

IN THE SPOTLIGHT

Nick Gartside, head of global fixed income at Schroders, tells Stephen Wilmot why he invests in US mortgage-backed securities

A strategy that continues to pay dividends



Nick Gartside admits he often hears a “sharp intake of breath” when he tells investors that nearly two-thirds of his £82m Schroder Strategic Bond fund is in US mortgage-backed securities (MBSs). Since the US housing market is widely seen as the rotten apple that, through securitisation, spoils the global economic barrel, buying MBSs has become something of a taboo.

But Mr Gartside, who is head of global fixed income at Schroders, insists he is being paid well to take on minimal risk. The securities he owns are all issues of Fannie Mae or Freddie Mac, the US mortgage brokers that were taken into “conservatorship”, in effect nationalised at the outset of the banking crisis last September. This gives these MBSs the same default risk as US Treasury bonds, he argues. Yet, he is receiving a spread of 200 basis points above Treasury yields.

Moreover, this spread is highly likely to narrow, pushing up the value of his portfolio. Last December, the Federal Reserve announced it would spend \$500bn buying precisely these Fannie Mae and Freddie Mac bonds in an attempt to bid down household mortgage costs. This scheme started on January 5, and in the week to January 21 alone it purchased \$19bn (£13bn) worth of securities.

“Risk assets are cheap” is one of two main themes Mr Gartside is currently playing in the Strategic Bond fund. The other is that risk-free assets are expensive. “The yield on government bonds is so low that the total return, even if they rallied, would be very limited,” he says.

This leads to a subtle but crucial distinction: while corporate bond spreads are at peaks not seen since the Great Depression, bond yields are only at average levels. It is not fabulously high credit yields that are responsible for the current record spreads; it is the rock-bottom return on Treasury bonds.

Traditionally, this would have been an intractable problem: corporate bonds are traditionally seen as two separate envelopes, default risk on the one hand and interest rate exposure on the other, stapled together. But the wizardry of modern finance allows Mr Gartside to isolate the attractive spread from the only average yield. He has bought risk assets – both MBSs and corporate debt – and sold Treasury bond futures against them. His credit exposure is now relative to government debt, rather than absolute.

This strategy has proved successful so far. Mr Gartside significantly increased his holding in MBSs when Fannie Mae and Freddie Mac were nationalised, and this meant Schroder Strategic Bond largely escaped the major downdraft that

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most bond funds suffered last autumn. From September 1 to January 23, while the IMA Sterling Strategic Bond sector fell 14.4 per cent on average, the Schroder vehicle gained 2.7 per cent.

As spreads on the MBSs narrow, Mr Gartside is likely to reduce his holding and buy corporate bonds instead. He currently has a 10 per cent weighting to US investment-grade credit, all of which he has bought in the new-issue market, where bonds are priced at a discount of up to 1 per cent compared with existing securities. These are the “best picks” of the Schroder credit team, and have an average A credit rating. Recent purchases include McDonald’s and Amgen, the US pharmaceutical group.

“Clearly, corporate bonds will be a theme that will develop over the year. We will be adding to our investment-grade holding as new issues come to market,” he says. But he is not interested in the riskier end of the bond spectrum. He says

it is still too early to buy high-yield debt, given the economic outlook. In fact, he currently requires any bond in which he invests to be both high quality and highly liquid – criteria the sub-investment-grade sector would not meet.

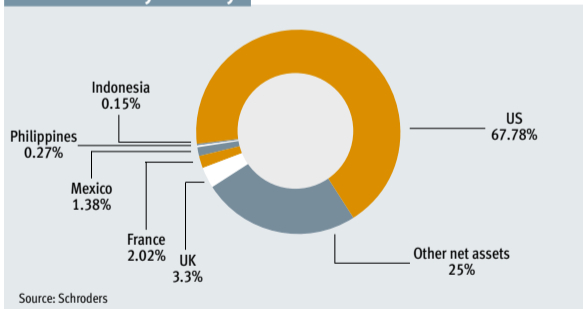
He has two further requirements: first, the company must have access to good terms of funding, either through capital markets or from central banks; second, it should “ideally” be a security that central governments are buying, such as the agency MBSs. Mervyn King’s recent announcement that the Bank of England would buy investment-grade bonds to stimulate lending therefore extends the universe of “subsidised” stocks he would consider.

Mr Gartside is pursuing two other major strategies, besides buying risk assets. First, he has a 5 per cent holding in US Treasury inflation-protected securities (TIPS) in the assumption that the macro-economic policies currently being pursued by governments across the globe will be inflationary in the long run.

