BROOKS MACDONALD

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Jonathan Gumpel
Fund Manager and Investment Director, London

Defensive investors have had a long free ride on the back of the 30 year bull market in bonds. At some stage in the future, possibly sooner rather than later, this bull market is likely to come to an end or even move into a long-term reversing cycle.

With some government and even some corporate bonds currently offering negative yields and most other quality or highly rated bonds offering very low yields, a flat market does not look likely to provide attractive capital returns and a reversing bond market could cause significant loss of capital value.

In these circumstances, defensive investors should already be considering their options and working out which assets could potentially provide both attractive and defensive returns. A simple option that some investors will already have considered will be to shorten term and duration to avoid or reduce the loss multiplier effect. However, with very low rates for short-term bonds this option can hardly be deemed to provide attractive returns and carries with it potential timing risks. Another alternative might be to go down the quality scale or the capital structure to seek out higher yields, although this could accelerate losses in capital value in the event of rising defaults in a rising interest rate environment. It would seem there is no simple solution.

In the current environment, investors' mindsets may need to change. In particular investors may have to take a wider and more imaginative approach to asset selection; one that may include focussing on finding the 'least worst' option rather than trying to find a potentially unrealistic best alternative.

Our view is that a balanced range of fairly good and 'least worst' assets is likely to provide some of the most attractive (least unattractive) defensive returns over the medium-term. Since this is our view it is no surprise that our fund, the Defensive Capital Fund, is invested across a broad range of these assets. I accept it may be an unusual promotional tactic to proclaim your fund has a range of the least-worst investments. However, this is not about promotion, but about preparing for a different world in which the interest rate tide is going out rather than coming in and in which different strategies need to be considered.

The assets the fund holds are generally relatively short duration and relatively senior in the capital structure. They tend to be well supported by relatively liquid capital assets ("pounds rather than promises") together with either high rates of capital return or with lower rates but scope for upside optionality due to inflation/interest rate linkage or corporate performance.

The specific assets we hold are:

- Senior bank debt, usually in combination with derivatives, whereby the bank is paying us to take excess risk sourced from client transactions off its trading books
- Secured lending assets and senior mezzanine loans including collateralised loan obligations, all of these pay high coupons relative to their risk
- Asset backed real investments, combining both infrastructure and defensive property assets, which offer the security of the cash flows from the underlying assets and attractive yields with low price volatility
- Convertible bonds, which offer the security of the assets of the company whilst providing optionality to the upside

The Defensive Capital Fund has built up significant exposure to these assets in the seven and a half years since it was launched. Once the tide turns, we believe that these assets will both remain well insulated from a downturn in bond and potentially equity valuations, whilst also becoming very attractive to a much wider audience seeking defensive returns in a post bond bubble world.

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