MAY 2003 ISSUE 10
PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

EUROPEAN CORPORATE BONDS

CREDIT RESEARCH MAKES ALL THE DIFFERENCE

Rapid growth in European corporate bond markets has highlighted the importance of independent credit research in providing fund managers with a leading edge over their competitors

The last three years have been a fruitful period for investors in European bond markets. Government bond yields have fallen dramatically against a background of a deteriorating economic outlook, weak equity markets, lower interest rates and more recently geopolitical uncertainty. In the Eurozone, we expect this "bond-friendly" environment of low growth and low inflation to continue, providing scope for further interest rate reductions.

Compared to their UK and US counterparts, European investors have traditionally been more risk-averse and invested a greater proportion of total assets in bond markets. With government bond yields at historically low levels and meagre returns on cash deposits, investors are increasingly looking towards investment grade corporate bonds (rating BBB– or above) as an alternative.

This has coincided with a number of longer-term structural factors that have fuelled new issuance of euro-denominated credit.

The launch of the single currency in 1999 has created a huge potential issuer base. Companies have increasingly sought to utilise capital markets to gain access to a much larger pool of "domestic" investors. In addition, the euro has also provided an expanding market for non-European corporates looking to tap investor demand for bonds. As a result, we have witnessed a rapid expansion in the European corporate bond market in recent years. (See Chart 1 on page 38.)

'The extraordinary growth of European corporate bond markets has created a diverse range of investment opportunities which require careful consideration'
Richard Hodges, Gartmore

The credit research process

An effective credit research process should be founded on three core beliefs:

- **Franchise and management strength are the foundations of credit quality, as they ultimately determine the sustainability of cash flows. This is of paramount importance to bond investors as it is out of cash flow that coupons are paid and ultimately principal is returned on maturity.**
- **The recognition that event risk is a major factor that can trigger a re-evaluation of credit quality and potential downgrades. An accurate and timely assessment of event risk is critical in helping to avoid the potential pitfalls of investing in credit markets. With this in mind, it is essential to examine the structure of each bond issue to determine if covenant quality can help insulate investors against potential event risk.**
- **Measuring an issuer's "endurance" is vital. This describes the capability of a company to withstand external shocks, in order to avoid potential downgrades.**

EXPERTISE

Companies such as Gartmore, which has been running European bond funds since 1985, have been developing particular expertise in the European bond market. In recent months a spate of new launches have taken place in the offshore European fixed income sector as a number of competitors have arrived late in the market.

The extraordinary growth of European corporate bond markets has created a diverse range of investment opportunities which require careful consideration from both a return and a risk perspective.

Successful investment in European credit markets requires an effective and well-resourced independent research capability, as opposed to pure reliance on the output provided by external rating agencies and sell-side broking houses. Indeed, in growing recognition of the importance of credit research, firms have been increasing their in-house research capabilities. For example, Gartmore hired three new analysts during 2002 and recruited two highly experienced investment professionals to supplement their capabilities in the European fixed income arena.

ROBUST PROCESS

A robust credit research process should be designed to resolve the inherent conflict between top-down factors, such as the macroeconomic and industry background, and bottom-up issues of a company and/or bond-specific nature.

Top-down factors can be revisited on a regular basis when the macroeconomic background, swap spreads and sector specifics are reviewed. Company-specific factors should also be assessed continually to take account of shifts in valuation parameters and changes in the risk characteristics of bond issues.

By analysing these factors, an overall risk/reward assessment of each issue can be determined. Questions such as whether the potential returns sufficiently compensate for the risk and if an issue's risk profile is appropriate given the nature of the investment mandate should be considered.

In order to assist in gauging these factors, credit research teams must forge a strong working relationship with their equity counterparts. In practice, there is some overlap between the criteria used in credit analysis and that employed by equity investors. For example, it is important to assess sector trends and to review the position of a company in the context of its industry. In order to contribute information for both fixed income and equity, in-house research teams are often divided according to their sector responsibilities.

For example, Gartmore currently has 13 analysts covering the technology, telecoms and media sectors, 14 with responsibility for consumer and industrial companies, and seven for financials. Members of both teams hold regular one-to-one discussions and jointly attend meetings with company management. Equity analysts are also regular attendees at the credit team's monthly meetings.

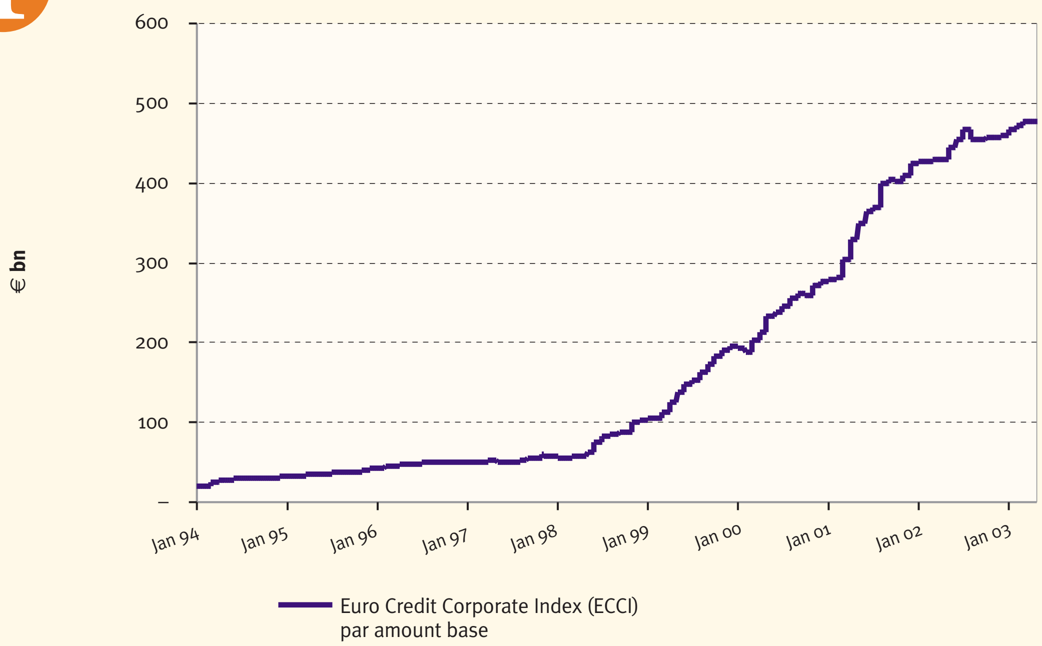
Combining the experience and expertise of fixed income and equity teams and their complementary skill sets allows a thorough analysis of the capital structure of each company to determine the relative merits of investing in bonds, equities and convertibles.

