

IN THE SPOTLIGHT

Adam Cordery, a fund manager at Schroders, talks to Anna Lawlor about the lure of high yield and managing a higher risk profile

# Making the right call and seeing the benefits



Investing in high yield – or ‘junk bonds’, in colloquial terms – “is not rocket science”, says Adam Cordery, manager of Schroders’ £63.2m Monthly High Income fund. The idea is to sell stocks when others are scrambling to buy, buy when others are fleeing for the exits and avoid stocks that are likely to default. Simple.

However, Mr Cordery is sensitive to the fact that bonds are rated high yield for a reason – they are higher risk than investment-grade credit. Investors expect that heightened risk/return profile to generate better returns on their capital.

In absolute terms, they will have been disappointed during the past three years, as the fund returned a loss of 19.4 per cent. However, in relative terms the fund has outperformed the sector average by at least 4 percentage points over one and three years, according to Morningstar, and by 7.2 percentage points in the past three months to January 5.

By contrast, the IMA Sterling Corporate Bond sector averaged a loss of 10.4 per cent over three years, still outperforming high yield by more than 10 percentage points, despite the additional risk. That said, Mr Cordery’s positive relative returns have been achieved with the lowest risk ratio – 2.2 per cent – in the sector. The average risk ratio is 3.3 per cent, but some funds’ risk reaches 5 per cent.

“What helped our performance is that we recognised in Q1 2007 that we were entering a credit bear market, so we positioned the fund as conservatively as we could while remaining high yield,” he says. “At one point we had 18 per cent in cash and government bonds. We reduced exposure to lower-rated bonds and to cyclical bonds, and used our exposure to subordinated bonds.”

He continues: “Basically, cash and government bonds did really well and everything in which we were underweight did relatively poorly. We made the right call on the cycle.”

He also managed to avoid costly “blow-ups” that dented the performance

records of competitors’ funds. Mr Cordery’s fortuitous timing is based on three key factors: spreads, fundamentals and market positioning.

The higher spreads are, he says, the more likely he is to trade and position the fund aggressively; fundamentals apply to the bullish or bearish sentiment of the market, and Mr Cordery tends to take a contradictory view, which merges into the market position factor. He applies the reasoning that if the market is bullish, the next significant move –

“Our stock selection is better than the market as a whole”

triggered by a momentous event – will be bearish.

The recent catalyst for such a shift in sentiment was the failure of Lehman Brothers and the forced selling that ensued during the market fallout. “Lehman’s collapse, the panic selling, high-yield spread indices exceeding 2,000bps – that defines the bottom for me.”

In the last quarter of 2008, Mr Cordery started to unwind the conservative positions that had benefited the fund previously, injecting risk exposure. To reflect his bullish outlook, the fund is concentrated, with 50 holdings. If he were bearish, it could hold up to 150 issues as a form of diversification, he says.

The fund’s sector weightings and stock picking are dictated by Mr Cordery’s bullish or bearish sentiment. “It’s a matter of picking stock that is the best way of expressing that view,” he says.

A team of 26 global credit analysts helps whittle down the universe. That industrials (73.14 per cent) and financials (18.81 per cent) are allocated so highly in the portfolio is because these are where the best high-yield returns can be found, he says, despite these sectors notoriously struggling in past recessionary environments.

Even regarding default levels, a usually sobering topic for bond managers, Mr Cordery proves to be an optimist.

“Defaults are definitely going to go up in the next year, maybe to 12 per cent. That means 88 per cent of companies will not default. If a further 12 per cent default the following year – which is unlikely but possible – that still means 66 per cent haven’t defaulted over two years. Unless you believe those default rates will continue year after year, then the likelihood is that during this recession at least 60 per cent of companies are not going to default. If you think you can pick those that won’t, why wouldn’t you buy?” he says.

Perhaps it depends on how much confidence investors have in the abilities of the fund manager? “As our performance shows, our stock selection is better than the market as a whole,” he responds.

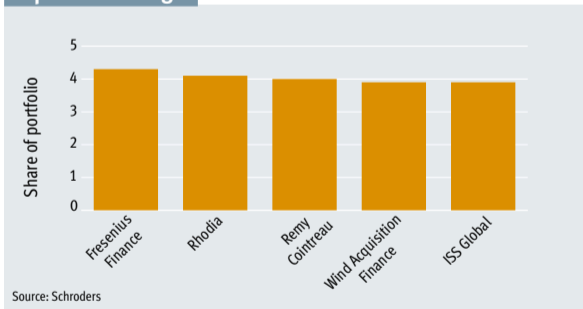
While savvy investors may intellectually appreciate the benefits of returning to credit now, will this actually translate into assets under management for high-yield funds such as Schroders’?

“In the past three months, people ran away from all risk assets and went into cash and government bonds. For a while, the rates were quite attractive on deposit accounts but now rates are coming down. Over time people will think, ‘Why am I earning 1-2 per cent interest on cash when there are bonds yielding 7-8 per cent and not all of them will default?’” he explains.

Interest is already mounting, Mr Cordery claims, with his time for the past two months taken up by meetings with prospective clients interested in credit. Though they are likely to “dip a toe” in investment grade first, he is confident high yield offering “more bang for your buck” will soon tempt them to move their assets.

