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ifund fundmanager interview

with Anthony Smouha, GAM Star Credit Opportunities EUR

“Obtain the higher returns on offer, for the same default risk!”

Zurich, October 5th, 2016

***ifund:** What is your fund all about and what differentiates it from your competitors?*

Anthony Smouha: The fund is a bond fund and is all about safety and income. Safety from investing in mainly investment grade companies, a steady high income deriving from investing across the capital structure of high quality companies including investing in their junior debt, which pays a higher income. Their junior debt is often sub-investment grade, but what matters to us is the rating of the issuer as reflected by their investment grade ratings. As such, we don’t have to extend the credit risk nor the interest risk. Many of these companies are recognisable national champions with low sensitivity to economic or credit cycles. This is also why we are buy-and-hold investors. We are very selective in terms of the issuers that we have exposure to and don’t need to trade in and out of companies or markets. We are not trying to make capital gains from trading interest rate curves, guessing the five year forward or shorting interest derivatives. The longer we own the securities the better as what matters over time is the predictable and steady carry that the fund captures. As an indication, the fund captures ca. 50bps coupon payments per month or an income of 6% per annum – despite the low interest rate environment. We are what bond investing used to be: invest in a strong company, collect the income and get our money back. The wonderful thing about a bond is that it is predictable. Our performance is driven by the predictable income we earn each month.

Where we differentiate ourselves is that we are extremely selective in terms of the issuers that we are exposed to as well as the exposure within the capital structure. For example, we have only 10% exposure to AT1 Cocos. We may like the issuers but are cautious on these new securities as their coupons are discretionary and non-cumulative. We prefer to invest selectively within securities issued under Basel II, in securities where coupon has to be paid or in case where deferability is cumulative. The safety comes from the assessment of companies’ fundamentals and investing mainly in Investment Grade companies, which by their nature have a very low default risk. Having managed the fund since 1985, we learned to test the strategy in different market conditions and have learned to stay extremely focused, disciplined and conservative – which are necessary attributes for fixed income investors. There are not many competitors that do what we do. We are not trying to achieve a high return by investing in the bonds of risky companies. By participating in junior or subordinated issues of quality companies, we can obtain the higher returns on offer, for the same default risk.

***ifund:** How do you add value for your investors?*

Smouha: While many investors seeking high income will find it in the bonds of riskier companies or riskier countries, we invest in safe companies and will invest lower down the capital structure to obtain the higher yield. So the alpha that we bring is not only the issuer selection but also the bond selection.

Issuer selection is bottom-up driven. We want to make sure to invest in safe companies, with strong corporate governance that have the ability and willingness to pay coupon and principal. Junior debt is a non-harmonized market, so bond selection means understanding the contractual obligation set in the prospectus. It is also about understanding how regulatory changes impact these conditions.

Alpha also derives from our suppliers: we have more

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than 30 counterparties that we trade with, so we have extremely good access in terms of sourcing and selling securities. Recent regulatory reforms increasing minimum ticket sizes to 100k has made investing bonds less accessible to private individuals. So the fund also gives access to private investors to an extraordinary and diversified pool of issuers and securities which may not be available to many.

The fund has been managed by the same manager for 25 years and the investment management team is capitalizing on their specialist skills. Experience itself adds value in many areas, enabling us to obtain the higher yields often attached to junior or subordinated issues, or those with more complex features, as well as capturing the capital appreciation as the bonds realize their true value.

ifund: *How do you generate investment ideas?*

Smouha: Our investment universe is very broad and while we invest a high proportion in subordinated debt of financial institutions the strategy also allocates into corporate and corporate hybrid bonds, some high yields and some emerging markets. The determination of regulators to make the financial system safer has resulted in a strong bias to the structurally improving financial sector, but understanding regulatory changes is an important theme. For example, the implementation of Basel III meant that securities issued under Basel II would become a very inefficient form of regulatory capital for issuers since losing over time their eligibility as regulatory capital. So by selecting the right securities, we are not only capturing the higher income, but also should benefit from additional capital gains in case of liability management exercises, when companies buy back their own bonds As there is for example no new supply, we are also capturing a rarity-premium. Regulatory changes are on-going and as such create on-going opportunities. For example, the Swiss Regulator grandfathered low trigger AT1-Cocos last year, meaning that it would only recognize them as regulatory capital until first call date. As there is no extension risk, one could price these securities to call instead to maturity. So we have perpetual securities that de-facto became dated one, creating interesting opportunities.

At the end of the day, ideas generation are bottom-up driven – meaning that we first need conviction in terms of the issuer. The financial sector comprises hundreds of banks and non-banks ranging from universal banks, to asset managers, real estate companies, brokers, life insurance and non-life insurance companies. In addition to the diversification these provide through their widely divergent business models and balance sheet characteristics, the sophistication and depth of the subordinated universe means a rich and continuously refreshed opportunity set for the strategy.

ifund: *How is your team structured and who is responsible for the investment decisions?*

Smouha: Our team is experienced heavy and focused with two co-managers working closely together to manage the funds. Decisions therefore are made quickly and brokers like that. Hence, they actively approach us with issues that are either too small for the big houses or too intricate for mainstream investors. Prospectuses are dense documents – I started my career 40 years ago writing prospectuses, and spent an important part of my career as a market maker. Understanding the technical aspects of prospectuses and the ebb and flow of markets provides alpha. For example, when there is some turmoil in markets – and we have seen that numerous times in the past five years – we are able to benefit from the high volatility and can snap up some top-quality bonds with very attractive coupons when they briefly drop significantly in price for just a few hours.

GAM provides us with full support in terms of operations and distribution. It allows us as managers to concentrate most of our time and efforts on seeking performance for our clients with the knowledge that the investment process is supported by GAM´s extremely strong expertise at all levels; middle-office, back office, valuation, regulation, compliance and administration capabilities.

