# Liontrust GF Absolute Return Bond Fund

## Q1 2023 review

Fund managers: Phil Milburn and Donald Phillips

**The Liontrust GF Absolute Return Bond Fund (C5 share class) returned 1.3% in sterling terms in Q1 2023 and the IA Targeted Absolute Return, the Fund's reference sector, returned 0.6%. The Fund's primary US dollar share class (B5) returned 1.5%.**

At the aggregate level the positive return was driven by the yield carry on the Fund, followed by just under 0.5% contribution from the rally in government bond yields. Credit spread widening within corporate bond holdings, a feature of the banking mini crisis in March, was a very small negative at under 0.1% during the quarter.

The start of 2023 witnessed a strong rally in fixed income assets as premature hopes for a turning point in the monetary tightening cycle was reflected in market prices. It soon transpired that bond markets had become too sanguine about the inflationary outlook, attempting yet again to price in a "dovish pivot" by central banks. Strong US employment data caused the prevailing market narrative to be turned on its head. Other economic data, such as inflationary data and PMI surveys, also surprised to the upside. Thus, February saw the unwinding of the rally in sovereign bond yields that had occurred in January.

The prevailing themes in later January and throughout February were stronger economic data and the need for higher terminal interest rates in order to conquer inflation. In March the markets' attention obviously shifted to the failure of three banks, Silicon Valley Bank and Signature Bank in the US as well as Credit Suisse in Europe. The write-down of Credit Suisse's Additional Tier 1 (AT1) to zero during the rescue takeover by UBS caused particular chagrin in some corners of the bond market.

To give some background, it was just under 14 years ago that the first contingent capital bank bonds were created. Their initial beginnings arose from exchanges out of banks having other bond-based capital securities that regulators deemed no longer fit for purpose, i.e., did not absorb losses in the way that regulators wanted them to. The name "contingent convertible," or cocos for short, was because under certain contingent conditions (usually a fall in tier 1 equity ratios below a certain threshold) the bond automatically converted into equity. There was huge debate about whether these were bond-like instruments; as time progressed the regulators decided that the cocos were still too bond-like in nature and gradually features have changed such that it is easier for this tranche of the capital structure to absorb losses. The whole point of this is to add extra layers of protection, beyond equity capital, to deposit holders and the taxpayer.

Due to some lazy market conventions the asset class is still frequently referred to as "cocos". It really should be called AT1 (Additional Tier 1 is extra tier 1 capital above and beyond that in equity; tier 1 sounds like the best – it is from a regulator's perspective, from a bondholder's perspective it is the riskiest). Some of the AT1 universe are still cocos (e.g. UK banks) in that when the bank gets stressed the bonds convert to equity. Other parts of the AT1 universe have more onerous terms for bondholders – having write-downs in the bond documentation rather than conversion. These write-downs can be partial or full, and they can be temporary or permanent. "Contingent write-downables" has less of a ring to it but is a more accurate description of these structures.

The documentation for Credit Suisse AT1 had a full and permanent write-down provision. The extraordinary support the Swiss authorities had granted to Credit Suisse enabled the triggering of the write-down of the approximately CHF16bn of AT1. Caveat emptor, the loss absorbing part of the capital structure absorbed losses. One complaint from AT1 holders is valid – why did the SNB/Finma not completely wipe out

shareholders? I'm guessing that it was to save face on the international stage and to persuade the board to vote for the deal (saving having to do a temporary nationalisation), but we may never know. The EU and UK authorities were very quick to respond on the Monday after the Credit Suisse rescue weekend saying that they would respect the capital structure; this does not mean that AT1 would have fared any better if an EU/UK bank got into trouble, merely that equity would be completely written off first.

This is not the end of the asset class for AT1; there will, however, be a large reassessment of the risk in the asset class. The demand/supply technical will be horrendous for a few months as forced sellers arise from mandate changes. Ultimately though, you never earn a much higher yield without taking on much more risk. This default, and zero probable recovery (good luck to those suing the Swiss), should be viewed in the context of the high yielding (and frequently high yield rated) nature of AT1.

Our view has always been that the asset class is risky but investable when returns (yields) are approaching equity-like levels, which is generally high single digits. The instruments are, however, only suitable for bond funds that have a high enough risk tolerance; the Liontrust GF Absolute Return Bond Fund is strictly prohibited from owning any AT1.

