

TRANSCRIPT: EPISODE 120

25 February 2020 (pre-recorded 17 February 2020)

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[INTRODUCTION]

**Darius McDermott (DM):** Hi I'm Darius McDermott from FundCalibre and this is the Investing on the go podcast. I'm delighted to be joined by Richard Woolnough, who is the Elite Rated fund manager on three fixed income products at M&G: the M&G Optimal Income, Strategic [Corporate] Bond and Corporate Bond funds. Richard, thank you very much for taking the time to come and talk to us this morning.

**Richard Woolnough (RW):** Thank you.

[INTERVIEW]

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**DM:** So I'd like to really focus on Optimal Income, which is now 15 years old since its launch in 2006. This is your most flexible fund. Maybe just give us a quick run-down of how you've enjoyed that flexibility and how it's actually helped give returns for investors over the years.

**RW:** Well it's very much a fund that's looking for the optimal income stream, hence its name. We think that every asset, whether it be a bond, an equity, a property... the income stream it generates is what you're buying. And that income stream is split into two compartments.

One is how long you've lent for, have you lend for a day or a year or 30 years, obviously the longer you lend for, the more volatile, the more you can make or lose in that investment. And secondly, how risky is it? Is it safe, like a government or is it more risky like a lower-end investment grade company like British Telecom, or is it very risky? Let's say something like a high yield, like Jaguar Land Rover, something like that. So they're the three areas that we look at really in terms of having that flexibility to look at, find the best income stream from a duration and a credit perspective.

And what this fund allows us to do, it allows us to take those views. Normal bond funds are very constrained. So the bond funds I run are not constrained, are less constrained than many of our competitors, but they're there for a purpose. They're a building block for a portfolio. This is a 'go anywhere' bond fund. And we're looking for the best income stream we can find and when we find

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an attractive income stream we'll own a great deal of it in the portfolio. When we find something that's less attractive, then we'll avoid it in terms of taking that particular risk.

The great thing about this fund is obviously it started in 2006 and the thing that's helped the fund is there's no point having lots of flexibility if nothing's happening. And I tell you, as we all know, a lot's happened from 2006 through to now, we've had a number of, you know, economic cycles, a number of credit cycles. And so it's not just the nature of the fund that matters, but it's the nature of the environment that fund exists in. And that environment is still very much alive today. Markets are very interesting, very exciting, and therefore having that flexibility, I think is a very, very good thing to have in your portfolios.

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**DM:** Well, I'd like to ask you a couple of questions about the environment, but I'd like firstly, to go back say around 12 months, because there was an exceptional year in the bond market in 2020, and then follow it up with where you are seeing opportunities in the bond market today. So 2020, lots of fun for you or lots of stress or a mixture of both? Give us a little recap of what you saw and the type of opportunities that you took in Optimal Income.

**RW:** I think 2020 was the most difficult year that investors faced, whether it be me or your clients or you, it's been a very, very volatile, very dramatic year, especially this time last year in February, March. I've seen some comments that the actual implied - the actual observed volatility in markets around the COVID situation was worse than in '87 or '29 or 2000. So you've have some huge volatility, not only in equity markets but in bond markets where it's been quite dramatic. And so that period was particularly you know dynamic, and all the associated difficulties come with that particular area. So it was a dramatic and a harder year to work than other years. The strange thing is, you know, we look back on the year, we sit here today and stock market, a lot of stock markets are back where they were, government bond yields are generally about where they were before the crisis, corporate bond spreads are about where they were. So, when you look at where we are now, it's very different from the huge moves we had last year.

What we did last year was try to take advantage of those dislocations. So there was lots of companies desperate to borrow money because they thought there was recession coming. So there was lots of new issues. Lots of people borrowing, raising capital, or to borrow and raise capital at the same time in a difficult situation. It meant there were lots of companies came to market we could take advantage of and lend them money to tide them over. A prime example of that would be something like Boeing. Boeing, obviously we can all understand had some difficulties in potential customer orders and order flow through the summer. And they did a record bond issue. Normally they don't need to borrow very much, a very high quality blue chip credit, but obviously in order to get through, to bridge themselves through the pandemic, they had to borrow money. And that provided opportunities for us to buy that particular type of stock. And when assets dislocate, we try

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to get involved, so we increased our exposure to high yield. We increased our exposure to long dated corporate bonds, and everybody was fearing deflation, and we weren't fearing deflation. And so we increased our exposure to index-linked bonds from more of a bond macro point of view.