The results of the credit research process should then be utilised to construct the portfolio for a mutual fund. A strong emphasis should be placed on controlling the risk profile of each portfolio relative to the most appropriate index. This has led to Gartmore employing a dedicated, full-time risk manager. The firm has also constructed a proprietary model to ensure that investment strategy is consistent across all corporate bond portfolios and that each fund operates within its risk parameters at all times.

In practice, this type of investment approach enables fund houses to capitalise on a broad range of investment

1

Performance: Euro Credit Corporate Index (ECCI)



Source: MSCI

‘An analysis of both top-down and bottom-up factors can often be combined to identify top-performing issuers’

opportunities in European credit markets.

An analysis of both top-down and bottom-up factors can often be combined to identify top-performing issuers. For example, since 2000, the European telecoms sector has been characterised by high volatility in bond returns. Telecom credit spreads widened through to summer 2002 due to undoubted credit deterioration as debt levels soared as a result of merger and acquisition activity and 3G licence investment.

Heavy new issuance, as short-term debts were refinanced, triggered a rapid fall in the telecom credit ratings of leading European issuers from AA to A/BBB in two years. In some cases, bond valuations moved to levels where the bad news had been priced in and improving fundamentals had yet to be taken on board.

Company-specific factors were then used to identify Deutsche Telekom and France Telecom as the best opportunities in the euro-denominated market. Both companies are now making a concerted attempt to reduce debt levels and are strong players in their domestic markets, offering the utility-like characteristics of strong cash flows from fixed line networks. They are also largely non-cyclical businesses which should demonstrate resilience in a weak economic environment.

In contrast, the core beliefs of a high-quality credit research process can flag a number of situations where credit quality looked set to deteriorate.

In mid 2002, concerns arose over the quality of franchise and management at food retailer Ahold. This led Gartmore to sell out of the bonds well before the disclosure of a discrepancy in the company’s sales revenues triggered a pronounced sell-off in early 2003.

Likewise, last year, event risk was identified as the key reason for disposing of holdings in speciality chemical and drug company Bayer. The firm faced lawsuits following the withdrawal of its anti-cholesterol drug Baycol, which had been linked to more than 100 deaths.

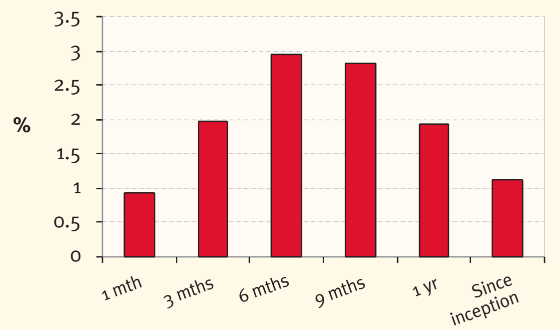
In addition, susceptibility to deteriorating market conditions in the hotel industry led to disposals of holdings in Hilton Group in September 2002. Disposals were made before spreads on the euro-denominated bonds widened considerably.

This approach to investing in European credit markets has been a key factor in providing fund houses with a competitive edge. For example, Gartmore’s SICAV European Corporate Bond Fund, which has employed this approach, has outperformed its sector average since launch. (See Chart 2.)

2

Relative returns

Gartmore SICAV European Corporate Bond Fund vs S&P EL Fixed Income Europe Sector Average



Source: Standard & Poor’s, April 30, 2003

Basis: Mid to mid, net fees, gross income, euros

*The value of investments and the income from them may go down as well as up and you may not get back your original investment. Past performance is not necessarily a guide to future performance.

RAPID GROWTH

Looking ahead, we are confident that plenty of attractive investment opportunities in European corporate bond markets can still be identified.

However, we are mindful of the low growth, low inflation outlook for the Eurozone. For this reason, we continue to be wary of issuers in the cyclical consumer sector, preferring non-cyclical areas such as tobacco with its relatively stable cash flow.

There is also need for caution on financial sector bonds. Valuations have become very stretched and specific concerns have been raised over the credit quality of some German banks. On the other hand, corporate restructuring continues apace as companies look to reduce their cost base and trim debt levels. In instances where the prospect of improving credit quality has not been reflected in bond valuations, corporate restructuring should present exciting opportunities for investors.

Richard Hodges, head of pan-European portfolio construction, Gartmore

CORPORATE STATEMENT

Gartmore is a global asset management firm providing world-class asset management solutions for individuals and institutional clients. Under the ownership of US insurance company Nationwide Mutual, Gartmore Group is represented globally with offices in Europe, the US, and Japan. Gartmore has €68.5bn AUM (December 31, 2002). Richard Hodges has been at Gartmore for 13 years. He is primarily responsible for Gartmore’s positive track record in European bond management.

Gartmore

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