Investment Bulletin
SAUNDERSON HOUSE
5 May 2010
CONFLICT-FREE FINANCIAL ADVICE

INVESTMENT GRADE CORPORATE BONDS 20, GOVERNMENT BONDS 0

Asset allocation switches, as recommended in January and June 2009, reduced conventional UK government bond weightings within the Saunderson House model portfolio (see note 1) to nil while allocations to investment grade corporate bonds were increased from nil to 20%. As investment grade corporate bonds have provided returns of almost 32% since 31 March 2009 and government bonds have returned less than 2% (see note 2) these reallocations have made a very useful contribution to returns within the relatively safe side of client portfolios. However, such strong returns are far from commonplace; typically, corporate bonds offer nothing more exciting than a small yield premium over government bonds in compensation for higher credit risk.

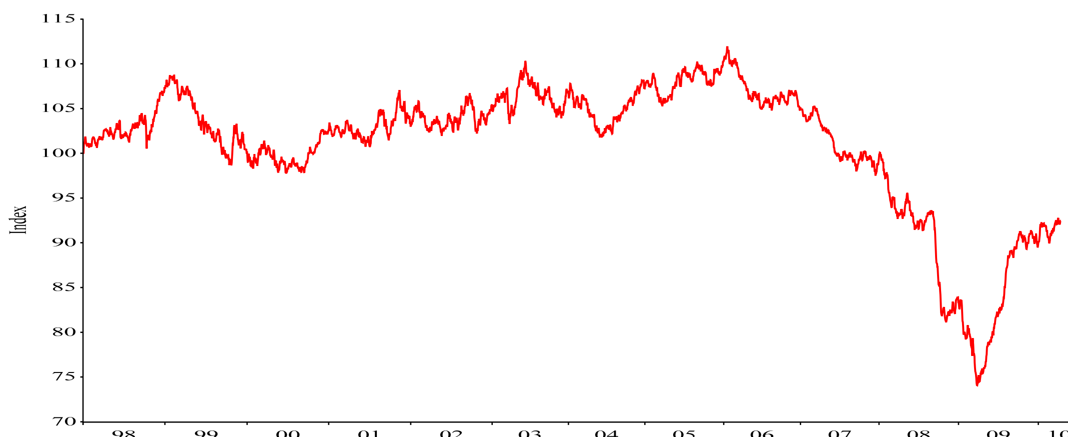
Understandably, such strong returns have prompted investors to question whether corporate bonds are now ripe for profit-taking. Another consideration that may prompt investors to take profits, comes from government bonds (gilts), which, if they fall, may undermine the attractiveness of corporate bonds. Three potential sources of gilt price weakness are:

- the increasing supply of gilts as government issuance rises to meet its yawning budget deficit;
- the declining creditworthiness of the UK, given the enlarged debt burden and the ability of a new government to take difficult decisions, especially if the General Election results in a hung parliament;
- the increasing threat of inflation, which would undermine the real return from all classes of conventional bonds including gilts.

Should investors therefore sell out of corporate bonds? We don't think so. Our rationale is set out below.

As chart 1 shows, the collapse in investment grade corporate bond prices between 2006 and 2009 was far greater than the recovery to date. Non-government bonds were at the eye of the financial storm and, at their lows in early 2009, corporate bonds were cheaper than at any time since the Great Depression. As government action prevented a repeat of the 1930s, corporate bond prices rallied. However, as is evident from chart 1, corporate bond prices remain well below the levels achieved both immediately prior to the financial crisis and for a considerable period before that.

Chart 1. Corporate bond prices – partial recovery from the early 2009 lows



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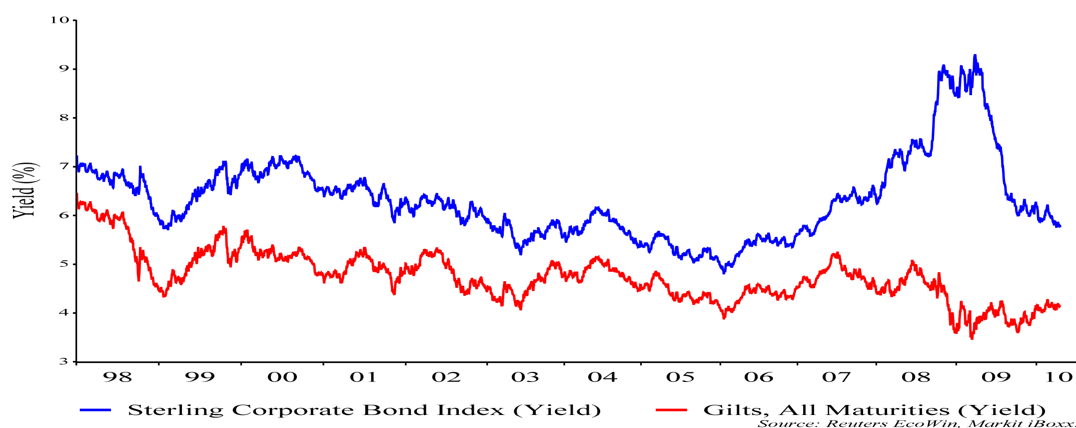
To address the concerns regarding increased government bond issuance, creditworthiness and potential inflation, we have, below, updated the yield chart that first appeared in our January 2009 Financial Markets and Portfolio Update (see note 3). Chart 2 shows the yield on the corporate bond index and that on 10-year UK gilts. We draw attention to the gap, or spread, between the two. This is the premium paid by investment grade corporate bond issuers to persuade investors to take corporate, rather than sovereign, credit risk. While the strong recovery in corporate bond prices (discussed above) has caused this spread to narrow, corporate bonds still offer a generous yield premium over gilts. The extent of this premium means that there is, in our view, scope for gilt yields to rise considerably without taking corporate bond yields with them. In summary, if gilt yields are driven higher by any of the concerns discussed above, in our view, there remains scope for corporate bonds to continue to perform well.

Chart 2. Corporate and Government Bond Yields since 1998



While we expect corporate bonds to continue to provide attractive returns, as chart 2 indicates, the scope for the spread between corporate and government bond yields to narrow is finite. Should any rise in gilt yields be large, corporate bond yields would be pushed higher causing capital values to fall. While we do not expect gilt yields to increase sharply, such a development cannot be ruled out entirely, especially given the current crisis in Greece which could spread to other indebted countries. To defend against such a rise in gilt yields, we have and are gradually increasing recommended weightings to bond funds with more strategic mandates within clients' fixed interest allocations. Managers of such funds have the flexibility to reduce or entirely hedge-out the risk that gilt yields increase, while still capturing the attractive yield premium available on corporate bonds.

(1) This is the Saunderson House 'Balanced' Model Portfolio in the 50-64 age range. Other models will have comparable weightings varying with client attitude to risk and age.
(2) Figures are for total return to 30 April 2010. Source: Markit iBoxx.
(3) If you would like a copy of our January 2009 note, 'Fixed Interest: Switch from Conventional Gilts to Highly-Rated Corporate Bonds' do please contact us.

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