

The high-quality debt of strategically important companies may offer investors a compelling opportunity while governments are willing to commit support and capital, **say Louis Chabrier and Michael Taylor**

TOO BIG TO FALL?



As market and economic conditions remain challenging for investors in fixed income and equities alike, investment-grade corporate bonds provide the potential to lock in attractive long-term returns – even by equity standards. In the following interview, portfolio manager Louis Chabrier and associate director of fixed income product management Michael Taylor discuss how to take advantage of this high-quality credit opportunity by accessing the most strategic segments of the investment-grade corporate bond market.

Q: Investment-grade corporate bond spreads are at levels not seen since the Great Depression. What do you think about this opportunity?

CHABRIER: The corporate bond market is clearly pricing in a lot of bad news. There are a wide variety of high-quality credits that are attractively valued and offer yields in the range of 7%-9%. This translates into a great buying opportunity.

Of course, mindful of the potential downside risk, should economic conditions deteriorate further, it only makes sense to target companies with attractive yields that you think are going to survive the crisis. Today, unlike during the Great Depression, governments are intervening in markets to support companies they consider strategic. They are providing liquidity to these strategic companies if they experience financing pressure. In many cases, the government is making direct injections of capital into these companies at a level of the capital structure that is subordinate to senior bondholders. These capital injections are often dilutive for equity investors, but they can significantly enhance the

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attractiveness of corporate debt valuations, as the prospects of government support provide an implicit backstop to certain strategic credits.

Q: Does the opportunity in cheaply valued, investment-grade credit need to be qualified somewhat by the potential for rising default risk in the current environment?

TAYLOR: Absolutely. As we have seen, even the most highly rated companies have experienced financing pressures, and many have been downgraded by the credit rating agencies. Some have even defaulted. According to data from Moody's Investors Service, the highest annual default rate for investment-grade corporate bonds in history was 1.5%, back in 1938. We could see a similar rise in defaults during the current crisis as credit pressures intensify on corporate issuers. For instance, we expect to see a record default rate for companies rated below investment grade in 2009, and recovery values could be less than half the historic average. This makes issuer selection even more important than usual.

CHABRIER: In the last default cycle, between 2001 and 2002, there were a lot of investment-grade companies that had significantly leveraged up their balance sheets, particularly in Europe. For example, many telecommunications companies assumed a crushing debt burden in the competition for the next generation of wireless subscribers. Many of them were government-owned to a greater or lesser degree, and what we saw was the government coming through: committing more capital and helping these companies restructure their debt to bring their capital structures more in line with their



ratings. We expect many of these companies will receive similar support now, which gets at the heart of the opportunity.

Q: What makes a company 'strategic' in your view?

CHABRIER: There are a number of reasons that issuers might qualify as strategic in the current environment. It may be that there is direct or indirect government support for a company. Or a company may play a vital role in a country's economy. The government initiatives I mentioned earlier are designed to ensure that strategically-important companies are not driven into bankruptcy, because the failure of these 'national champions' would have devastating implications for confidence at this critical time for the global economy.

Q: Do particular regions or sectors present bigger opportunities than others at the moment?

CHABRIER: In general, the US corporate credit market offers the biggest opportunities at the moment, although not all of these corporate issuers are domiciled in the US. US credit today is very cheap, in both an absolute and a relative sense, and this often holds true for companies whose debt is traded in different markets. Right now we are seeing a significant discrepancy in the valuations of US dollar-denominated credit versus sterling-denominated credit and euro-denominated credit, often for the same exact issuers in the same place in the capital structure. Companies issuing debt are being penalised in the US more so than they are elsewhere.

Q: How do you judge the commitment, effectiveness, and timing of government responses to the ongoing crisis in capital markets?

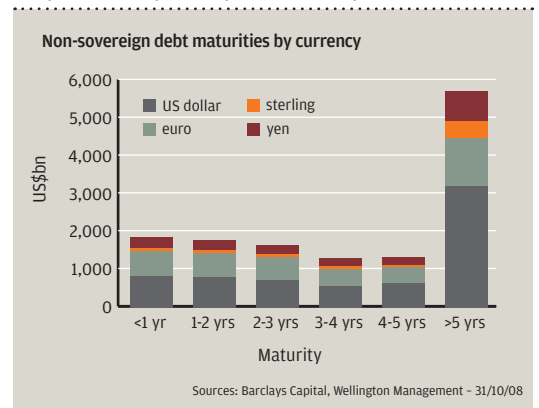
KEY STATISTICS

1.5% the highest annual default rate for investment-grade corporate bonds, in 1938

7%-9% the range offered by a wide variety of high-quality credits

£109bn the average non-government debt maturing each month for the next 36 months

CHART ONE - Refinancing upcoming maturities may sustain upward pressure on yields



CHABRIER: If we look at the sheer number of policy initiatives worldwide, as well as the supranational efforts being made to coordinate these responses, it is a sign that governments are preparing themselves to provide a critical backstop to strategic companies. Indeed, they've already done so. In the UK, the government has stepped in and bought huge equity stakes in UK banks, for example. And in the US, key recipients of federal aid include a number of large banking and insurance companies. A positive take on this is that key countries, particularly the US, are doing their best to learn quickly from what look to many market participants like mistakes - such as the decision not to intervene in the case of Lehman Brothers.

