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The name's bond

We ask why the bond sector continues to trade on a premium, despite the sell off in gilts.

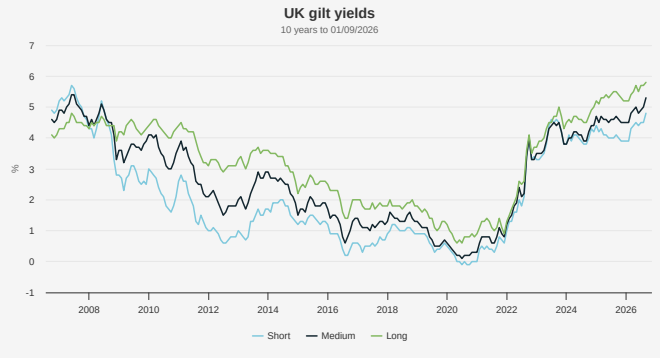
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The government bond market has been the subject of a lot of concern in recent weeks, with rising yields cutting the value of the existing bonds owned by investors, and more importantly raising fears of a fiscal crisis. Yet, the investment trusts in the AIC Debt – Loans & Bonds sector have largely sailed through, and continue to trade on premiums and issue shares. Here we ask why the sector has been so successful, whether the current crisis threatens this success, and highlight the key opportunities and risks the trusts offer.

Casino gouvernemental

UK gilt yields have risen in recent weeks. The chart below shows the beginning of this move, which has been across the short (five year), medium (ten year) and long (thirty year) maturities. Since the start of September, yields spiked to c. 5% at the five-year mark, 5.5% at the ten year mark and 6% at 30 years, before giving most of this back, but volatility remains. Various components go into making up the yield demanded by the market, so what is driving yields this time?

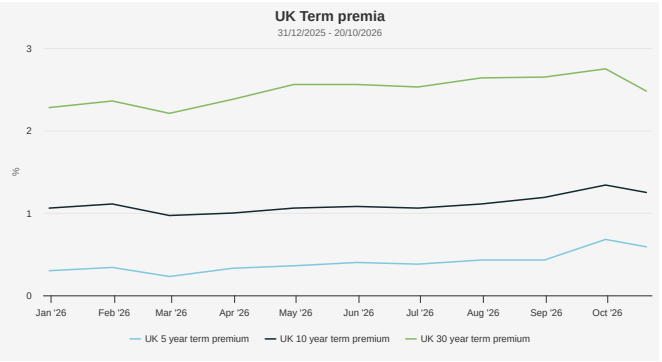
UK GILT YIELDS



Source: Debt Management Office
Past performance is not a reliable indicator of future results.

While there has been a lot of speculation about interest rate hikes, the data doesn't really bear out the idea that yields are rising because investors expect hikes. For example, the BoE's latest survey of market participants finds that as of the first week of September, they were expecting rates to stay at the current 3.75% level until March next year, when they will then start to fall. What really seems to be going on is the term premia are rising across all maturities. The term premium is the extra compensation that investors demand on top of what they think nominal rates are going to be over the life of the bond. You want a long-term bond to compensate you for economic growth and inflation over its lifetime, plus a little extra to soften the risks you are taking of things going wrong and your money being locked up. Term premia are often higher the longer you are lending for, as there is more time for these things to go wrong. Since the summer, they have risen across short, medium and long term maturities, as the chart below shows. Investors more used to looking at equity market charts will have to remember that these are significant moves in the exciting world of bonds.

TERM PREMIA

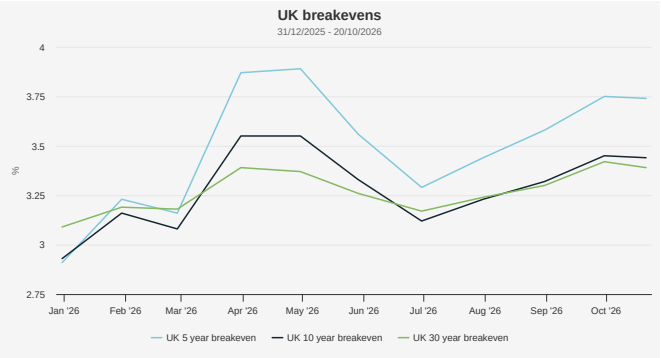


Source: Bloomberg
Past performance is not a reliable indicator of future results.

