



Every financial crisis produces opportunities, and this one is no different. We are in the middle of what the media have termed a “credit crunch” in the banking sector; brought on by too much lending to the wrong people. Mortgage companies and investment banks are caught in the eye of the storm, so it is no surprise to see their own bonds trading at the cheapest level for some twenty years.

So how did it get to this? The answer is that Western economies have experienced exceptionally high levels of private sector borrowing over the last four years, partly fuelled by America’s low interest rates. Greenspan must shoulder some of the blame, having kept the Fed Funds rate below 3% for four years from 2001 to 2005. But the real blame may lie with the commercial banks, which seem to have forgotten the principle of prudence. The most reckless lending was made to U.S. homeowners, private equity firms and investment funds.

Wind back the clock just twelve months and banks were falling over themselves to lend money in the sub prime mortgage market. The clue was in the title, and by the summer of 2007 everything had changed. The default rate on sub prime home loans had risen to 15% across America, exceeding 20% in Mississippi and Michigan. Stories emerged of aggressive intermediaries selling housing dreams to people who could not really afford the monthly payments.

Meanwhile investment banks and some hedge funds were busy creating another lending bubble, this one to private equity firms. It is an extraordinary fact that more than US\$ 500 billion of leveraged loans were made in 2006, mostly to fund the acquisition of companies by KKR, Blackstone, Carlyle Group and the like. But in July 2007 investors went on strike and refused to buy a combined £14bn of loans for Chrysler and Boots. Consequently the ability and appetite of the institutions involved to make further loans to fund Private Equity transactions was limited.

The sheer volume of new buy-outs had become a problem for leverage financiers, forcing them to write down the value of their loans. Like any paper currency, if you print enough of it, the value falls! There has also been a knock on effect to more mainstream corporate loans; they have become worth less, prompting write downs and forced sales by the most exposed investors. A number have gone bust, including the snappily titled Bear Stearns High Grade Structured Credit Strategies Enhanced Leverage Master Fund Ltd. You couldn’t make it up.

That brings us up to the present day, when banks are now scared to lend, even to each other; and the debt markets have virtually ground to a halt. The risk premium on corporate debt has returned to levels last seen after Enron defaulted. The distrust between financial institutions has also pushed inter bank lending rates to more than 1% above Base Rates, something that has not occurred for twenty years.

We believe that the after effects could be with us for some time. While the U.S. Federal Reserve has quickly dropped interest rates by 0.5%, the Bank of England is playing a waiting game. Mervyn King quite rightly suggests that a Central Bank bail out would encourage further herd behavior and penalize those prudent institutions that ‘sat out the dance’. The long term impact of this financial crisis may include slower economic growth and rising corporate delinquency. We hope that a more realistic lending environment is one positive outcome. Perhaps the word ‘prudence’ may even form part of the banker’s vocabulary once more.

Our conclusion is that the financial bonds of strong institutions, like Lloyds TSB, HSBC and Royal Bank of Scotland, now appear attractive. We do not think that they are going bust, which means that a 6.5% annual yield is decent relative to Gilts at 5%. We can not rule out trouble at a weaker institution, but much of the banking system is in better shape than the current rumors and market behavior suggests. Once bank results clarify any losses, light should appear at the end of the tunnel.

Q&A with Peter Harvey, Fund Manager, Cazenove Strategic Bond Fund.

How would you describe the Cazenove Strategic Bond Fund?

We lend money to companies that make things and provide services. It is a corporate bond fund with an absolute return approach.

Isn't that the aim of all corporate bond funds?

Not really, some other corporate bond funds buy quasi-government debt and speculate on the direction of long term interest rates. The sector is really quite mixed with some exposed to government bond yield curves and others exposed to corporate earnings. We definitely fall into the second camp. We aim to offer a yield significantly above base rates and look to beat cash returns through investment in investment grade and high yield paper.

Which looks more attractive at the moment - high yield or investment grade?

We think high yield is a great asset class over the medium term but right now neither the price nor the quality is particularly compelling. There are some interesting opportunities in secured debt and shorter maturities, but high yield as a whole hasn't corrected in price as much as investment grade. Within the financial sector we think that AA-rated bank bonds, with a yield of 6.5%, offer an attractive opportunity.

So how are you playing high yield in the fund?

We will always have significant exposure to the sub-investment grade market, so within this we are staying in the defensive end. For us, that means BB-rated bonds and short term maturities. A short time frame gives you better visibility of earnings and revenue for that company. It also gives you what is called temporal seniority. This means that while the bonds may be junior in terms of capital structure, you'll be getting out before the senior guys.

Your fund can use quite high amounts of derivatives. Do you use these instruments to 'enhance' returns?

Yes, we do use bond derivatives, for both hedging and investment purposes.

But there is no substitute for solid credit analysis. All the derivatives in the world will not help you make good lending decisions. We spend 9 out of 10 hours looking at companies, examining their balance sheets and meeting management.

So how does your credit analysis differ from others?

What matters more for us is that we lend to companies that can afford to pay us back in the future. As such we have an emphasis on financial projections. Where possible we estimate the profits of a company over the coming year or two. We then stress test our assumptions, to see whether a particular borrower can weather an economic downturn.

What else do you look for in the bonds you hold?

The commercial sector clearly matters. We have quite a high weighting to companies involved in metals, mining and energy. These companies are certainly exposed to commodity prices and volumes, but they do not have so much financial gearing. In the high yield market, we see reasonable risk adjusted returns in the basic industries like paper, pulp, metals and chemicals.

Is that helping in the current market environment?

Yes, that emphasis has already helped us and I think it has still further to play.

What other areas are you focused on within the fund?

We also like the telecommunications sector, due to the predictable revenue stream and steady earnings. By way of example, the fund lends to Cable & Wireless plc and TIM Hellas. We prefer to be at the top of the capital structure, to have a first lien on the firm's assets. Some of our bonds are backed by the factories or offices of the companies we invest in and we get the keys to that factory if anything goes seriously wrong.

Isn't that an expensive place to be?

Yes, you don't get quite the yield but there is no substitute for quality. It may be pricey but it is worth it.

What about allocation geographically?

We invest predominantly in pan European companies, but not exclusively. We are happy to invest in U.S. and emerging markets where credits meet our requirements. Stock selection is the priority.

What is the duration on the fund?

We hedge out the majority interest rate duration, which means that we have less exposure to inflation and long term interest rates. It's just not our game. We are focused on corporate debt and the ability of issuers to repay us.

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