

TRANSCRIPT: EPISODE 358

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we're considering how a flexible fixed income approach can help navigate today's complex economic conditions.

Chris Salih (CS): I'm Chris Salih and today we're joined by Colin Finlayson, co-manager of the Aegon Strategic Bond fund. Colin, thank you very much for joining us today.

Colin Finlayson (CF): No problem at all. Thanks for having me along, it's a pleasure.

[INTERVIEW]

CS: Let's just start with a snapshot — the fund had a very strong start to the year outperforming the sector. Strategic bonds in general, are seen as a sort of one-stop shop for bonds for investors. Maybe just talk us through performance and sort of structure of the fund as we speak today.

CS: Yeah, I can absolutely do that. No, you're right, we think of our strategic bond fund as being a sort of, you know, unconstrained or flexible fund that can give investor access to broad range of opportunities right across the fixed income universe. So, you know, if investors are looking for access to a broad set of fixed income based risks and returns, then they absolutely can get that within our strategy.

In terms of this year, well, the first thing I'd say is it's certainly not been easy this year. There's been a lot going on and we've tried to manage risks effectively and take advantage of a wide range of opportunities. This year so far, there's really been sort of three different drivers of performance in three areas we've been focusing on.

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The first one in many ways is about, you know, taking in less risk rather than more. Markets have been very uncertain. Volatility has been high, so conviction and taking large directional risks in the portfolios have been, you know, has been lower than it has been at times in the past. So, so one of those three areas of focus has been around duration risk, and we've been having the duration at levels around about the average of where it's been over the last five years, and instead focused more on market selection. So where we want to invest. So we started this year the strong preference for US treasuries. We didn't like European interest rate risk. As we moved through the first three or four months of the year, that completely switched, you know, with the news of tariffs and other factors. So it's been more about markets we wanted to select.

The second thing has been about positioning for changes in the shape of the yield curve. So we felt yield curves were too flat and were likely to steepen, so we wanted to own shorter dated bonds rather than longer dated bonds as we felt they offered a greater return potential and offered a little bit more protection, again, against this degree of uncertainty. And in so far this year, we've seen yield curves in the US and in Europe steepen up for different reasons. But it's something that we were positioned for, we had to benefit from.

And then the third factor is around sort of corporate bond allocation. So again, credit spreads are tight, therefore the amount of risk we wanted to take was lower. And what instead we thought was a better way to add value was to focus more on bottom up security selection to generate returns. So reducing the beta and focusing more on the alpha from the individual bonds that we've been buying.

So when you're putting these three things together with you know, an average level of duration, focusing on a steeper yield curve and bottom up security selection on the corporate bond side, and you put all that together, that's gonna be driving the performance against what has been a very uncertain and volatile backdrop.

CS: Okay. I wanted to touch on one of those points, which was the duration risk. Firstly, what are we talking about in terms of average, and then, and secondly, with sort of central banks looking like they're gonna cut more in the next year, do you think there's room to take more duration risk?

CF: Yeah, no, that's a really good question. So, so for us, the average duration that we've had over the last five years has been about 6.5 years. And our bias is to be at that level or slightly higher. Because we, I would agree, we believe that that central banks are gonna continue to cut rates over the course of this year. I think the amount that they cut and the timing of that will vary from country to country, depending on the different macro factors that they face. So ample is very clear. Downside risks from growth, we think the backdrop is becoming disinflationary, and that will allow the ECB to cut rates more aggressively than had been thought even just a few months ago. And this is supportive for European fixed income risk. So again, that we would expect, you know, to have a higher duration risk in Europe.

As a result, the story in the US is a little bit more complicated because yes, downside risk from growth coming from the tariffs, but then upside risks to inflation, which makes the picture there a little bit more difficult for the Federal Reserve in terms of what they will do. And then also the outlook for for the treasury market. But we believe that the risks are very much skewed to the downside from a sort of macro standpoint, which will keep central banks cutting. And when we feel the opportunity is attractive to do so, then we will absolutely look to increase duration risk. But right now we feel it's too early to be taking large long duration positions in the portfolio.

CS: Okay. I mean, I guess we touched on it a little earlier, but where do you see the sort of main couple of opportunities in the market at the moment? Is it those corporate bonds you talked about a little earlier? Maybe just give us a bit more insight on that please.

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CF: Yeah, well, we feel there's opportunities in a range of places. It's about being selective and then sizing your risks accordingly. So within the corporate bond side we continue to see opportunities, for example, in financials within banks. They're less influenced by some of the macro factors driving markets, you know, tariffs and such like but the real opportunity there we feel is more in sort of shorter maturity assets or bonds that have a sort of a call date within the next sort of one to two years. Many of these assets are still trading with quite attractive yields, and because there's short dated in nature, they're bringing less overall credit risk to the portfolios. We're seeing similar sort of trends within more sort of high yield names and some emerging market corporates as well, where there are attractive valuations, attractive yields, but shorter maturities, which allows you to maybe reach down a little bit further into sort of lower rating the kinda lower rating spectrums.