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**DM:** And I know you have the flexibility to have a small portion in this fund in equities. Did you use that or were actually those income streams that you described earlier - were they more favorable in the bond market than the equity?

**RW:** The equity was a lot more challenging for us. I mean, my bias on equities is as a value investor, and we all know how value investing has suffered relative to let's say the tradition of growth investing, or the newer tradition of growth investing. So when we went through this particular phase, it was quite difficult because a lot of the things I had exposure to tended to be those cyclicals. So it was a bias towards, you know autos, oil, it was biased towards those particular areas and they suffered.

So the strangest thing was even through the crisis the best example I can think of from a bond perspective is an equity we've owned the past is Microsoft, we didn't buy any this time round, it was still too expensive on a value basis for our traditional measures. But during the crisis, the Microsoft equity fell less than the Microsoft bonds. So even though you could say, well, equities should have underperformed bonds, the dislocation in the corporate bond market was so large, a long dated bond by issue by Microsoft would fall as much or more in price than the long dated equity. So when you have a situation where people are scared and chaotic and the safer assets falls more than the dangerous assets, well, you've got a bias towards focusing on the safer asset. So we tend to look at it that way around. So long dated corporate bonds are quite volatile. And in this draw down, there are some great opportunities, whether that be a long dated auto bonds, high-quality bonds, AAA's, like Microsoft. And so there was lots of opportunities there.

Fairly shortly over the course of the summer as confidence returns you know, our bias has been remained towards these [inaudible] stocks. And over the course of the year, we have bought and sold some particular stocks, but it's not been a main driver of what we'd been doing. The main driver of what we've been doing is it's driven by the interest rate market and our outlook for the world economy, but it makes us different. And I think it goes back to, it's quite interesting. Now this fund's had the ability to own equities since it was launched. The question you asked the start in 2006, I think the UK stock market was broadly where it was in 2006.

**DM:** Yeah.

**RW:** So which is quite a shocker when you think about it, if you'd told that to me, when we launched the fund and so you know, having a equities in the portfolio, if you think about it, has

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always been a structural headwind compared to what bond yields have done over the period where bond yields have collapsed. Yet, despite owning, you know, at times up to 12% of the portfolio in equities, you know generally speaking it's helped us produce these better income streams.

And a good example of that might be just sitting down now, if you think about a company, let's say that we own, that's owned by other people in business, like Imperial Brands. We look at what the dividend yield is and the earnings on that is, we compare that versus where their debt trades or you compare that with reverses where a long-term bond yields are, it's a lot more attractive way to gain income. Again, we use equities in the limited sense. We don't have any equity position more than a half percent of nav, but I think there's a very interesting area, especially as equities have some kind of inflation protection. If inflation comes back, equities, you know, have some kind of inflation protection in them, whereas fixed interests tend not to have that protection.

[9:01]

**DM:** Absolutely, absolutely. Now many commentators make an observation, and you did again touch on it that we're roughly at the same sort of yields for government and spreads on investment grade. And I thought a lot of people thought the bonds look expensive last year. Do you feel that bonds are expensive generally? And where are you finding examples? I see you've got some emerging market debt in the fund at the moment.

**RW:** Yeah. I think the sort of investment grade is better value than high yield. So we have a bias towards investment grade from high yield. If you look back through the histories of where they trade. Within investment grade, you tend to find better value in long dated bonds. And you tend to find a better value in dollars where the central bank hasn't bought lots of corporate bonds, whereas both the Bank of England and the ECB have bought lots of corporate bonds, therefore distorting the market. So we tend to find a better value in longer dated dollar securities. So within that bias in terms of where our asset allocation goes, it goes towards dollar. It goes long dated. It goes investment grade.