What seems to be happening is the market views economies as relatively weak and likely to need rate cuts, but they see a hard to quantify risk that a disordered series of rate hikes become necessary in a crisis. A lovely mix if you are running a

central bank or a government. There has been a modest uptick in expected inflation looking out five, ten and thirty years, according to the breakevens derived from nominal and inflation-linked bonds. However, it is clear that expectations of higher inflation isn't the only or over-riding driver behind rising yields, which is important when considering the impact on the appeal of the investment trusts in the debt sector, as inflation erodes the real value of assets and income if it isn't indexed.

BREAKEVENS



Source: Bloomberg

Past performance is not a reliable indicator of future results.

Octopenny

It's worth looking at the key features of the trusts in the sector and how they work before considering how the current crisis might affect the appeal. We think it obviously starts with the average 8 pence in the pound yield, although it can't be quite as simple as that. A number of trusts, particularly in the renewable infrastructure sector are trading on higher yields but on wide discounts: investors in the debt sector clearly need to have confidence in the outlook for the NAV too. The closed-ended structure allows managers to implement some particular strategies which really maximise the yield that can be generated from the debt sector while keeping key risks to manageable levels.

AIC DEBT – LOANS & BONDS SECTOR

	TICKER	LATEST PREMIUM (DISCOUNT)	12 MO YIELD
CQS New City High Yield	NCYF	7.4	9
CVC Income & Growth GBP	CVCG	-1.8	8
Invesco Bond Income Plus	BIPS	1.2	7.5
M&G Credit Income	MGCI	0.1	7.7
TwentyFour Select Monthly Income	SMIF	0.1	8.2

Source: Morningstar

Past performance is not a reliable indicator of future results

A key place to start is duration. Duration is interest rate sensitivity, and measures how much a bond will decline in price if yields rise. All the trusts in the sector have relatively low durations, and certainly lower than an investment in the gilt market or investment grade corporate bond market. Not all the trusts publish their duration monthly. **M&G Credit Income's (MGCI)** latest factsheet gives a duration of 1.1, while CVC Income & Growth (CVCG) gives 0.9, and TwentyFour Select Monthly Income's (SMIF) latest factsheet has 3.5. What these numbers are roughly saying is that if gilt yields rise by 1 per cent across all maturities, all other things being equal, the value of the portfolio should fall by 1.1%, 0.9% or 3.5% respectively, so fairly modest amounts for a major move in rates. At the time of writing, five year gilt yields have risen by

just under 1% since the summer. This low duration is one reason why investors are rightly willing to look through the recent gilt yield spike.

Crucially, duration has only a temporary effect on bond prices. Ultimately, you get back the value that was borrowed at maturity, so as a bond nears maturity, its price nears par value. Any decline in bond prices due to duration will be gained back eventually. This is very different to an infrastructure portfolio. While the latter may be valued using discount rates, with higher yields feeding through into lower asset values, any sale price will depend on the rates available at that time. For a bond, it doesn't matter what the rates are when it matures – you're getting back the same amount you lent.

Closed-ended funds, as they aren't subject to investor outflows, are particularly well placed to take advantage of this. For example, Darren Toner and Ian 'Franco' Francis, the managers of **CQS New City High Yield Fund (NCYF)** take a low turnover approach to managing their portfolio of high yielding debt. The managers invest in the highest yielding parts of the high yield market, looking for opportunities in bonds that are in specialist areas or so small that they don't receive credit ratings and the borrowers have to pay a higher yield to compensate for the poorer liquidity. These sort of bonds might see some volatile price behaviour at times, but the investment strategy doesn't involve a lot of trading, so price movements are typically largely irrelevant to the managers unless they think the outlook for being repaid has materially changed.

Low duration is one reason that investors are liable to look through the recent volatility in the gilts market. Gilts yields are pricing in uncertainty and the chance of an unexpected series of rate hikes, but investment trusts can simply hold on to their bonds to maturity, meaning any impact on the price would be temporary. Moreover, the market thinks the economy's fundamentals point to steady rates followed by a gentle decline, a pretty decent environment for investors in higher yielding bonds. And in reality, if we do get temporarily higher rates, a closed-ended fund manager can let existing positions mature and reinvest at higher yields. Managers with more of a focus on yield rather than total return, like those in our sector, can more easily stick to this lower risk approach rather than trying to maximise any gains from trading around rates moves.

Quantum of SONIA

One of the reasons for the low duration in the peer group is that the trusts all invest significant amounts in floating rate debt. These instruments have a coupon set at a margin over a base rate, such as the SONIA interbank lending rate, which follows the Bank of England's base rate, so the income they pay rises when UK interest rates do. SONIA hasn't risen in the recent gilts rally – it is based off interest rates, not gilt yields – but it would do if the BoE raised rates. As a result, there is some protection built in against this uncertainty about rate hikes which has been seen in higher gilt yields. To the extent that these trusts are invested in floating rate debt, they actually stand to benefit from rate hikes and generate a higher income. In the table below we have gathered the latest data we could find on the trusts' exposure to floating rate debt, as well as the average credit rating of the rated debt in their portfolios. Some trusts only publish this once a year, so some figures are out of date. The table is intended to illustrate the rough exposure that might be expected – the strategies do tend to hold to a certain range for floating and fixed investments.