But then outside of the corporate bond market, again, we would see, you know, sort of shorter dated government bonds also offer value primarily in Europe but also in the US to an extent as well where we still feel that, you know, rate cuts will come through the starting yield is quite compelling and as we see the sort of growth and macro slowdown and this will be supportive of these assets as well. So, there's definite opportunities out there, but you just need to know what you're buying and be careful in terms of the size of the risk you're taking.

CS: Okay. One area you didn't mention there, which is quite interesting is high yield because obviously Aegon has quite a really strong capability in that space, and I know some of the guys in the multi-asset space are looking at it. What's your view on it? I mean, spreads are tight, they've been a little less tight recently. Some would argue that's not necessarily about the worst thing in the world. It kind of indicates a good economy. But how do you see the risk for your reward in high yield?

CF: Yeah, it's definitely a challenge in terms of how you assess the outlook for the high yield market. And there's been a debate within the market probably over the last 12 months or so, as to what's the key metric for value within the corporate bond market? Is it spreads or is it yields? And traditionally the focus has been on credit spread, so the additional yield you're paid for taking that credit risk rather than holding government bonds. And I think that is an important barometer of all value, but the bigger driver of total returns. So within fixed income markets, and high yield in particular is your starting yield. So the higher your yield, the greater your total return potential is over the period ahead.

And, you know, when you look back over historical periods when yields have been at the sort of elevated levels that they are today then the total returns are very compelling over the subsequent five years from that point. So, for today, when we look at the high yield market spreads might be, you know, close to cyclical lows, but your starting yield is somewhere in the region of, you know, 8%. So it becomes quite difficult to be overly bearish on high yield when you've got that attractive starting point because if your yield's at 8%, then you know, yields and spreads can move a lot higher before you actually lose any money from a total return standpoint. So the break even of owning high yield is actually very attractive.

But that said, you do have to respect the sort of tighter valuations on the spread side. So for us, the way we would think about that is it favours having just a little bit less in terms of the exposure to sort of generic high yield risk and focus more on the individual bonds that we're buying within that.

CS: You are not too worried about defaults in that space, then?

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CF: Defaults will absolutely increase. You know, they almost can't go any lower. They have to move higher and but it's a question of the extent to which you will go and whether you're being compensated for that. That's part of the reason why within our strategic bond fund, we can have between sort of zero and 40% allocated in high yield. And more recently we've probably had that around so maybe 20% type level. So you know, right in that middle of the range and in and around the average, we've been over the longer term, so we've been sort of dialling down our overall exposure to high yield because of where we are in the cycle. But redoubling our efforts in focusing on the individual bonds that you buy, which we think are less exposed to default risk, or you're being compensated enough for the potential default risk that you're facing. So, we can't ignore the fact of where we're in the cycle but it's about, you know taking risks accordingly. But it's a very difficult market to be underweight or be zero weighted because you're paying away a lot of potential yield and potential return by doing so.

CS: Okay. Inflation was the bogeyman in markets - moderated at what do you have, can you take a view on inflation in this environment with Trump and tariffs, which we will talk about in a moment, but yeah. Can you take a solid view or are you in some sort of really sort of crossroads position where you can go either way quite quickly?

CF: The inflation outlook is absolutely right, has been the bogeyman for fixed income markets. You know, this kind of like post post covid period. And it felt as if we were moving into a period where those upside risks inflation had, you know, were behind us and we're starting to move into more of a normalisation on the inflation side. Some of the confidence around that has definitely been weakened by what by more recent events. I do think you have to separate out which parts of the market and which regions you're looking at when you're, you're thinking about inflation.

So the the impact of, you know, thinking the impact of tariffs is very different whether you are in the US or you're in the rest of the world. So in the US the impact of tariffs is clear. Domestic consumers will pay higher prices, therefore inflation should be higher as a result. And it's very difficult to argue against that.

Outside of the US and the rest of the world, what's happening with the tars is actually disinflationary, it's actually reducing inflationary pressures. You know, if you think about in the context, if you're a European manufacturer, usually exports into the US you're manufacturing process is very difficult to dial up and dial down in terms of how much you're producing. The result of the tariffs is you're facing probably an excess supply of of goods relative demand to demand, because though that demand from the US will be lower than it, than it otherwise would've been, that in itself will be disinflationary alongside weaker growth, which will come as a result of the tariffs, which again, feeds through into the the the sort of disinflationary pressures.

The UK is an interesting example as well, because that's one of the economies where inflation has been a little bit stickier, but more difficult to get down back towards target. But we are seeing, I guess, better news more recently in terms of the trajectory of prices, but we're also seeing quite a drop in commodity prices this year, which is another factor that will play into energy costs in the uk, which have been a real problem in the past. So we think that there's the potential for UK inflation, not necessarily to collapse, but to be a lot better behaved than it had done before. And as opposed to, you know, reaccelerating in a way that you might see in the US.