Our view is that this is not a systemic crisis; the banks involved have all shot themselves in the foot in some way or other over the last few years, either completely mis-managing the duration of their assets (relative to their liabilities) or having a series of scandals that eroded stakeholder trust. Although legitimate market concerns remain about the asset quality of some US regional banks due to their exposure to commercial real estate lending, deposit flight from the system did slow as the month progressed. It is hard to disaggregate whether deposits moved to money market funds due to "return of capital" or "return on capital"; I would posit the fortnight post SVB failing was mainly the former but outside of that period it is about the latter. By "return of capital" I mean depositors are just worried about getting their money back; any balances above $250k in the US are not insured by FDIC (respectively £85K and the FSCS in the UK). "Return on capital" is about how much more attractive yields are at the very front end of the bond market than on current accounts. Banks have been particularly slow to pass on rate rises to their customers, or, to use market jargon, there has been a low "deposit beta" (rate of interest rate increases being passed through to depositors). As quantitative tightening (QT) continues, some banks are going to have to accept a squeeze on their net interest margins (from high levels) to hang on to funding.

The US Federal Reserve, inter alia, is providing various liquidity facilities so there are more than enough dollars to go around, just not all in the right places. This feels more like an idiosyncratic mini crisis for now, with SVB and Signature being akin to the BNP money market funds "breaking the buck" and the Credit Suisse solution feeling a bit like a larger Bear Stearns. The crisis would become more systemic in nature, a "Lehman's moment," if we start to see a shortage of dollar funding available. I think it will still need the Federal Reserve to undertake another $1-2trillion of quantitative tightening for this systemic shortage of funding to occur, so another 12 - 30 months at the current QT run rate. One hopes that if signs of the banking system falling short of funding do happen then the Federal Reserve will pre-emptively manage its balance sheet accordingly.

The transmission of the banking sector turmoil into the broader economy has four main channels, the first two are through business and consumer confidence. The latter has remained robust so far, even in surveys conducted after the bank failures. Next we have the quantity of loans available; the ability of banks to lend will have reduced as treasurers and chief financial officers look to increase the amount of liquid assets on their balance sheets to cover the risk of any deposit outflows. Finally, and most importantly, there is the price of loans as well as willingness to lend; these are captured in lending standards data. Lending standards had already been tightening significantly before SVB and Signature failed. The next SLO (senior loan officer) data for April's survey, due out early in May, is likely to show a large further tightening.

This tightening in lending standards, and fall in economic sentiment, can do some of the Federal Reserve's monetary tightening job for it. The FOMC meeting came after the bank failures and it instigated a dovish hike of 25bps to take Fed funds rates to the 4.75% to 5.0% range. The statement comes with the appropriate health warnings about the banking turmoil: "… *Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain*." The most important sentence, in our opinion, was that the FOMC "…*anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time*." There are two significant changes compared to prior meetings, firstly

the deliberately non-specific “*additional policy firming”* has replaced the prior *“ongoing increases”;* secondly, they have moved from “*will be appropriate*” to “*may be appropriate.”*

The Summary of Economic Projections (SEP), produced quarterly, had one hawkish element in that the core PCE forecast for 2023 was revised upwards from a 3.2% - 3.7% range to 3.5% - 3.9%. However, the much anticipated increase in the dot plots did not occur. Fed officials had spent most of January and February guiding the markets to an increase in anticipated terminal rates from 5.1% to 5.6%, but the recent banking sector developments have led the Fed to maintain 5.1% as the median dot peak. In the space of two weeks the tightening of financial conditions created by the US banking mini crisis has, by my estimates, knocked 50bps off the Fed’s terminal rates. Most economists are predicting one more 25bps in May; the market has approximately a 50% probability of this hike occurring and is then pricing for rate cuts to begin in the summer.

Overall, the key message is that monetary policy works and the cumulative monetary tightening we have seen brings weaknesses in the system to the fore. Although monetary policy infamously works with “long and variable lags” when things do go wrong (a Hemmingway reference to bankruptcy) events unfold “gradually, then suddenly.”

Whilst the majority of the macroeconomic parts of this commentary have been on the monetary front, one cannot ignore the fiscal side. The US has reached its debt ceiling with an “X date” (when this becomes fully binding) likely to be hit around August time. This issue has slipped off many investors’ radars for now, but remains a risk to be cognisant of. We provide some additional information as an appendix to this commentary.