RISK CHARACTERISTICS

	FLOATING	AVERAGE CREDIT RATING	DURATION
MGCI	78%	BBB	1.1
CVCG	77%	B	0.9
BIPS	49%	BB	3.8
NCYF	41%	B*	Not given
SMIF	34%	BB	3.5

*Source: Company factsheets, annual and semi-annual reports; * Based on the < 50% of portfolio to have a credit rating*

MGCI's high exposure to floating rate debt is a key factor behind its low duration, and doesn't tend to vary much from the current level of 78%. Our table above also shows the average credit ratings of the trusts, and MGCI's is the highest, at BBB, which is considered the low end of corporate debt (as opposed to high yield, which starts with BB-rated debt). The trust manages to achieve this combination of low duration and low credit risk by investing in lots of different sectors of the private debt market, which allows it to generate high yields for higher credit quality, as we discuss below.

Pay another day

Credit risk is a critical factor for trusts in this sector. Typically, taking more credit risk is how the conventional bond fund boosts its yield. Sometimes going out into long-dated debt can boost income, but a more reliable approach and a more relevant one in today's market is to invest in high-yield-rated debt, i.e., debt where the issuer is considered more at risk of default. All of the trusts in the sector have relatively unconventional approaches to taking credit risk which allows them to increase the yield they can generate for taking a given level of credit risk.

Perhaps the most conventional in approach is **Invesco Bond Income Plus (BIPS)**. It tends not to be amongst the highest yielders in the sector, but its simplicity is doubtless part of its appeal to many investors, as all of the strategies for generating a higher yield do bring along their own risks to be weighed up. BIPS is manged by Rhys Davies, who aims to deliver a significant yield pick up over gilts and cash without taking imprudent risks. Rhys focuses on conventional high yield and takes a cautious approach to sector and stock selection, being willing to hold investment grade debt at size and see the income generated slip if he thinks the market is expensive. However, Rhys and his team have a great deal of expertise and experience in the subordinated financial debt market. Banks have complicated balance sheets to manage and since 2008 regulations have become ever more strict on capitalisation. They issue many small tranches of debt with complicated structures and covenants to consider. The complexity and small size of the issues means it tends to attract more specialised investors, who receive higher yields as a result. A lot of this debt is floating rate, and explains that exposure in BIPS' portfolio, but aside from this the trust is a conventional high yield strategy, albeit one which can take advantage of the closed ended structure to worry less about the liquidity of individual holdings, to trade less, to remain more fully invested and to take on gearing.

NCYF really leans into these advantages and generates a higher yield with significantly higher credit risk. Darren and Franco explicitly target the less liquid issues, in the financials or elsewhere. Many of the smaller issues aren't covered by rating agencies, which explains the high weighting to non-rated debt. Darren and Franco lean on the credit analysis of their own team to get comfortable with credit risk, and this plus the liquidity explains why they are able to earn a higher yield. They are also much more willing to look at the highest yielding credits in the space and take on the associated risks, if they are comfortable they are being compensated, as well as dabbling in high-yielding equities if they see the space for some dividend growth. A consistent use of a moderate level of gearing is another important feature which boosts the yield on offer.

Credit spreads have been very narrow by historic standards for a few years now. This means that these sort of strategies that allow managers to extract higher yields have naturally been more attractive. In particular, we think it is the ability to look into areas where there aren't ratings, or yields are driven by liquidity and complexity rather than credit risk, which has made these trusts so attractive. Credit spreads shouldn't necessarily be affected by changing rate expectations. However, the uncertainty which is being felt in gilt risk premiums is something to watch. In fact, US high yield credit spreads have widened in the government bond sell off of recent weeks, which implies the market fears whatever disordered outcome is on the horizon could feed through into businesses' performance. Unexpected rate hikes, disruption from the war in the Middle East and/or forced government spending cuts in the light of high borrowing costs could all contribute to an economic slowdown or recession which could see credit markets sell off.

