

Baillie Gifford Strategic Bond

Sterling Strategic Bond

Introduction

The objective of the fund is to produce monthly income and, if market conditions are suitable, some capital growth. This fund is managed with a longer term asset allocation framework looking to deliver returns through security selection.

[Click here to read the Baillie Gifford approach to ESG investing.](#)



Why RSMR Rate this Fund

- Baillie Gifford have developed a fixed interest approach which utilises key strengths of wider equity teams
- Bottom up focus on credit selection rather than macro calls
- Strong preference for companies in growing sectors which can demonstrate economic resilience
- Fund has avoided defaults by using milestones to monitor company progress
- Experienced lead managers have worked through many cycles
- Fund competitively priced and suitable for long-term bond investors

Fund Process

The fund is actively managed through bottom up bond selection and will typically hold 60-80 names so is relatively concentrated. At least 80% of the fund is hedged back to sterling. The fund is managed by Torcail Stewart and Lesley Dunn who have many years of investment experience within corporate bonds and who also draw ideas from the credit team. Bonds are selected on the basis of their fundamental attractions, with industry and country exposure a derivative of the stock selection process. There is a focus on companies considered to be resilient with stable or improving financial characteristics.

The fund sits in the IA Strategic Bond sector so it has the flexibility to vary its asset allocation, however it prefers to take a longer-term view, with an optimised allocation which will typically be in its neutral position of around 65% in investment grade corporate bonds and 35% in high yield. A maximum of 50% can be invested within high yield and the split will vary around this according to macro conditions and valuation / bottom-up stock opportunities. In keeping with the growth orientated philosophy at Baillie Gifford, the fund managers seek out companies which are growing, as these are considered to be most likely to see an upgrading by credit rating agencies, and much less likely to suffer defaults. The defining characteristic of the fund is looking for companies whose balance sheets are on an improving trajectory, and it targets companies, industries and geographies on a global basis to find the most attractive opportunities. The corporate bond exposure in the fund will be increased if economic conditions are improving and reduced if they look to become more troubled. In markets with higher levels of uncertainty, exposure to government bonds will be increased. In terms of interest rate risk the fund will typically match or be close to the overall duration for the benchmark index.

The investment process relies on detailed fundamental research to build up a deep knowledge of the companies invested in. There is an emphasis on bonds where Baillie Gifford believe the long-term risk / reward for investors is attractive, which typically will be the lower end of investment grade and the higher quality end of high yield. Having undertaken in-depth research, the managers have the confidence to make significant conviction investments in certain bonds, so there is a clear impact on client portfolios from stock selection, however within this, there is diversification on a global scale across a broad range of sectors. Companies are considered on a longer term basis with a focus on businesses producing products and services of the future, not the past. By focusing on companies where the balance sheet is likely to improve, investors can potentially see capital gains over time.

Within the team all members also work as analysts. Corporate bonds offer two sources of potential outperformance and return – firstly yield and outperformance is produced if the corporate bond generates a higher income over time than the index, and secondly capital appreciation which is designated between accelerated and event driven bonds. At the core of the portfolio are steady yield businesses which are of the highest quality, bringing stability to the portfolio at a reasonable valuation. These compounding yield businesses have operations which are expected to be resilient through cycles.

Companies identified as having the potential for price appreciation are expected to deliver future positive incremental balance sheet events. This could include a decision to divert cash towards reducing leverage, a turnaround in profitability or a company improving its balance sheet through organic growth. Balance sheet improvement results in a market happy to invest at a lower level of spread premium, and therefore the price of the bond will rise. For these bonds there are pre-set milestones to measure that this improvement is taking place. The final category of bonds is where a single event can materially improve the prospects for the business and its balance sheet. This could come from the disposal of an asset resulting in a cash injection, or a non-investment grade company being acquired by an investment grade company, or a private company coming to the market via a stock IPO.

The fund is a best ideas fund and is not constrained by the bond index. Company meetings and external conferences, together with ideas from colleagues on the equity side help identify opportunities.

The fundamental research on bonds involves writing an in-depth research report which is discussed within the team before a final decision is made. There is also an assessment of the macroeconomic environment using the bi-annual Global Economic Outlook review. Portfolio construction looks to back the best bond ideas with conviction, whilst still ensuring there is diversification in the portfolio. Good governance and a sustainable strategy are now equally weighted with a company's competitive position and capital structure when assessing the long-term prospects for a bond.

Evaluation

Within the sector overall, the fund is likely to be overweight credit although not always overweight high yield versus peers. It is likely to do best when markets are focussed on long-term fundamentals and could struggle if markets are in a severe 'risk off' phase when all correlations go towards one. The fund is suited to periods when the market is placing a high emphasis on the individual prospects of companies which drives returns over longer time periods.

Application

The fund is suitable for use as a core holding for long-term bond investors who want a bottom-up approach within the sector taking strategic rather than short-term asset allocation views.

Our Opinion

Whilst this is an actively managed fund, the emphasis is on bottom-up bond selection rather than big macro asset allocation calls. The team believe taking a longer-term asset allocation view using an optimised allocation approach will deliver a portfolio with returns driven by bottom-up stock or security selection, although with the ability to flex the high yield exposure and hold government bonds at some stages during an economic cycle.

A differentiating feature of the fund is the focus on companies whose balance sheets are likely to improve through growth in profitability and cash flow. It takes a global approach to security selection and there is a rigorous research process with standardised research notes outlining targeted milestones the company is expected to achieve. This is a relatively concentrated bond portfolio which focuses on best ideas, with resilience expected to come from the strength of the business model or franchise of securities held. Ultimate decision making resides with the two co-managers, although research ideas are discussed and debated amongst the entire team.

Whilst concentrated, the fund is always diversified across sectors and takes account of liquidity within the individual bonds held. The initial research reports set out both positive and negative future milestones and so ensures there is not thesis drift if bonds do not perform as expected. The incorporation of ESG factors both controls risk and helps identify opportunities within corporate credit. There is a longer term approach with lower quality bonds not purchased for short term trades and there is a focus on longer dated bonds as these have the greatest potential for gains if spread tightening does occur. The fund invests for long term income rather than short term yield. Macro risks are controlled by taking into account longer term themes and scenario analysis. Around two thirds of the fund is in income assets, while a third is in capital assets. The setting of milestones, especially on high yield, means there is a clear pathway for each individual investment case and holdings are monitored to ensure they are achieving this.

The fund has a different approach to many in the sector as there is less reliance on macro positioning. The fund takes a long term approach and offers a competitively priced active investment option. The credit selection approach is differentiated from the peers by focusing on companies seeing growth in their overall business, and historically this has made the bonds more resilient at times of economic stress. Baillie Gifford have now built up a strong fixed interest resource and have delivered good results within credit. The overall strength of Baillie Gifford as an investment house and the experience and record of the team justify an RSMR rating for a fund which is suitable for longer-term bond investors.



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