In terms of where the bonds are expensive or not. That's quite an interesting question. I mean, we are back at historical type spreads, the portfolio itself has roughly got the same amount of cash in risk-free, as it had before, fairly defensive we're about a third of the portfolio is in cash or risk-free governments, which is actually the highest it's been since the fund launched. And it's the same as it was this time last year and not surprisingly spreads are the same, my positions the same, there's a bias, more towards cyclicals, and the bias more towards buying a little bit of emerging markets, which you touched on there, which have lagged, which we bought a little bit of over the last month or two, some attractive opportunities there.

So from my point of view, it looks as though things are expensive, but there are a couple of things to bear in mind here. Looking forward, what is different in 2021 compared to what is different in

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2020? A number of things have changed permanently. One, central banks are going to go for growth and governments are going to go for growth. So the risk of recession in the next two years, is limited, assuming a normal course of events with the vaccine and reopening. Secondly, on top of that we've got pent up demand, we all need a break. We all need a holiday. We all want to go away. We all want to socialise. So there's a huge pent up demand in there that will come through.

And lastly, you have a situation where a lot of the weaker companies have gone to the wall. So anybody who was weak and vulnerable in terms of a corporate sense has gone, which leaves the surviving cohort that's very strong. So admittedly spreads are where they were last year, but the economic outlook is more rosy than it was this time last year. This time last year I was expecting rates to be put up to slow the economy, rates are not gonna get put up for a couple of years, they're going to run a high inflation, high growth environment for a while.

And secondly, you know, the corporate universe we can look at, whether it be high yield or investment grade, is really healthy now compared to where it was this time last year. And therefore you're going to have less victims of downgrade, less victims of default, because you have a healthier cohort than you had at the start of 2020. So I'm a bit more balanced than other people may be, so I'd argue myself being sort of roughly neutral about credits. I wouldn't say I'm particularly thinking it's expensive. And I think that differs from maybe some of the other consensus views out there, I think.

[12:34]

**DM:** Yeah. So the key question on fixed income as an asset class is inflation or deflation? I didn't actually do economics, I did a chemistry degree and the first time we had QE post the financial crisis, I got onto Google and I went "QE what does it mean?" and it said inflation. That was 11, 12 years ago and we didn't get any. Do you think the huge amount of stimulus this time will be inflationary? And if I could fairly briefly have a sort of a one to two year view and then maybe a 10 year view on that?

**RW:** Yeah, I'm always, I always find it, my ability at science was always one of my weaker areas. But having done economics apparently I'm a Bachelor of Science, which I always find quite ironic.

**DM:** Yes.

**RW:** So I actually go back to that period. It did create inflation, you know, so when you look back through there and there's this general sort of consensus that no inflation was created, but we did - remember the oil price went through the roof. Commodity funds were all the rage. You know, so there was quite a lot of inflation, actually the central banks, the ECB made a policy mistake of putting the rates up to kill inflation ahead of 2012. So there was inflation around, not, not exorbitant but there was some inflation around.

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This time around I think the inflation impetus is stronger, why? One, the monetary response is bigger. It's huge. Second, the last time, traditionally economics about monitoring fiscal. What about fiscal policy? Last time we were going for austerity, we're trying to sort the problem out. This time round we're spend, spend, spend, typified by the change in the administration in the US. So this time around, we've got a lot more fiscal measures going forward, but a lot bigger monetary response. And so we did get some inflation last time around. I think we should be able to get some this time around, if you print enough money, you get inflation. You know, argue what that number is. But you can see it quite simply. If you just went and gave a large, if you gave £500,000 cheque to every individual in the UK, you know, you would expect the price of certain things to go up and the price of money to go down. So there is a way of creating this inflation.

And I think we wrote something on Bond Vigilantes blog back in the tail end of last year, where I go into a great deal about this. If anybody wants to look any further. And you know, I think that the central banks want to get away from the zero interest rates so they can actually cut rates going forward. The only way that you'd get away from zero interest rates is to create inflation. So I think they've got a bias to create inflation. They need to get inflation up so real rates are negative. So it means they've got room to do some of the next cycle. And you look around central banks. I think they're becoming a lot more tolerant and relaxed about inflation then they were before, and they'll keep rates low for long, and that's good for bonds. Low rates is good for short dated bonds. The question of how long-term investors react to the idea that you know, their principal and their interest payments, will be worth less and less and less as inflation comes back.

