TRANSCRIPT: EPISODE 22
19 September 2019 (pre-recorded 16 July 2019)

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[INTRODUCTION]
Darius McDermott (DM): Hello and welcome to the Investing on the go podcast brought to you by FundCalibre. I'm Darius McDermott and today we're joined today by Jonathan Platt whose Head of Fixed Income but importantly the manager of the Elite Rated Royal London Corporate Bond fund. Hi Jonathan.

Jonathan Platt (JP): Hi Darius.

[INTERVIEW]
[0:17]

DM: Lets get straight into the asset class, with so much of the world's global government bonds on negative [interest] rates, what should attract our listeners to fixed income today?

JP: It's a good question. My first comment would be I'm surprised at the level of global government bond yields, particularly in core Europe. I think generally, core government bond yields reflect a degree of pessimism that we don't share. But your question was where are the opportunities - so I don't think they're in government bonds.

I think they are in credit [corporate bonds] and you have to be choosy within credit because the components that make up a credit return are two component parts: the credit spread and the government bond yield. And if I think government bond yields are unattractive, that part that is the credit spread has to be really good to offset that.

[1:15]

DM: And is that the case at the moment? You're still able to find opportunities where the credit spread minus that government spread which you've mentioned, there's still enough out there for you?

JP: I think in a lot of main stream investment grade credit there isn't enough compensation - given where government bond yields are - so you have to look more widely. I think that's where my experience as manager of the corporate bond fund, as you talked about, you have to look more widely. That might be in sub-investment grade bonds, that may be in bonds that don't have a credit rating, it may be bonds that aren't in a credit index. It may be bonds that are out of favour in a credit index but you need to get that compensation.

I think one thing that's talked about at the moment is 'are BBB bonds [bonds that are only just beeped to be investment grade - one rating higher than high yield] for example really risky?' - not if you get paid sufficient compensation. It's about getting paid for taking that risk and you have to go into the overlooked areas of the market to get that.

DM: Now I first met you at least 15 years ago.

JP: Ha, longer.

[2:20]

DM: It probably is…and one of the things I learnt the first time we met was about something called an 'unrated bond'. You opened my eyes to this part of the market for which you're now quite well-known. Would you give a summary of what an unrated bond is to our listeners and how they've been so successful in the performance of your funds over the long term?

JP: Perhaps I'll answer that in a slightly different way and look at what a credit rating is and how a company - more particularly a bond - is actually credit rated. A credit rating tells you about the probability of a coupon - the interest payment, or the money - the principle - you get back being paid on time. Which sounds like a good assessment of risk.

If I'm a company, lets say I'm Marks & Spencers, and I want to issue a medium term debt, a 10 year bond, I'll go to S&P or Moodies or Fitch.

DM: They're the three big ratings agencies.

JP: Yes, the three big ratings agencies and basically pay them, the company will pay them, to get an assessment of their credit worthiness on that basis: the probability of the cash flow being paid on time. So that's it in a nutshell.

Now an unrated bond is basically very simply a bond that hasn't gone through that process. Doesn't mean it's speculative, doesn't mean it's sub-investment grade or junk, it just hasn't gone through that process. It doesn't make it an intrinsically bad bond. Now the City may be saying "well if they haven't gone through that process what are they trying to hide?"

We have to deal with that. But there are a lot of bonds out there that instead of offering a credit rating to you as an investor, would offer you something else. What that something else is, is security. Most of the time companies that issue bonds, issue them as unsecured bonds, so you're just one of many unsecured creditors if the company fails.

[4:21]

DM: So they're actually giving you some form of protection, or some form of asset, to back the fact that you're lending them money?

JP: Yep, correct - on a bond that doesn't have a credit rating. That's the trade off. So this is interesting in how the market is changing.

You talked about how long we've known each other - I've been doing this for 30 years and when I started my boss was saying what we need to do is lend on a secure basis, not on a basis of a credit rating that can change over a period of time. Now that's been completely changed over the last 30 years when now the focus is on credit rating as your prime determinate of risk. Not the convenance of the underlying security of the bond that goes with it - it's a massive change. What it's allowed us to do is focus on parts of the market where those bonds are unrated, but offer security, get overlooked.