Q: Given the fact that attractive yields are readily found among investment-grade issuers today, and given the high visibility of nationally strategic companies, is your investment thesis relatively easy to implement?

CHABRIER: Although attractive yields are indeed easy to find, it would be a mistake to purchase investment-grade debt indiscriminately. The negative news that's priced into the corporate bond market has yet to be reflected in corporate fundamentals, broadly speaking, and so default risk will likely rise. As Michael mentioned earlier, being selective in the corporate bond issues you buy is exceedingly important right now.

Again, we think the most attractive issues are those of companies that, if the worst happens, will be supported by their respective governments. But making that determination - identifying the right strategic companies that may stand to receive government support - is not as easy as it sounds. If you're looking to buy good companies, and not just companies that will continue to exist thanks to government intervention, we believe that requires superior levels of access to companies and their managements, as well as knowledge of the specific ways in which they offer truly strategic value on a national or regional level.

Q: Corporate spread widening may interest a variety of fixed income investors, particularly pension schemes, who've seen an erosion in the value of their equity assets and, consequently, larger funding deficits this year. Would an approach focused on strategic companies enable such investors to meet their funding challenges?

A word from the sponsor...

TAYLOR: When you realise that many pension schemes are assuming 7%-9% in their internal rate of return (IRR) calculations – a return target they have pursued primarily through big allocations to equities in the past – then current investment-grade spread levels offer a particularly attractive investment opportunity. Equities may snap back, or they may not, but if you can effectively lock in a return of 7%-9% through a portfolio of high-quality corporate bonds, why take the additional risks presented by equities? This is a question many pension schemes are asking.

CHABRIER: Having an allocation to a portfolio of companies that implicitly or explicitly could be guaranteed by governments might make sense for many investors in the current environment. Most investors will probably not be satisfied with a 0% return on their cash or money market holdings, which is a likely outcome in the short to medium term given that the policy of most central banks around the world is to bring interest rates as close to zero as possible. Buying the debt of strategic companies allows us to get a significantly higher yield on our money with much more limited downside than many alternatives, particularly equities. Although we may be taking exposure to many of the same companies, we are doing so at a much higher point in the capital structure of these companies. Moreover, we are somewhat insulated from financing pressures by the willingness of governments to inject capital into these companies, often at a point that is below us in the capital structure.

Q: How long do you expect this window of opportunity among strategic, highly-rated credits to last?

TAYLOR: We believe investment-grade corporate credit spreads will remain volatile as a result of the ongoing deleveraging process, and that the deterioration of credit fundamentals will continue as economic conditions worsen in 2009. It is also important to note that there are significant debt maturities coming due in the US and European credit markets (chart one). We estimate that over the next three years, there will be a total of US\$2.4trn (£1.74trn) in non-government debt coming due in the US market and the equivalent of nearly US\$2trn (£1.45trn) coming due in euros. Combine this with the debt maturing in the UK and Japan, and you have an average of nearly US\$150bn (£109bn) of non-government debt maturing each month for the next 36 months. These refinancing pressures will likely keep yields high and governments engaged, while providing some great buying opportunities for investors with dry powder.

CHABRIER: Exactly. I expect we may be facing a period over the next several years in which investment-grade corporate bond spread levels will remain attractive from a historical perspective, and relative to other alternatives in the fixed income markets. When equity markets stabilise and economies worldwide begin to recover, it may make sense to broaden the opportunity set – for example, by taking advantage of opportunities in the below-investment-grade sectors of the fixed income markets.

Background

Wellington Management serves as an investment adviser to over 1,600 institutions located in more than 40 countries. It is not a broker, lender or underwriter. Its business is focused exclusively on managing investments – from global equities and fixed income to currencies and commodities. Its most distinctive strength is its proprietary, independent research, which is used only to generate differentiated moneymaking ideas for clients. It believes the best way to accomplish this is through multi-dimensional, hands-on research, shared freely throughout the firm. Wellington Management is a private partnership. It exists solely to meet the needs of its clients. An independent structure and collegial culture are two of the main reasons investment professionals join Wellington Management – and stay for their entire careers.

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With \$160bn (£114bn) of fixed income assets under management, Wellington Management is a global market leader. It manages a full range of fixed income investment approaches spanning the global government, investment-grade, high-yield, mortgage-backed, emerging markets, structured finance, inflation-linked, and municipal sectors. These include both broad market portfolios and more

specialised sector portfolios, as well as a full range of specialty and alternative strategies.

Data as of December 31, 2008.

Biographies

Louis Chabrier is the chair of Wellington Management's global credit strategy group, responsible for setting portfolio strategy as it relates to sector and issuer selection for global credit portfolios. He is also a senior member of Wellington Management's global bond strategy group, managing global fixed income portfolios for insurance, central bank, pension, and mutual fund clients of the firm.

Michael Taylor is associate director of fixed income product management at Wellington Management. Working closely with the investment teams, he leads a group that is focused on ensuring the integrity of the investment and risk management processes.

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