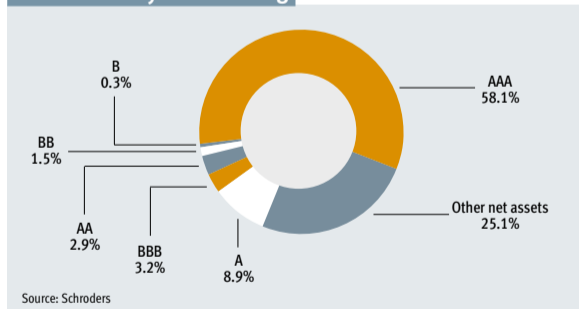
“If you think the Federal Reserve is planning to buy half a trillion dollars’ worth of agency securities this year, they are not sterilising that: they are literally printing money to fund those purchases.” He adds that he bought his TIPS at a break-even rate of -50bps – implying US prices will fall by 0.5 per cent per year until the bond expires in 2015. “I think that’s wrong. Even if inflation is zero, I will make money on that trade.”

Second, he has bought an interest rate swap to gain exposure to central bank rate cuts while avoiding the overpriced gilt market. He argues the only difference between a government bond and the swap is the additional counterparty risk involved in an over-the-counter derivative trade. But Mr Gartside has taken out his swap contract, at a spread of 100bps over the Treasury equivalent, with the Royal Bank of Scotland, which is 70 per cent owned by the Treasury. Again, thanks to a recent government bail-out with which markets have not yet caught up, he believes he has found extra yield at no extra risk.

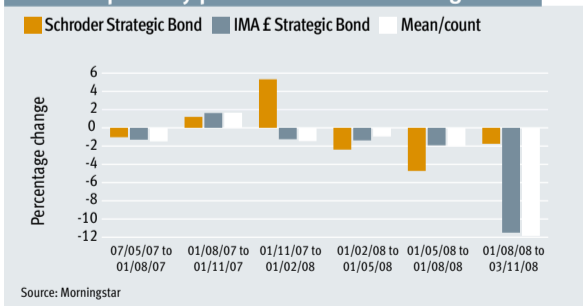
Breakdown by country



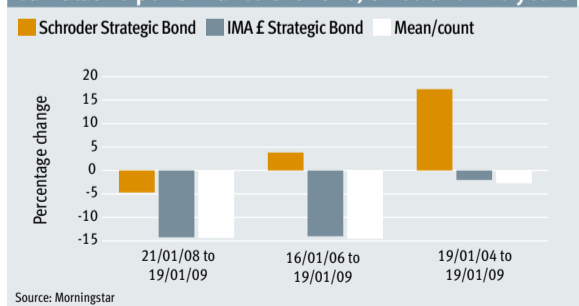
Breakdown by credit rating



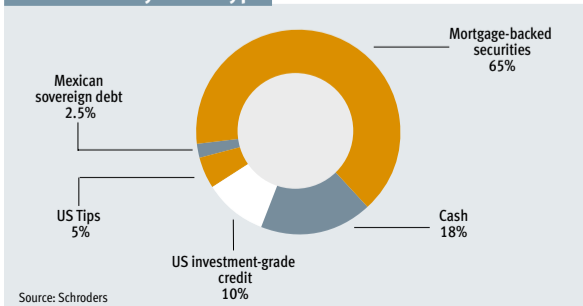
Discrete quarterly performance since manager start



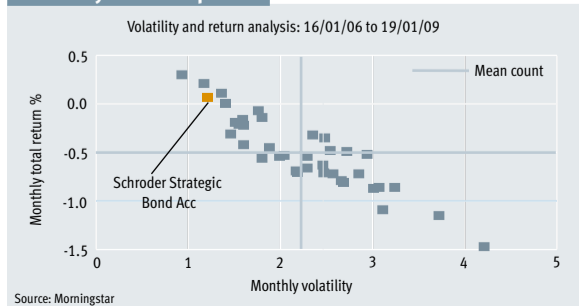
Cumulative performance over one, three and five years



Breakdown by asset type



Volatility v return profile



fund footprint

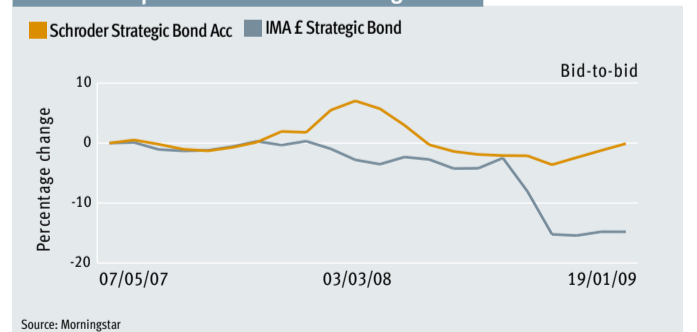
Launch date: 09/03
 Manager start date: 05/2007 (as co-manager)
 Previous manager: Robert Michele
 Fund size: £80m
 Number of holdings: 274
 Benchmark: none

Information ratio: 0.25
 Sharpe ratio: -0.28 (RFR 5 per cent)
 Tracking error: 2.07
 Volatility: 1.21
 Average duration: 3.92
 TER: 1.17 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



Discreet annual volatility over three years