You're in this situation where a bond that is more secure actually pays you a high yield.

DM: And has some protection?

JP: Yeah and so it's great and you asked the question Darius about what contribution has it made to funds, well if you look at the fund that I run it's about 8% of the portfolio is in unrated bonds - so 92% is in rated, so we have to acknowledge that - but they punched harder, they contributed more, so they probably could have contributed 15-25% of the alpha - the outperformance - the excess return that we produce.

[5:51]

DM: Now we can't be with a fixed income manager, certainly one of your learned experience, without talking about [interest] rates. Rather than picking on the next rate hike or the next rate cut, can you see normalised interest rates in the UK? And by normalised I'm talking what north of 3[%], is that something that's in the tunnel, or not?

JP: No, I don't think so. If it's confession time, I didn't see government bond yields going as low as they have become. I think if you take a step back and say "look, the UK has a tremendous level of employment now, we've got 30 million people employed, wage growth is at 3.5%, the economy is flat-lining, but we could be looking at growth at 1-1.25% on a 12 month period." It seems strange to me that we're talking about a period of interest rate cuts…

DM: Yeah, it's not quite the usual match: that level of employment with these ultra low rates.

JP: No it's not. So why are we here? I think it's basically because, well I've made two observations. Central banks are worried what impact another recession, or the next recession should I say, will have on the financial system. Has the financial system fully healed? Is the level of indebtedness that we see still so high that actually a relative slow down and recession will create an economic turmoil? So they are worried about that.

I also think that central bankers probably have been taken hostage by markets. I think they're paying too much attention to equity markets. You can see that and perhaps also politicalisation of central markets where President Trump is making much more comments on monetary policy, the attitude of the Federal Reserve to interest rate changes, he's putting a lot of pressure on there and that ultimately, I think, is a bad thing for us as investors because the independence of central banks has been one of the key drivers of the stability that we've seen over 30 or 40 years.

DM: Yeah I think the relationship between the central banks and politicians may be one for another version of Investing on the go's podcast…

JP: Sorry about that.

[8:10]

DM: No that's okay. Maybe this leads me nicely to the next question which is, we are going to have change at our central bank at the turn of the year, with Mark Cairney leaving his role? Would you like to be his replacement and if so what might you do a little differently?

JP: Oh wow, I wouldn't venture into that area that's for certain, I'll stick to asset management thank you very much.

However, there is some interesting points here, I do think that central bankers have fallen into a similar mindset. I think you need to take a step back and say what is it you're trying to achieve here because low interest rates, the potential for more quantitative easing, it's not really addressing the underlying problem: we've got a lot of debt.

At some point, economies will go into a recession and I think we've just got to acknowledge that and I think central bankers, in talking about the Bank of England, have been too slow they should have put up rates earlier to give themselves more ammunition if they need to cut. Because the only thing there they're going to be able to resort to, they can take rates down to 0 but going from 75 to 0 - 75 basis points [0.75%] to 0 - is going to make a big difference, you're going to have to have more QE [Quantitative Easing] - they already own 40% of the gilt market. It creates those financial bubbles and you get onto all sorts of other issues about inequality and how QE has basically saved the wealthy and not really done much for the real economic growth in the UK.

I wouldn't venture in that area but I would think that my advice, if that's not too strong a word, to the next governor would be well think about bit differently and also think, can you take better advantage and this is more of a government policy than the Bank of England? Can you take better advantage of these phenomenal low interest rates. No government in history in the UK has had the ability to issue long term debt at these levels of interest rates. If a government can not earn a better return over a 100 year period than 1.5% they're not doing their job. You should be thinking differently now.

DM: Well, listen, I think that's a really interesting discussion on the current positioning with rates and credit and hopefully highlighting a few of the things I know you've done with your team on Royal London for a long period of time, which remains only for me to say to Jonathan Platt thank you very much for your time and your views, I'm Darius McDermott and if you'd like more information on the Investing on the go podcast, please subscribe to FundCalibre.