**Carry Component**

We split the Fund into the Carry Component and three Alpha Sources for clarity in reporting, but it is worth emphasising we manage the Fund’s positioning and risk in its entirety. As a reminder, the Carry Component invests in investment grade bonds with fewer than five years to maturity; within this there is a strong preference for investing in the more defensive sectors of the economy.

At the aggregate level the positive return was driven by the yield carry on the Fund, followed by just under 0.5% contribution from the rally in sovereign bond yields.

**Alpha Sources**

**Rates**

The Fund spent most of the quarter with a duration in core bond markets of 2 years, above the neutral level of 1.5 years (as a reminder, the permitted range is 0-3 years). Duration was reduced by 0.25 years during January as we believed that sovereign bonds yields had rallied a little too far and fast, this was then added back during February’s selloff. At the end of the quarter the Fund had duration in core markets of 1.9 years split between 1.05 years in the US, just above 0.80 years in Europe and 0.05 years in the UK.

The emphasis above is on core duration; the Fund also has a 0.5-year short duration in Japan. The Japanese Government Bond (JGB) market is much lower beta than other sovereign bond markets, partly due to the ongoing market manipulation by the Bank of Japan as part of its Yield Curve Control (YCC) policy. The JGB market has become dysfunctional so the YCC policy is no longer fit for purpose and the new Bank of Japan governor Ueda is likely to try to find a gradual exit. The short position in Japanese duration is offside in absolute terms but the JGB market has rallied far less than other markets. The position provides a useful low beta hedge for the Fund, helping to provide a risk offset so that the long duration in core bond markets can be maintained.

Near the start of March, the Fund established a curve steepener position in the US as we believed that the inversion of yields between 10-year and 2-year bonds had gone far too far at above a 1% differential. The banking mini crisis, and ramifications thereof, catalysed a reduction in the inversion (a steepening). The Fund took profits having made almost 10 basis points in a short period of time. If the inversion grows close to 1% again we would look to put a steepener back on.

**Allocation**

The weighting in the Carry Component has been in the mid to high 80s percentage area throughout the quarter, due to the compelling yield on short-dated defensive investment grade. A low of 84% was seen at the end of January due to bond maturities and a couple of sales. The weighting then increased during February and March

to finish the quarter at 89% due to purchases and as the declining time to maturity of a couple of Selection holdings brought them within the strict criteria to qualify for Carry.

**Selection**

Activity was relatively low during the quarter. Profits were taken in early February on some Credit Suisse senior bonds as we became more concerned about ongoing deposit outflows, but we did not expect such a rapid demise to occur. The holding in Castellum was trimmed after its very strong start to the year.

Only two corporate bonds had a contribution from spread tightening (or widening) of over 5bps in the quarter. Within Selection, Catalent's bonds rallied after a press story emerged that Danaher was looking to buy the company; even if a deal does not go ahead, we view Catalent as the kind of solid defensive business that we like to lend money to. Within Carry, Aroundtown's bonds started the year strongly which was both a reversal of an oversold position from December and due to the company tendering for some debt.

During the quarter, two holdings were sold from Carry: firstly, a Hutchison Ports entity where our conviction on the business had reduced and the bonds had been less liquid than initially forecast; secondly, RWE, where a combination of strong bond performance and a new coal development (which downgraded our ESG view on the company) led to a sale. New purchases within Carry included Amgen, T-Mobile US, IBM, Conagra, BT Group and Aetna (part of CVS); the latter three all US dollar denominated with 2023 maturities.

**Appendix – US Debt Ceiling**

During January there was a fiscal development that will need closely watching. US Treasury Secretary Yellen sent a letter to Congressional leadership on Thursday 19th January stating that the "*…outstanding debt of the United States was projected to reach the statutory limit*". Firstly, it is worth a reminder that the US has some really badly concocted legislation. The debt limit was first introduced in 1917 and having an absolute limit for debt in an economy that grows in both real and nominal terms makes no sense at all; ad valorem debt or deficit limits are much better structured (see Germany or even the Maastricht Stability and Growth Pact). The current limit, which was hit, is $31.4 trillion; it was last raised in December 2021 by $2.5 trillion – the limit was suspended for two years before that due to the pandemic.

