For professional adviser use only

Close Brothers Asset Management

Investment **Insight**

Fixed Income - Research Matters

January 2023

In this Investment Insight, we take a look at Close Brothers Asset Management's approach to fixed income analysis, and why research matters, with Fixed Income Portfolio Manager, Andrew Metcalf.

Andrew, what are the characteristics of a fixed income investment?

Investing in bonds essentially means lending money to a company or government for a defined period of time at a fixed interest rate. The money raised by the borrower is then used to finance new projects, maintain existing operations or refinance existing debts.

In many ways, bonds are similar to a loan that banks offer to individuals – but there are two key differences:

1. Bonds are tradeable, and can be easily bought and sold

2. Bonds are usually repaid in a single lump sum at the end of the defined period (after five years for example)

Why is fixed income analysis important?

When deciding whether to invest in a bond, we must decide if the return (ie the interest rate that the bond pays) provides adequate compensation for the risks we are taking. Our analysis therefore is focused on ensuring that the underlying company (or government) can meet its interest payment obligations throughout the life of the investment – which could be very long term, 10 years or more for example. As such, it is critical to understand the company's business model and financial situation.

There are many complex factors which could impact a company's ability to meet its financial obligations – and our analysis is focused on assessing the probability of such risks arising. For example, a significant pension deficit could result in a company making sizeable payments to reduce the deficit, which in turn reduces the amount of cash available to make interest payments on bonds. Additionally, companies in cyclical industries such as mining or oil tend to have 'bumpy' profits, which increase the risk that a company may struggle to make interest payments at some point in the future.

How is fixed income research different to equity research?

It is not unusual for the best fixed income investment ideas to make poor equity investments – and vice versa. While both fixed income and equity research involve significant analysis of individual companies, there are several important differences:

- **Non-public companies** – Unlike equity research which is focused on public, listed companies, fixed income investors can more readily invest in entities that are owned by private individuals, mutual societies or governments

- **Bondholder** – friendly financial policies – As fixed income investors, we like conservative companies that prioritise debt management over shareholder remuneration. So, unlike equity investors, we prefer companies that do not pay dividends, do not engage in share buybacks, and do not engage in sizeable mergers and acquisitions (M&A)

- **Security** – Some bonds provide collateral (such as buildings or inventories) should a company not be able to make interest payments. This provides an extra layer of security for bonds which is not available to equity holders

What do you look for in a fixed income investment?

There are four core qualities we look for in a fixed income investment:

- **Stable earnings** – We believe fixed income investments should deliver stable, predictable income. Capital preservation is key. As such, we only invest in companies that generate stable, predictable revenues and profits - ideally in regulated industries such as utilities. Unlike equity investors, we do not favour companies that are rapidly growing profits, and prefer stable earnings growth

- **Conservative** – We favour companies that operate with strong balance sheets and prioritise debt management over shareholder returns. This frequently means we invest in companies with ‘non-traditional’ ownership structures

- **Quality** – Good management is crucial, and we favour businesses with high barriers to entry, regulated revenue streams, monopolistic business profiles, and government support. Such companies should be resilient through the business cycle

- **Value** – We are patient, long-term investors. At the outset, we plan on holding all bonds to maturity, so only look to buy high quality bonds at attractive valuations. We use proprietary models to assess the ‘fair’ value of a bond, and measure our investment ideas against the thousands of rival bond issues in the investable universe

Bond case study - Bupa

What is it?

Bupa is a UK-domiciled, international healthcare group with 23 million customers across 190 countries. Around 71% of revenue is generated via core private medical insurance products.

Why do you like the bond?

- Bupa is a very bondholder-friendly company. This is a function of its unique ownership structure – Bupa is effectively controlled by an Act of Parliament and has no shareholders or owners. As a result, the group does not pay dividends and 100% of cash flows are used to invest in new assets or manage debt

- It is a high quality company with a strong balance sheet, leading market positions in core markets, high level of earnings diversification given operations in UK, Australia, New Zealand and Spain, and high barriers to entry given the group’s extensive asset base of hospitals and clinics
- Bupa is a very conservative company. The bonds have strong investment grade ratings, and over 90% of the group’s £3.7bn investment portfolio is held in cash or ‘cash-like’ instruments

- Our fixed income funds own two Bupa bonds: a senior Bupa bond maturing in 2035 (rated BBB+) which yields 6.7% (2.9% more than the 2035 UK Government Gilt); and a subordinated Bupa bond which is callable in 2032 (rated BBB-) which yields 9.3% (5.5% more than the 2032 UK Government Gilt). We consider these valuations very attractive

What are the risks for the business?

- The key risk for Bupa is around UK regulation. The UK government continue to increase Insurance Premium Tax (a special tax added to the cost of all insurance products, including private medical insurance), and we are concerned this could increase over the next three years. This rising cost could hurt demand for Bupa’s product – albeit only in the UK. This risk is closely monitored by our fixed income analysts

CBAM 10056 01.2023