amount invested.

This film was produced and approved in May 2020 and has not been updated subsequently. It represents views held at the time of recording and may not reflect current thinking.

Lucy Isles: Hello, welcome to the Baillie Gifford High Yield Bond Fund insight video, live from my snug, a less formal working environment but one with speedy access to the fridge. I hope you all have been able to navigate the chaos and confusion and challenges over the past few weeks and are holding on tight to your loved ones.

Our Response

Despite delivering 60 per cent fewer defaults than the market average over its 18-year track record, this crisis has been a true test of the fund's resilient approach. We aim to invest in companies that can adapt and thrive in various market conditions through the cycle. However, this situation is unprecedented. Many previously perfectly viable businesses are struggling for sales, burning cash and taking on more debt to comply with government restrictions to save lives.

By and large, our focus on resilience first and foremost means that we've not had to alter the shape of the portfolio. Trading activity has been limited, avoiding unnecessary sales in a weak market. Instead we have been able to support companies with our clients' capital through this challenging time. In doing so, we're ultimately helping their underlying resilience to shine.

As we review company reporting season, we are starting to see this resilience emerge. Take one of our holdings Enviva. It produces wood pellets used for power generation and their demand is secured with strong long-term contracts. Herbalife is another example. It is a direct seller of nutritional products and it's seeing record volumes with increased customer focus on health and wellness. Or Equinix – it's a data centre provider - facilitating over 350,000 connections for 10,000 customers, such as Netflix, and it is riding our insatiable demand for data. The company is even raising capital to fund potential acquisitions to enhance its network.

Portfolio Positioning

A key aspect of our process is to rigorously stress test each investment to appropriately position the holding. We did not, however, envisage this particular scenario, which for some companies means zero sales for many months, in our initial testing. So the immediate task for Rob and I in March, when the implications of the crisis weighed heaviest on bond markets, was to vigilantly reassess our assumptions on resilience. Which competitive positions have been harmed? How does this impact sustainability goals? How will liquidity, balance sheets and debt maturities impact the financial stability of our holdings?

So far, the portfolio is holding up well. We believe the vast majority of our holdings can manoeuvre their way through the ongoing uncertainty. Only one review has resulted in a sale of a 0.4 per cent position. Only 1 issuer of 73 is considered a high risk of default, which makes up 0.2 per cent of the portfolio. We are, however, only in the early stages of realising the economic implications of this crisis. A rise in default rates within the asset class is already underway. On the other side of this picture however, is massive stimulus from governments and central banks. Many investors are also looking to be more lenient and support companies through this event. We will constantly be looking to balance supporting companies while proactively responding to a deterioration in resilience.

Outlook

With a tight grip on our existing holdings, it is now time to look to the future. Not thinking about how companies will survive the next few months but how they will operate sustainably in a new normal post coronavirus. The volatility in bond markets to date means, for the first time in years, many BB and BBB rated bonds have fallen by double-digit percentages in price. Many of these are high quality companies with a low risk of default, facing short term pressures. In other words, an excellent opportunity for our fund.

We are seeing investment grade companies and fallen angels pay premiums in the primary market and trading wide in the secondary market. Take our new holding in Carnival as an example: a likely fallen angel cruise company who issued a short-dated bond with, by our calculations, a near 100 per cent recovery rate offering an 11.5 per cent yield. Or our new secondary market purchase in PVH, the investment grade owner of the Tommy Hilfiger and Calvin Klein brands, delivering double-digit online sales growth in loungewear, their predominant offering. PVH's operational flexibility, long-dated debt structure and significant liquidity we believe will allow them to weather the uncertainty ahead.

Whilst we're not calling the bottom, we are certainly finding and capitalising on incredible value in the market. We believe the fund is well positioned to deliver resilient, long-term income in the challenging months and years ahead.

Annual Past Performance to 31 March Each Year (%)

	2016	2017	2018	2019	2020
Baillie Gifford High Yield Bond Fund	-0.4	10.4	5.4	2.7	-10.8
IA Sterling High Yield	-1.9	10.6	3.1	2.7	-10.1

Source: FE. B Inc. Sterling. Net of Fees.

The manager believes an appropriate comparison for this fund is the Investment Association Sterling High Yield sector average given the investment policy of the fund and the approach taken by the manager when investing.

Past performance is not a guide to future returns.

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The fund's share price can be volatile due to movements in the prices of the underlying holdings and the basis on which the fund is priced.

Bonds issued by companies and governments may be adversely affected by changes in interest rates, expectations of inflation and a decline in the creditworthiness of the bond issuer. The issuers of bonds in which the fund invests, particularly in emerging markets, may not be able to pay the bond income as promised or could fail to repay the capital amount.

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