However, it is important to remember that for a portfolio which doesn't have to manage outflows, higher credit spreads would represent an opportunity to lock in a higher income. It is only if a bond has been bought at a premium to par that a loss would be booked with rising rates, unless there is a default. Assessing default risk is a key task for managers in this sector. While investing in less conventional segments of

the market means less of the yield is compensating for default risk, it is still a higher risk for these trusts than for corporate bond funds. As a result, if the current gilt market volatility presaged a crisis or a serious recession, this could lead to significant problems for this sector.

For your fund only

Where the closed-ended structure really comes into its own is allowing debt portfolio managers to invest in assets outside the conventional bond market. These are inherently less liquid and more specialised investments, for which investment trusts are perfectly suited. Historically they have been the preserve of institutional investors, but the trust structure allows them to be opened up to the general investor.

MGCI is the starkest example. The portfolio is split across public and private debt, and invests in any and all segments of both markets. In the private debt space, this includes bilateral or club loans which are directly arranged with borrowers. These may be too small deals for the banks to deal with, or they may be from borrowers who are willing to pay a higher yields for specific features which they can arrange directly with lenders. Private investments also include asset backed securities (ABS), collateralised loan obligations (CLO) and leveraged loans which don't trade on a market amongst other assets. Private debt brings along a higher yield for a given credit quality because of the liquidity risks and because the lenders are taking all the burden of origination and research, which is something only teams of a certain level of expertise can do. As such, MGCI has been able to deliver a yield in line with the more high yield focused trusts with a much better credit rating. Of course, there are risks. Low liquidity and no external research means the portfolio bears the risk of investments running into trouble and defaulting. However, M&G's huge research team, including restructuring specialists, give it good resources to manage these risks.

Private debt has had a bad press in recent years, but it is really too big a catch-all term to have much meaning. There have been serious issues with risky lending in some American funds, largely those focused on software, but to us it makes no more sense to discard private debt because of poor lending practices in certain funds than it does to reject unlisted equity because some companies fail. There are strong structural reasons behind the growing use of private capital which means a lot of assets are going to be formed in this space in the coming years, and investment trusts offer one of limited ways for the mass market investor to participate. MGCI looks at asset-backed debt and for borrowers with defensive characteristics and good covenants; it's a completely different style of investment with no read-across, in our view.

In this connection, we would also highlight the defensive sector focus of **Sequoia Economic Infrastructure Income (SEQI)**. While this trust sits in the infrastructure sector, it invests in private loans backed by infrastructure assets. It is a much more concentrated portfolio than MGCI, so there is more specific issuer risk, but we think the discount of 13.3% is highly attractive given the premiums in the debt sector, while the trust yields 8.6% at the time of writing. We think the market may not have appreciated it is a debt portfolio which shares more features with the trusts we are discussing here than the equity infrastructure trusts with which it shares a sector.

CVCG focuses on the loans market. While these are public assets, it isn't an area in which the typical open-ended bond fund invests. The trust looks at the higher-yielding segments, and targets loans trading at a steep discount which the managers think can recover. Meanwhile, SMIF invests in conventional bonds, but also invests significant amounts in ABS. ABS are securities created by banks or insurers from loans they have made, packaged up in a portfolio and then sold to the market in tranches of varying seniority. There is a public market for them, although liquidity is much lower than the bond market, but some are traded off market. SMIF also invests heavily in subordinated financial debt.

Conclusion: No time to sell

We think the key to the appeal of the trusts in this sector is their strong focus on income rather than total return which matches investor preferences, Additionally, we think their incredible flexibility and ability to squeeze additional yield from the market without taking excessive credit risks really underlines their superiority to open-ended bond funds. There are therefore good reasons for the trusts to be trading on premiums, although as with all closed-ended funds, investors have to be aware of the possibility for discounts to widen when market conditions change.

We don't think the ructions in the government bond markets represent a threat to the sector's success. The impact via duration would be limited, but the market seems to think rate hikes aren't actually likely. With such high duration in the

bond market, we also wouldn't expect a lot of investors to switch from the trusts to gilts even if the ten-year stabilised at or above 6%. The major risk is that if the sell-off presages a serious economic crisis, then poor performance from credit would be expected. Those of the trusts with higher credit risk, and higher exposure to cyclical sectors like financials, would see a greater negative impact. However, as the trusts are generally income-focused and buy-and-hold in their approach, the opportunity to invest at higher yields might outweigh in investors' minds the immediate negative impact on portfolio valuations except in the worst-case scenarios.

Finally, we think the features we highlight demonstrate the appeal of bonds rather than alternatives for income investors. When rates were very low in absolute terms, alternatives provided welcome diversification. However, we think the low duration, ability to reinvest into higher-yielding assets quickly without permanent loss of capital, and more diversified portfolios support the use of debt for income over alternative assets when yields are high.

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