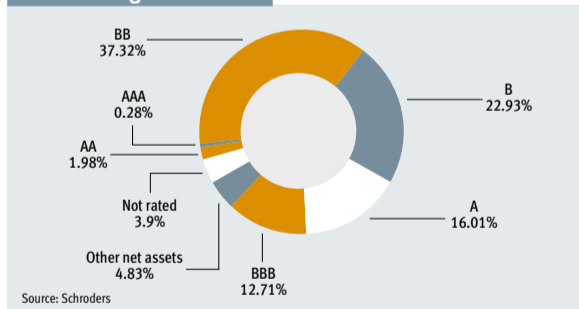
“With bonds, you can’t really have a good year without a bad year before. It’s not like equities where prices go up or down indefinitely. A few years ago, you couldn’t really get growth out of credit, whereas now you can. Valuations are very attractive,” he concludes.

Top five holdings



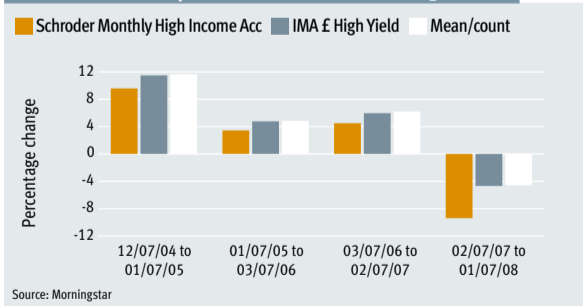
Source: Schroders

Credit rating breakdown



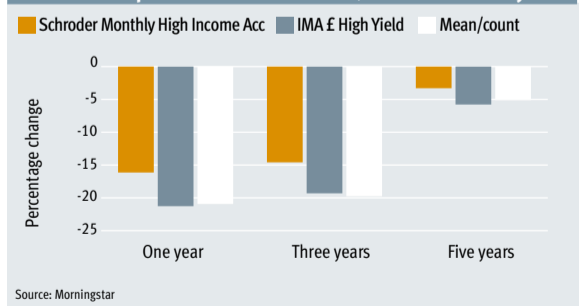
Source: Schroders

Discrete annual performance since manager start



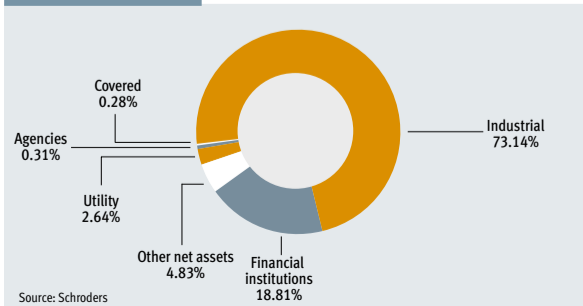
Source: Morningstar

Cumulative performance over one, three and five years



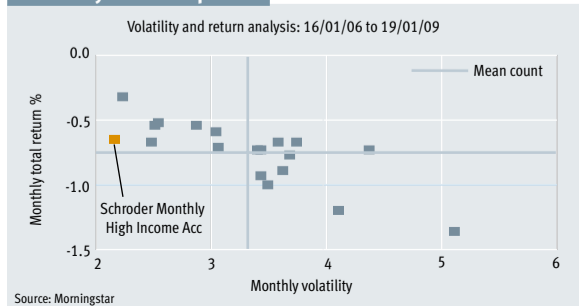
Source: Morningstar

Sector breakdown



Source: Schroders

Volatility v return profile



Source: Morningstar

fund footprint

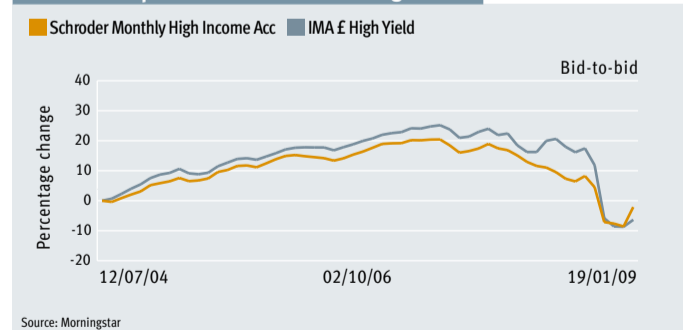
Launch date: 03/2000  
 Manager start date: 07/2004  
 Previous manager: Jamie Stuttard  
 Fund size: £63.2m  
 Number of holdings: 50  
 Benchmark: IMA Sterling High Yield  
 Information ratio: 0.04

Sharpe ratio: -0.49  
 Tracking error: 1.28  
 Volatility: 2.16  
 Average duration: 3 years  
 TER: 1.38 per cent

Source: Schroders/Morningstar

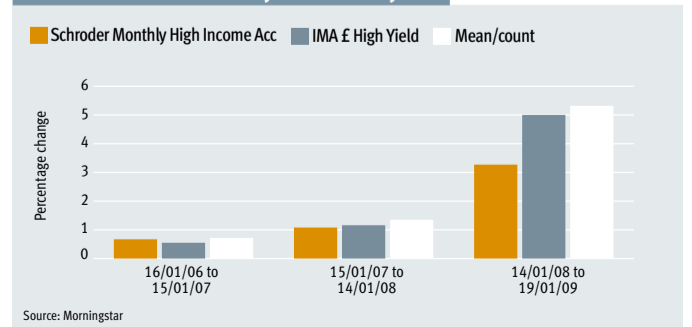
Note: Mean/count contains fund survivor bias. IMA sector (index) is an average of fund data over six weeks, including funds since liquidated.

Cumulative performance since manager start



Source: Morningstar

Discrete annual volatility over three years



Source: Morningstar