CS: Okay. Just quickly on tariffs, because we can't not ask. What's happened in the past four weeks or five weeks now, maybe just give us an indicator of what your sort of instant reaction to them was, and do you feel that the sort of conflicts have, and sort of the conflicts coupled with increased sort of government borrowing, do they concern you about yields possibly rising?

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CF: My first reaction to the tariff announcements was that it was far more comprehensive and aggressive than I expected. I also certainly didn't expect it to be announced on a giant bingo card in the rose garden, but that's a different story. But what it did bring was a huge amount of uncertainty was injected into financial markets and into, I guess the, the economic outlook and the market response in the first instance I think was completely logical, which is that this is good for government bonds and it's bad for risky assets, bad for, you know, for corporate bonds and credit spreads. And that initial reaction I think was correct. And I think that's the reaction which still fits for the majority of majority of the world.

I think in the US the story's a little bit more complicated and you'll see mentioned there, but the challenges on the fiscal side and the bond issuance and what that might mean. And I think that's still an issue that's still an overhang for the market. I don't necessarily think that it's been driven by the tariffs per se. In so much as the, what we saw in April in the US was almost like a sort of sell America theme. So whether it was US equities, US dollar, or US treasuries investors decided to spend their marginal, you know, their marginal euros or marginal powers somewhere else. And they decided to not, you know, not recycle assets back into the US partly because of the the uncertainty that had brought.

But the other factor is that the Trump administration wants to have some fiscal loosening to increase sort of the fiscal spending through tax cuts and such like, and right now they don't have the headroom or the capacity to do that because they're not doing a good enough job shrinking the debt and the deficit, which, they have outstanding because their aim will be to reduce the deficit, to give them enough headroom to be able to increase you know, sort of spending on other areas where they think it's more more beneficial to the US economy.

What they also want to try and do is get their debt, the cost of debt, debt interest payments lower. So they need to either have less debt or the interest rate on that debt has to be lower. And until they managed to do that, then it's very difficult for them to enact their kind of quite ambitious fiscal plans if they try to do that. And president Trump did make some noises about looking at, you know, moving on to looking at tax cuts. And that was probably the catalyst, I think for the kind of big sell off that we saw in treasuries, particularly long dated treasuries. And that was their so-called bond vigilantes putting their hand up and saying, nah, not right now. There's not, you know, we don't have the bandwidth for that. The math doesn't add up. And until you reduce the deficits efficiently, we're not gonna sponsor that sort of that sort of approach.

CS: Okay. I guess a lot of what you've just sort of talked about there, I mean, the indication is that there's gonna be a lot of volatility and therefore dispersion in security selection. Does that sort of lean into the need for you guys to be quite the flexibility you guys have to be quick to adjust that positioning? Because there are a lot of directions the market could go in for the rest of this year?

CF: 100%. You know, the outlook is as you see the path potential the outlook in terms of different paths that we could go on from here, potentially economic outlooks, the path has really been as wide as it is right now, and that doesn't generally sit well in financial markets. We like stability, they like more predictable outcomes. And that's exactly what we're not gonna get. So you need, you need to use flexibility, whether that is on managing your interest rate risk, your credit risk, the markets you choose to invest in the individual sectors that you want to you to lend money to individual companies that will survive and not survive. All of that needs consideration and thing with strategic bond funds is, you know, that's exactly what they're designed for.

You've got all these different levers you can pull on and you can have to use them all. Because having simply setting your fund up with big directional macro bits and assuming that they're gonna work and pay off, I think is very, very dangerous, you know, at this time. And it is, you know, it is a time to use flexibilities and

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not be, and not be static. One of the sort of I guess mantras that we have and maybe one of the frustrations that I've heard from some clients is that when you invest in a flexible fund, you expect the managers to use that flexibility as opposed to simply having a sort of quasi static asset allocation and set up that they hold through the cycle. And there's never been a time where, you know, the flexibility is more valuable.

So we're absolutely doing everything we can to generate returns. Also just to manage the risk as well. Some of it's about you know, making sure you're not exposed to parts of the market that are at risk and trying to protect yourself on the downside as much as it is as about managing upside risk. But the more flexibility you've got, the more avenues that are open to you to generate returns also improves your ability to manage your overall risk profile and by not concentrating your your risk into like, into a handful of particular areas or particular biases within your within your strategy. So by using flexibility and we'll be looking to do that in the coming months.

CS: On that note, Colin, thank you very much for joining us today.

CF: Cheers. Thanks very much your time.

SW: This fund is everything a strategic bond fund should be. It's highly active and flexible and whilst other strategic bond funds often exhibit a permanent bias for a particular area of fixed income, this fund can, and will, quickly change its positioning to adapt to the prevailing economic environment. For more information on the Aegon Strategic Bond fund, please visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.