Another key point is to keep it simple. Our funds are not leveraged. We don’t use derivatives to hedge our positions. Instead, if we don’t like a position anymore because we have some doubts about how it might perform, we will simply sell it. In a complex and uncertain world, where you have at the same time in different parts of the world both inflation and deflation, both growth and recession, both loose and tight monetary policy, it is important to follow a clear strategy.

ifund: *In which market environment does your investment style work best?*

Smouha: We have been managing the fund since 1985 with a compound return of more than 8% per annum, the bulk coming from coupon payments.

As we are exposed to national champions that are by nature less sensible to economy or credit cycles, we tend to perform in all types of environment. The higher the cost of equity, the higher the income we can capture as issuing junior debt is a cheaper form of equity-like securities. In addition, these fixed income securities are non-permanent with tax-deductibility advantages so very attractive for both the issuers as well as investors.

During systemic crises we do suffer transitory price volatility and the strategy tends to be correlated to other asset classes for a period of 6-9 months. While at the time the prices may decline, these lay the foundations for future good performance and given the quality of the issuers that we have selected and since we invest in fixed-income securities, we tend to benefit from a quick pull-to-par. Coupon income, which accrues slowly day by day, a 6% coupon or .0135% per day can be overwhelmed by daily prices moves. Those who understand that our fund is coupon driven and that prices recover will enjoy the fruits of being patient. In this sense, systemic crises have worked work well for those who had the patience to stay in the fund. But in a traditional bull/bear market, the strategy tends to be very uncorrelated.

ifund: *Where do you currently see the best potential and largest risks in the market?*

Smouha: Because of coordinated and excessive monetary easing by central banks, assets are in general expensive. In addition, investors have been forced into taking more duration risk. These are some of the two biggest risks.

As explained earlier, we currently have a strong bias towards the financial sector which is structurally improving following the global financial crisis and still contains huge potential. Taking banks for example, they had to simplify their business model, shutting down risky investment banking and trading departments, and have to use more capital to underpin their remaining activities. The implementation of Basel III meant that more than EUR 400bn additional capital has been built by EU banks and GBP 160bn by UK banks since 2008. The regulatory pressure has been on-going and this is one of the only sectors that can surprise us on the upside in terms of on-going capital build up combined with on-going de-risking activities. What is positive for us is that our legacy junior bonds, which had been issued before the crisis, are now classified as senior to this new core capital. Hence, the ongoing process of balance sheet strengthening has given our holdings a strong boost

In terms of valuation, we are still buying at spreads that are significantly wider than fair-value – so not everything is expensive. But one has to be selective. Looking at the top 10 of the securities, we are capturing on average more than 450bps, invested in national champions – compared to EU HY that pays around 250bps for BB issuers! In terms of duration risk, we have naturally mitigated this by investing in securities whereby coupon can be fixed-to-floater or even already a floater. This is why the fund has very low sensitivity to rates and for example had a double digit performance in 2013 – despite tapering. But by the same token, we didn't really benefit from the declining interest rates and as such the bulk of the performance only came from the high steady income.

Most bond investors see rising rates as a risk. We have mitigated this and remain positioned for higher interest rates, as we have been for some time. One key benefit of investing in junior debt is that these securities – despite being perpetual – can have coupon that are either fixed, fixed-to-floater or already floating. During the portfolio construction, we combine these securities in such a way that we are naturally protected against rising rates. For example, we own discounted floating rates note that could generate up to 30 points capital gains should interest rates rise 100bps and capital gains would offset capital losses that we would experience on fixed-dated securities. We are not afraid of rising rates – to the contrary this scenario would benefit our floating rate notes and fixed-to-float bonds, while our high-yielding fixed-rate bonds would prove fairly resilient. If rates remain at current levels, we will be equally content, since we can continue to lock in the around 6% annual yield of our holdings.

ifund: *Which aspects of responsible investing do you consider in your investment process?*

Smouha: Responsible investing considerations are integrated within the existing investment management research and analyses processes and such findings form part of the investment decision making process applied.

At the sector level, we avoid controversial sectors such as armaments and casinos, as we believe the credit markets are sufficiently deep and diverse that we do not feel compelled to invest where we are not comfortable being associated with the industry or business. When assessing specific issuers, we consider whether the profile of the issuer is suitable for the portfolio in terms of them being comfortable being associated with them. This assessment will take into account E, S and/ or G factors. One of the key aspects we look at is corporate governance, for example the transparency around corporate behaviour and alignment of key executive's objectives to the company objectives and results.

ifund: *How do you invest your own personal assets?*

Smouha: Investors can take comfort from the fact that we have most of our assets invested in the funds – meaning that we have aligned interests. This is also where we find the best returns on a risk-adjusted basis.

ifund: *What do you do in your leisure time? What is your preferred hobby and why?*

Smouha: Golf as it provides the need for technical skill and the need to balance safety and risk. And as with investing, the more you practice, the luckier you get.

About Atlanticomnium
With nearly 40 years of experience, boutique manager Atlanticomnium S.A. approach bond investing from a different angle than most others. While many investors seeking high income will find it in the bonds of more risky companies or countries, Atlanticomnium invest in quality companies and lower down the capital structure to obtain a higher yield. Their investment thesis is based on the fact that investment grade companies rarely default, hence the junior debt of such companies rarely defaults, yet it delivers a more attractive yield.

About ifund
ifund provides fund research, manager selection and asset management based on liquid investment funds. Clients include banks, asset managers, family offices, pension funds and insurance companies in Europe. ifund has signed the UN Principles for Responsible Investment and integrates sustainability criteria in fund analysis. www.ifundservices.com, info@ifundservices.com, +41 44 286 8000

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