Investment update on the
Baring High Yield Bond Fund

The combination of robust fundamentals and high demand from investors has seen the high yield bond market go from strength to strength in recent months. Since the beginning of the year, the Bank of America Merrill Lynch Global High Yield Index has returned +15.0% in US dollar terms, making high yield credit one of the better performing asset classes, not just within fixed income but across the broader investment universe[1].

In spite of this strong performance, we remain positive on the outlook for high yield bonds. In our view, issuers have manageable levels of leverage, with sensible maturity profiles, while corporate balance sheets are generally strong notwithstanding the challenging economic environment. In turn, this has helped to keep default rates low amongst issuers and below the long-term average. Moody's and S&P predict default rates of just 3.1% and 3.3% respectively for year-end[2].

Even after the returns seen so far this year, the risk premium attached to high yield bonds remains too high in our view, reflecting a market consensus that default rates will be closer to 4% - 5%. We believe this is unduly pessimistic, on the basis of the forecasts from Moody's and S&P. In our view, high yield bonds continue to present solid value at this level, offering investors coupon payments as well as the potential for capital growth.

In a world where dividends and yield are in short supply, we believe demand for high yield bonds will remain a further source of support for the asset class as we go forward from here. Not only do yields compare favourably with other asset classes, in our view, but an increasing amount of money is being allocated into high yield credits.

Rising demand has undoubtedly had an effect on market liquidity. Where we would previously take a new position in the Fund in one or two days, it might now take a week. However, we believe this is still acceptable. One of the reasons that issuers offer a more attractive level of yield is the liquidity of the issue – lower liquidity typically attracts a premium, and the high yield market has experienced these conditions before. Increased demand is also being met with a record level of issuance from corporates – US$220bn since the start of the year – which is going some way to meet growing interest[3].

We take liquidity risk seriously, and seek to manage it prudently through our investment process. We require new issues to be of a certain size before we will invest – US$400mn / Euro350mn. We reduce single issuer risk by holding on average 150 to 170 names in the Fund, with a maximum active position of no more than 0.9%. Consequently, we will rarely hold more than 3% of a particular issue. Finally, we limit our exposure to lower-rated credits, potentially most exposed to liquidity risk, to no more than 10% of the portfolio. Our focus instead is on higher rated credits, typically in the B – BB band.

The combination of this approach with our longer-term investment horizon – our annual turnover is typically just 60% to 70% – means that current conditions are manageable, in our view, and we do not believe investors should be unduly concerned. In the meantime, we remain positive on the prospects for the asset class, and believe high yield continues to offer investors an attractive combination of income and potential for growth.

Sunita Kara
Investment Manager, Baring Fixed Income & Currency Team
Baring Asset Management, London

Source: [1]. Thomson Reuters Datastream, as at 18/9/12; [2]. Moody's, August 12 / /S&P, April 12; [3]. BoA Merrill Lynch/Bloomberg, Aug 12

18th September 2012 **FOR PROFESSIONAL ADVISERS ONLY**

Baring Asset Management Limited | 155 Bishopsgate | London | EC2M 3XY | Tel: +44 (0)20 7628 6000 | Fax: +44 (0)20 7638 7928 | **www.barings.com**