For professional UK investors only

Liontrust GF High Yield Bond Fund

Q2 2022 review

Fund managers: Phil Milburn and Donald Phillips.

The Fund (C5 sterling accumulation class) returned -13.6%* in sterling terms in Q2 2022 while the ICE Bank of America Merrill Lynch Global High Yield Index (GBP hedged) comparator benchmark returned -10.3% and the average return for the IA Sterling High Yield reference sector was -9.6%. The primary B5 US dollar share class returned -13.5%, while the ICE Bank of America Merrill Lynch Global High Yield Index (USD hedged) comparator benchmark returned -10.0% and the average return for the EAA Fund USD High Yield Bond (Morningstar) reference sector was -10.4%.

We also compare the Fund's performance to a leading Global High Yield ETF (seeking to outperform by 1.5% a year)[†]. The Fund's C sterling shares class return was behind that of the ETF in Q2 and has marginally underperformed it since inception (June 2018).

This has probably been the most challenging quarter of my fund management career for both the strategy and the market. While government bond markets had the worst first half to a year since the 1850's and major equity aggregates the worst since 1970, liquidity and market moves point to stress that has arguably not been seen in credit markets since the global financial crisis.

Fundamentally, we view the market as temporarily broken, but do not think the same is true of the business models of the companies we lend to. We believe patience will be rewarded with strong returns from this point and Phil and I remain heavily invested in the Fund alongside you.

In the second quarter, close to 60% of the index-relative underperformance has come from bonds in the real estate sector. We believe this sector is suffering particularly because of troubled debt capital markets, not broken business models. That is certainly our view of the companies that we lend to on your behalf.

Frustratingly, given the marked underperformance, there has been zero bad news in relation to the Fund's holdings during the period. Other unrelated real estate companies, Adler and SBB, have had very aggressive notes written by the fearsome short-selling fund, Viceroy, with accusations of financial shenanigans the key issue. Add to this some sentiment spill-over from everything happening in Chinese real estate (which is mainly a property development issue) add bid side liquidity in real estate bonds has gone very dry.

Anecdotally, there has been forced selling due to industry-wide outflows and hedge funds have taken the opportunity to attack the whole sector in Europe. The drop in prices has been dramatic. To put it into context, our holding in bonds issued by Swedish office company, Castellum has dropped in value by around 45% since the end of March, while the high yield market has returned about -10% during the period. Our holding in Heimstaden, a residential real estate company, has fallen -36%. Our holding in CPI Property, a CEE/German primarily office company, has fallen -35%. Even in the last week of the quarter, the Castellum bond fell by 12pts into month end, but then as I type on 1st July, has bounced ~10pts and is bid by various counterparts. This is evidence of market technical at play, not fundamentals.

Note the diversity we have between residential and office, which have much different elasticities of demand, and also by geography across Nordics and Germany/Central Eastern Europe (N.B., not Russia and Ukraine). In addition, please note that in each case, the parent company of the bond issuer is an investment grade-rated company and the minimum rating amongst the three bonds is BB-. The Nordic economies have low debt-to-GDP ratios in an international context and very healthy banks. These companies are mainly landlords, not property developers.

Moreover, the loan-to-value of each company is below 50% and the companies generate profit which far outweighs interest cost. Indeed, each company has tenant agreement based on index pricing, so rents will continue to increase in this inflationary environment. We continue to believe each of these companies are resilient and sustainable.

However, we have to concede that the deterioration in sentiment towards European real estate companies has taken us by surprise. We have felt low LTVs and high interest coverage ratios would provide resilience, which we believe will still prove to be true, but the market, at least the European debt capital market, is testing this view.

Indeed, the market is treating these bonds like its 2008/9. The fundamentals in the property sector, although coming off a top, do not match that level of bearishness, in our view. The bonds in question do have flexibility over when they redeem, which impacts the present value, but we believe each company will remain a going concern.

This appears also to be the view of the equity market for the two listed companies. For example, Castellum's market cap is SEK46bn, versus around SEK150bn of property assets and ~SEK77bn of debt. Heimstaden and CPI Property have told us they are considering buying their own bonds at stressed prices and also that they fully intend to call bonds (at par) at first call dates. Using the Castellum bond, should they choose not to call at any date (not our base case), the current spread into perpetuity is in excess of 8%.

In recent conversations with Castellum's Head of Treasury, he confirmed that the Swedish banks continue to support his company and the spreads at which they lend to them are the same today as last year, five years, ten years ago.

Heimstaden recently confirmed to us SEK40bn of liquidity, which can cover debt maturities to 2025, assuming debt capital markets remain closed.

CPI Property has continued to issue debt in Germany and US during this difficult quarter. It has a bank loan that was issued to bridge finance of its recent acquisition of a competitor, which falls due in 2024. Excluding this bridge finance, which the company has used the recent debt issuance to partially repay, the weighted average life of its debt is 5.3 years and it has no debt to refinance in European debt capital markets until 2026. The company also has €2.4bn of liquidity, which is approximate to the amount of debt that matures in the next two years. Meanwhile, all of these companies are cash flow generative.