So I think that's a far more inflationary environment out there than other people may think whether it's a blip for a year or two, or whether it's a permanent change, we'll wait and see. But I think a move to a more easy fiscal and monetary policy in response to the hard time we've had economically, and in response to the fact that we're running out of policy options, maybe inflation is one of the policy options that makes it easier to do things going forward.

[16:10]

**DM:** Yeah. I always like to just pick out a stock or a bond, which some of our listeners may have heard of, and Kraft Heinz is the one I'd like to just briefly touch on today. Tell us a bit about Kraft Heinz and you know, what's your investment case on that?

**RW:** Yeah. So Kraft Heinz obviously is a large company it's pretty much staple consumer goods. And it's a result of a merger sponsored by the great investor Mr. Warren Buffett. You look at his filings he's still got a large stake in the company and therefore you know a potential helper. If they need to raise capital always good to know who the shareholders are. And they went from being investment grade to high yield.



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They made a big acquisition, took lots of debt on board. Because they put lots of debt on board their credit rating went to the low end of investment grade. That's BBB-, they failed to delever as quickly as they said they would and therefore the rating agencies in early 2020, got impatient with them, said, you haven't delevered as much as you should have done, your credit profile hasn't improved as much as you just said it would do. And therefore we're downgrading you. And this has caused an index problem. You know, certain people have a cut-off point. Let's say, if it's in the index, I buy it, if it's out the index, I sell it. If it's investment grade, I'll own. If it's sub-investment grade, I won't own it. And so it has to be a transition. And so not only is there a psychological thing, it is more risky, it's one notch lower, but obviously there's a technical that comes with that as well.

The description for this, they're called fallen angels. We can all see how equity markets you know, if you're in an index or not an index, it helps test the rents in the index helped test them. So you know, these things are quite important then about how they used and how they go forward. Speaking to our analysts thinks that they're just deleveraging slowly and he thinks they will return to investment grade. So we speak to our analysts on that and Steven, and he says, well, they have gone to sub-investment grade, but it's in their destiny. If they want to become investment grade, they can be investment grade. So what did they do when they went to some investment grade? They cut their dividend, which means they have more cash to retain their investment grade.

So we believe that will return to investment grade, which is why, you know, we continue to add to it and like it, and why we'll tend to buy a long dated issues, because they used to be an investment grade company, they've got 20 or 30 year bonds outstanding. You know, the more volatile part of their bond capital structure, the one that suffers the most when their credit deteriorates, but regains the most when their credit improves. And that's why, you know, we have a large level of those, and we expect them to return to investment grade.

Hopefully, you know, again, given the sector they're in, they've been helped slightly by the, you know, the change to stay at home and return to a more staple food over the last year or two, and the management have changed their attitude. The management wants to retain the investment grade rating, and that comes back to the point we were talking about earlier, you know, credit spreads might be tight, but the management who survive this they've now got conservative attitude going for the next two years. They haven't got a growth, let's go for it attitude. They have a conservative return to investment grade, save the balance sheet, raise capital, be defensive. And that's what I want as the bond holder. I don't want an equity manager or a management team who are going to transform the business - equity guys want things like that, transform a business, wow all the upside. You know we don't want that. We want stable, conservative management who are very careful in how they approach. And they are custodians of the business, as opposed to being transformed as a business. And you know, Kraft-Heinz at the moment is in a very much a custodian phase, having gone through a rapid expansion through the transformation phase a few years ago, with this large merger.

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**DM:** Richard, thank you very much for talking us through not only Kraft Heinz, inflation and your views, both backward and forward looking on the fixed income market. If you would like to see any more information on any of Richard's three funds, the M&G Optimal Income, Corporate Bond or Strategic [Corporate] Bond fund, please visit [fundcalibre.com](https://fundcalibre.com). And if you'd like to subscribe to our podcast, please also visit FundCalibre, or any of your usual podcast subscriptions.