Most of the time the debt ceiling is not a problem – new legislation just gets passed to increase the limit. For example, according to the US Treasury: "*…Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents. Congressional leaders in both parties have recognized that this is necessary*." The issue is when the politics heats up to such an extent that a deal to increase the limit cannot be struck in a timely manner. The best recent example was in 2011 (under President Obama) when the US lost its AAA rating and markets had a few very skittish days. In a similar vein to 2011, there is a Republican controlled House of Representatives with the Democrats in charge of the Senate and White House.

For the immediate future there is no cause for alarm as the US enters a "debt issuance suspension period" (DISP) and utilises "extraordinary measures" to bide themselves over for a few months. Most of the extraordinary measures involve extracting US debt from various trusts, for example by not rolling over maturities, and replacing it with different obligations that do not count towards the debt limit (with a promise for a future make-whole once the debt limit is raised). The cumulative impact of these extraordinary measures is estimated by Oxford Economics to be $428 billion; JP Morgan economists estimate $448 billion capacity so a very similar ballpark. Note that the US can also run down its Treasury General Account cash balance if it chooses to do so, which was about $400 billion when the limit was reached.

The date at which the debt ceiling becomes a binding constraint, and draconian remedial measures need to be taken, is referred to as the X date. Exactly how long the US federal government can keep servicing its obligations is a moveable feast; one of the bigger variables is the size of the April tax receipts (which are likely to be lower than in 2022 due to less capital gains tax being realised). August is normally a big budget deficit month so that makes a good central case for when the X date is reached, with June being the earliest and November the latest.

The politics around this will be more testing than usual as Speaker of the House McCarthy was only elected by promising right-wing Republicans that he would use the debt limit to force through spending cuts. On the flip side the Democrats want to just raise the limit with no strings attached. There is a reasonable probability that

this will be taken to the wire and hopefully common sense will prevail, but the polarisation of politics has increased the risks.

If all the cash balance and extraordinary measures are used up, the federal government will go into shutdown. Even then the US will not necessarily default on its debt obligations as the Treasury could attempt to prioritise debt payment to avoid a technical default. Transcripts from FOMC meetings during past debt ceiling episodes suggest that this option has been given serious consideration.

There is another option, invoking Section 4 of the 14th Amendment. The key sentence is: "…*The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned*." This could allow for the Treasury to breach the ceiling given that the debt limit itself is creating an unconstitutional situation – this would be viewed as using the least illegal option. Obama rejected this idea in the past, but there is no guarantee that Biden will either remember or even care about that.

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

| | Mar-23 | Mar-22 | Mar-21 | Mar-20 |
|---|---|---|---|---|
| Liontrust GF Absolute Return Bond C5 Acc GBP | -1.5% | -1.9% | 6.4% | -2.5% |
| IA Targeted Absolute Return | 0.3% | 2.5% | 10.1% | -3.3% |

*Source: Financial Express, as at 31.03.23, total return (net of fees and interest reinvested), C5 class.
**Source Financial Express, as at 31.03.23, total return, C5 class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio

## Key Features of the Liontrust GF Absolute Return Bond Fund

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|---|---|
| Investment objective & policy[1] | The investment objective of the Fund is to generate positive absolute returns over a rolling 12 month period, irrespective of market conditions. There is no guarantee the investment objective will be achieved over this or any other time period. The Fund aims to achieve its investment objective through investment in corporate and government fixed income markets worldwide, including developed and emerging markets. In achieving its objective, the Fund also aims to minimise volatility and reduce the possibility of a significant drawdown (i.e. a period where the Fund is worth less than the initial investment at the start of a 12 month period). The Fund invests in a wide range of bonds issued by companies and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 20% of its net assets invested in emerging markets. Investments are made in US Dollar denominated assets or non-US Dollar denominated assets that are predominately hedged back into US Dollar. Up to 10% 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 10% 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).<br>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] | 2 |
| Active/passive investment style | Active |
| Benchmark | The Fund is actively managed without reference to any benchmark meaning that the Investment Adviser has full discretion over the composition of the Fund's portfolio, subject to the stated investment objectives and policies. |
| 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.*

*Fund positioning data sources: UBS Delta, Liontrust.*
† *Adjusted underlying duration is based on the correlation of the instruments as opposed to just the mathematical weighted average of cash flows. High yield companies' bonds exhibit less duration sensitivity as the credit risk has a bigger proportion of the total yield; the lower the credit quality the less rate-sensitive the bond. Additionally, some subordinated financials also have low duration correlations and the bonds trade on a cash price rather than spread.*

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 Absolute Return 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.

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