Sparinvest

Quarterly Report

VALUE BONDS

Technology – a strong player in the bond

Another very strong quarter in credit is behind us. The first part of the quarter was a recovery from Brexit, which took place much faster than many expected, especially in the UK. Emerging markets suffered a short blip with a coup attempt in Turkey, followed by a downgrade to high yield later in the quarter. The holiday season during the quarter was very benign followed by increased volatility on the back of interest rate expectations. In September we saw a surprise on the oil front from an OPEC meeting agreeing new quotas leading to a rally in oil prices. Also, European banks suffered from renewed fears surrounding Deutsche Bank. Ironically, the quarter ended with news of Brexit implementation kicking off with triggering of Article 50 by March 2017.

In this brief we will aim to highlight some of the areas in our investment universe that we quite like and where we see good value relative to the wider credit markets. Some of these areas will be more long term than others. This quarter will we touch on the small sector Technology, where we are overweight and see good value.

Technology is low risk in credit

Technology, compromising three subsectors: Software & Services, Hardware and Semiconductors, is one of the smallest sectors in our universe with just under 5% in weight in both investment grade and high yield benchmarks. Unlike what general press headlines imply, for credit investors, the Technology space is considered low risk in credit with average spreads below their wider indices. This is usually a surprise for our equity focused readers. The equity history of Technology including the dot-com bust of 2001 and many cases of low asset backing have made technology not very popular with banks or credit investors. As a result, the Technology companies that do make it to the bond markets are only strong players. These often have market leading positions, strong cash generation and low leverage compared to their overall valuations. These are the reasons we like investing in Technology. This however does not apply to the Technology companies that every now and then try to use bond proceeds to replace venture capital equity – this is something to stay away from as bond investors do not have the massive upside for these work out, but they do have the downside.

Ignoring the odd quasi equity funding cases, the two biggest focus areas of risk for Technology companies are very fast moving product cycles and M&A (mergers and acquisitions). Most will still remember the fall of Nokia, once the top producer of mobile handsets. There are two ways credit investors can cushion the effects of such fast moves in product cycles. One is low leverage to start off and the second is not to venture too far out on the maturity front. The second major risk can also be a positive if you are the one being acquired by a higher rated company. This is the most difficult area for credit investors given that low leverage often does allow for debt funded acquisitions. Our approach here is to focus on shorter maturities but also we spend more time on understanding our equity colleague's views on the M&A landscape in the given subsectors.

Technology has actually outperformed the wider universe in high yield as per Figure 1 and marginally in investment grade over the past 10 years so the numbers are on our side on being long in the sector. In high yield in particular Technology is one of our largest relative overweights in the fund.

On final note, I would encourage everyone to read our monthly commentary on their respective funds to get insight into current events happening in the market and more specific fund developments.

Technology outperforms in high yield

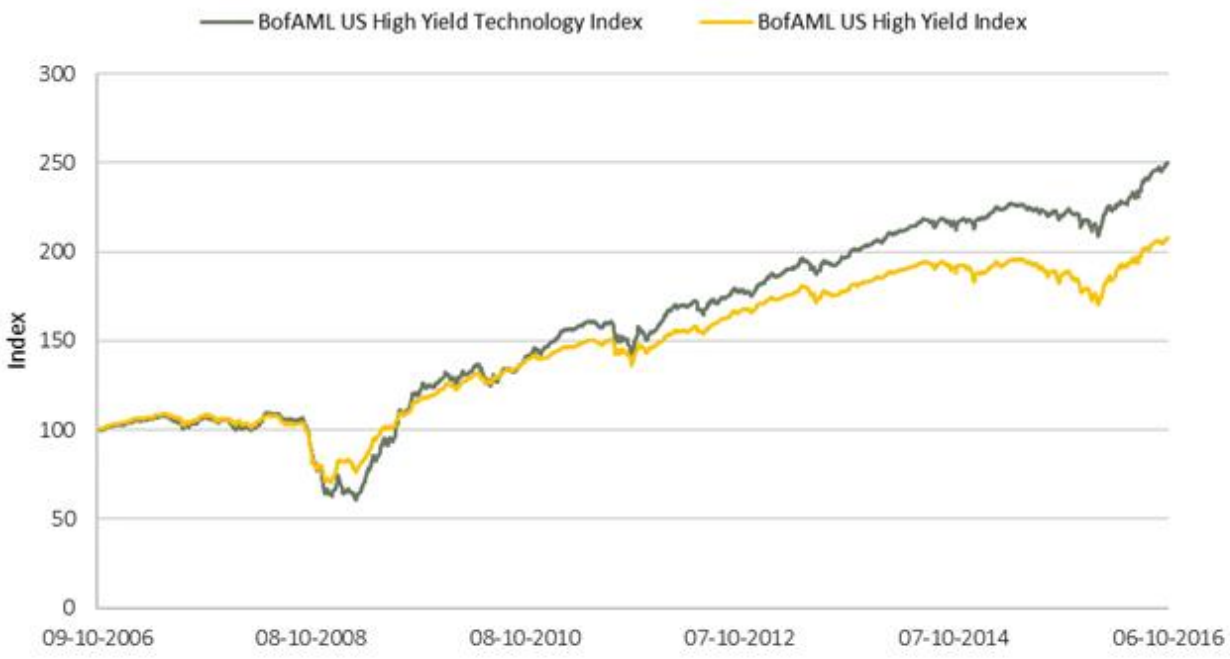

Figure 1: Technology Sector vs. General High Yield benchmark (last 10 years, US HY data), Bloomberg

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