Conference call highlights

High yield bonds

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A constructive fundamental backdrop
We are forecasting modest levels of economic growth in the developed world in 2011, with more robust activity in emerging markets. Meanwhile, although central banks in Europe and the UK are likely to begin normalising monetary policy in the coming months, we do not expect this to mark the beginning of a concerted programme of rate hikes. This economic background should allow companies to generate healthy earnings growth and ensure that default rates remain low.

Prudent management
Economic growth, whilst adequate, is not sufficiently strong to encourage speculative activity by companies – instead, management teams remain focused on balance sheet structure and continue to reduce leverage. Having been around 4.5x at the highs for this cycle, market leverage is now below 4x and is set to fall further. At this degree of leverage, most high yield companies are cash-flow positive even without any earnings growth.

Technicals balanced
New issuance has been a feature of the market in recent months, with €15bn of deals placed already over the year to date. We expect this run rate to continue, resulting in full-year issuance of around €40bn across a broad range of sectors and credit ratings. This supply is being met with ongoing high levels of demand as investors continue to seek alternative sources of income in a low interest rate world. Demand can suffer short-term setbacks and supply will not come at a constant rate, which means that bouts of volatility are to be expected. Nevertheless, we anticipate a balanced demand/supply picture in the coming months.

Valuations reasonable
Spreads at current levels represent fair value in the context of our default rate expectations. As such, the scope for further significant spread compression and attendant capital gain is limited. However, by the same token, the market is not over-expensive and spreads provide some insulation from rising government bond yields. The benchmark index is yielding around 7% and our portfolios' gross yields are slightly higher than this. We continue to expect total returns to be roughly in line with the yield over the coming year.

Focusing on higher-yielding names
Given our positive views on the market, we are managing our portfolios with a bias towards higher-yielding issues and are also underweight in BB rated bonds, the highest credit rating in the index. We continue to find the best risk-adjusted return potential in the single-B area of the market. We are tending to avoid interest rate sensitive names, enhancing one of the key positive factors supporting high yield as an asset class at present, namely its low duration characteristics.

Muted sector strategy
Our sector positioning is relatively muted, with no significant bias towards either cyclical or defensive areas. Among our more cyclical holdings is Ineos, a chemicals company with significant economic sensitivity but also a well-defined deleveraging programme and good refinancing potential. We balance holdings of this kind with more defensive issuers such as Heidelberg Cement, a BB rated company that is likely to be upgraded to investment grade in the future, with positive implications for capital performance.

Event-heavy environment
Continued high levels of new issuance, refinancing and M&A activity are likely to create an event-heavy environment in high yield over the coming months. Our proven stock-picking skills, based on credit-intensive, fundamental analysis of companies, should serve us well in this environment. We are using these skills to participate selectively in the new issues calendar and to understand the refinancing potential of the businesses we meet. Meanwhile, high yield issuers will see their fair share of takeover approaches in the coming months. These are typically positive events for bond holders as they often result in bonds being tendered or called.

Recent activity
In the new issue market we have recently participated in deals from Labco and KBW. The former is a French company operating in the consolidating industry of laboratory testing, while the latter is a high quality, well-managed German cable company. We have also invested successfully in bonds issued by UK healthcare company Priory Group. Conversely, we chose not to invest in new issues from Fiat and UPC, both of which offered unattractive valuations. Elsewhere, we have continued to take profits in Virgin Media, the UK-based cable company that was recently upgraded to investment grade.

Strong performance
Our high yield bond funds have delivered excellent absolute and relative performance over the long term. The Threadneedle High Yield Bond Fund has outperformed its benchmark index by 2.35% annualised over the past ten years, while the Threadneedle European High Yield Bond Fund has outperformed by 2.55% annualised over the same period. Moreover, the team continues to generate strong investment ideas across the market, making us confident that this impressive performance record will be sustained.

Summary
High yield bonds are benefiting from a positive fundamental backdrop, with modest growth allowing companies to generate healthy cash flows and engage in further deleveraging. Technicals are well balanced, with heavy new issuance likely to be met with ongoing strong demand. Spreads are in fair value territory given our default rate forecasts. In our portfolios we are underweight in BB rated bonds and overweight in single-B, where we see the best risk-adjusted return potential. We expect the recent event-heavy environment to persist over the coming months and this should play to our strengths given the team's proven credit analysis and stock selection skills. We are confident in our ability to deliver further value to high yield investors.