Away from real estate, bonds issued by pharmaceutical company Bausch Health cost the fund ~35bps relative to index. Bausch Health is spinning off a relatively stable part of the business (Bausch & Lomb eyecare) and leaving the remaining pharmaceutical business with a lot of debt to deal with. Meanwhile, a competitor is challenging the patent on one of its key drugs, a major driver of revenue. This was all known before March, but the drop in sentiment has seen the market really punish companies with some uncertainty. We believe Bausch has enough time (no major debt to deal with before 2025) and cash flow potential (could generate $4.5bn cash in next 2-3 years) to get through this tricky period. We have reduced the position size at an average price of 77 (current price 55), but remain with a ~1% position.

Another detractor, automated transaction machine manufacturer Diebold, had a profit warning largely based on supply chain bottlenecks. It has a lot of debt to deal with 2023-2025 and the issues it is having in 2022 make refinancing trickier. It plans to issue asset-backed financing to refinance the bank debt which falls due next year. It is allowed to issue this ahead of the secured bonds (which we owned) and ahead of the bank debt it will replace. We are left uncomfortable that secured bonds will be junior to the new debt and this is before we consider the prospect of recession in 2022/23. We sold the bonds at 76.5, which was a relative hit to funds in the region of 27bps.

More positively, during the quarter it was announced that the large European recruitment agency House of HR is being acquired by private equity, and it will seek to refinance the bonds in the bank market at some point in Q3. This held the House of HR bonds close to par in a falling market.

Outlook
Clearly, severe market volatility and uncertainty in outlook come hand in hand. The slowness of central banks to increase base rates has left them behind the curve and in less control of the inflationary environment. We are encouraged that supply constraints appear to be improving, but inflation remains very sticky and the risk central banks will catalyse a recession to control inflation has increased.

Our view is that there is a large gap between a 'soft landing' and a very harsh recession. In general terms, high yield companies have pushed out their debt maturities and come into this slowdown from a good place in terms of liquidity and profitability. We do not foresee a default environment akin to the global financial crisis experience.

It's also worth pointing out that if you invested in high yield bonds in June 2008, before the financial crisis took its toll on the global economy, you still made an annualised return of 12% over the next three years. The income engine and resilience of the high yield market has always proven itself over long periods of time, and we believe this time is no different.

That is not to suggest we are sanguine about the returns generated in the year-to-date period. We understand the negative returns generated by high yield bonds and our underperformance relative to that will be uncomfortable for our clients, as it is for us. As ever, we are available to our clients to discuss what is going on in the fund and in markets more generally.

Discrete 12 month performance to last quarter end (%):**
Past Performance does not predict future returns

	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust GF High Yield Bond C Acc GBP	-16.6%	13.2%	-1.3%	7.1%
ICE BofA Global High Yield Hedge GBP	-15.5%	13.7%	-1.6%	6.5%

*Source: Financial Express, as at 30.06.22, total return (net of fees and interest reinvested).
**Source: Financial Express, C share class, total return, net of fees and interest reinvested. As at 30.06.22. The primary share class for this Fund is in US dollars (B5) but we are showing the C sterling-hedged class to compare against the IA Sterling High Yield sector. Discrete data is not available for yen full 12-month periods due to the launch date of the portfolio.

[†]While the managers of the Fund seek to outperform a leading Global High Yield ETF by 1.5% a year net of fees over rolling three years, this is not a formal objective. There can be no guarantees this will be achieved over the stated time period. The formal objective of the Fund can be found in the Prospectus.

Key Features of the Liontrust GF High Yield Bond Fund

Investment objective & policy[1]	The investment objective of the Fund is to maximise total returns over the long term through a combination of income and capital growth, through investment in the global fixed income market. The Fund invests at least 50% of its assets in high yield bonds (i.e. bonds classified as below investment grade) issued by companies worldwide which are denominated in US Dollar or non-US Dollar bonds that are hedged back into US Dollar. Although the focus is on high yield corporate bonds, the Fund may also invest in investment grade corporate bonds, government bonds, cash or assets that can be turned into cash quickly. The Fund invests in developed and emerging markets, with a maximum of 20% of its net assets invested in emerging markets. Where the Fund invests in non-US Dollar assets, the currency exposure of these investments will generally be hedged back to US Dollar. Up to 5% of the Fund's currency exposure may not be hedged (i.e. the Fund may be exposed to the risks of investing in another currency for up to 5% of its assets).The Fund may invest both directly, and through the use of derivatives. The use of derivatives may generate market leverage (i.e. where the Fund takes market exposure in excess of the value of its assets). The Fund has both Hedged and Unhedged share classes available. The Hedged share classes use forward foreign exchange contracts to protect returns in the base currency of the Fund. The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
Recommended investment horizon	5 years or more
Risk profile (SRRI)[2]	4
Active/passive investment style	Active
Benchmark	The Fund is considered to be actively managed in reference to the ICE BofAML Global High Yield Hedge USD Index (the “Benchmark”) by virtue of the fact that it uses the Benchmark for performance comparison purposes. The Benchmark is not used to define the portfolio composition of the Fund and the Fund may be wholly invested in securities which are not constituents of the Benchmark.
Sustainability profile	The Fund is a financial product subject to Article 8 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: 1. As specified in the KIID of the fund; 2. SRRI = Synthetic Risk and Reward Indicator. Please refer to the KIID for further detail on how this is calculated.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/glossary

Key Risks:

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Investment in the GF High Yield Bond Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. Bond markets may be subject to reduced liquidity. The Fund may invest in emerging markets/soft currencies and in financial derivative instruments, both of which may have the effect of increasing volatility. The Fund may invest in derivatives. The use of derivatives may create leverage or gearing. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead.