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INVESTMENT | STAR MANAGER

Anthony **Smouha**

Banks are bouncing back strongly and are no longer the bad boys of the bond universe, according to Anthony Smouha. He tells **Dalvinder Kular** how financials have fuelled his stellar outperformance and why Brexit talk won't be catastrophic for his credits

As befits a fixed income manager with almost half his fund allocated to the UK, Anthony Smouha, CEO of Atlanticomnium, has taken a very clear position on Britain's future in the EU. He cannot understand how any good thinking Englishman would vote for Brexit.

However, the Citywire AAA-rated manager, who oversees a range of GAM funds, including its Star Credit Opportunities strategy, is well aware that the wider financial world is not on such sure footing when it comes to this issue. Uncertainty, he believes, will dominate the near future.

'You don't know what markets are going to do. They could go down in the short term, but it is not going to affect anybody immediately. It is a high level, longer-term process. Historians will write about it and will say that those people who voted for Brexit were on the wrong side of history,' Smouha says.

'Will it be catastrophic for our credits? No. I think the UK will continue growing, one will have to live with it. It will have much longer-term implications and that is part of the reason underlying the argument why I think that there should not be a Brexit.'

Smouha has 42.6% of his $1.2 billion (€1.08 billion) GAM Star Credit Opportunities fund allocated to the UK and thinks the international outlook for businesses in his portfolio will offer some protection in the event of Britain leaving the EU.

'Although we have a heavy weighting in the UK, most of those names are global franchises. Aberdeen Asset Management, HSBC, Prudential, Aviva, many of these UK-based companies are top players in the global market. Even if there is a Brexit, they will remain leaders on the global stage.'

While the UK is the main focus of the fund, Smouha has 8.4% of the portfolio allocated to France. French-based names the manager holds include financial services firm BNP Paribas, which is the fifth largest position at 2.7%, as well as other big players in the sector such as AXA.

'We have more familiarity with European names and in many cases the yields and structures are better,' he says.

Sticking with areas he knows best has helped power performance. In the three years to the end of February, Smouha's fund returned 17.91% against a rise of 4.82% by the BofA Merrill Lynch US High Yield BB-B Rated TR benchmark.

BANKING ON INTEREST

Many of the bonds held in his fund are issued by banks. Financials represent the portfolio's largest holding by sector at 79.4%, while banks as a sub-sector make up 46.6% of the fund. Smouha has recently bought more bonds in mortgage lender HBOS, this now totals 2% of the overall portfolio.

'This is a very interesting bond because during the period in which Lloyds was told it was not allowed to pay discretionary coupons, the non-cumulative nature of the coupons only kicked in if the bank was insolvent. Effectively it became known as a "must pay bond", so it always paid its coupons over the years.

'In terms of risk-adjusted returns, we think this is one of the nicest things to have at the moment because of its high yield of 6.9%. Before you had to pay above 100% and had the risk of the call with a slightly lesser yield. Now, if we are called out we actually get a higher yield because we would get paid back at 100% and we paid only 99%,' Smouha says.

The manager thinks that banks have improved significantly since the financial crisis and structural changes in the sector will offer a degree of protection should another shock occur.

'All the banks have strengthened their capital positions. This is a thematic trend mandated by the regulators. If the financial system comes under pressure, there is a much bigger buffer of protection because the capital levels on risk-rated assets are much higher,' he says.

Despite recent losses from banking giants such as Deutsche Bank and Credit Suisse, Smouha remains positive on the outlook for the sector. He says that Deutsche Bank has committed to pay the additional tier-1 capital and is able to do so. He thinks that another global recession is likely to have more of an impact on equity holders rather than bond holders.

'Many of the large universal banks are reshaping their investment activities, so there is a secular change going on. Investors shouldn't be throwing the baby out with the bathwater because times will be good at again.

'The leading players will do well and will make good profits, but it will be from reshaped businesses because governments and regulators are being a lot stricter. We are moving away from the early 2000s when there was a more lax economic environment. This is positive from a credit point of view,' he says.

TAKING INSURANCE

Smouha also has 14.1% of the fund dedicated to insurers, with Australian group QBE Insurance the portfolio's eighth largest holding at 1.9%. Elsewhere, he has been buying more bonds in UK insurance company Prudential. 'This gives a 6.5% yield in certain cases or 7.75% in some callable bonds. We are getting good yields and this is something that we have been adding to over the last month,' he says.

'Big insurance companies are attractive because they have a good franchises, are producing high earnings and are strengthening their solvency ratios. The companies we own such as Prudential, Aviva and AXA, are all highly rated and their bonds give good yields.'

By contrast, Smouha sticks with the consensus that government bonds offer poor yields and their volatility risk is too high, which is why he has only allocated 0.3% of his fund to them.

'We are corporate credit specialists. We are trying to get high yields from high quality companies. Those yields are 6%, whereas in government bonds, I am going to be paid 1.7% for a 10-year bond. I have a cushion of 5% or 6%. It has been very rare that the cushion has been so high. This is an enormous thing. By just sitting on our paper in one year, if we are getting 7% versus 1.5%, we have a 5.5%

carry advantage,' he says. 'We are buy and hold investors, which is why we don't go into government bonds. We look at the long-term interest carry to get our yield. We are not traders or speculators on where government bond rates will be.'

So what else does he look for in a good bond? Smouha says he studies both the credit and equity side of companies. He like firms with good governance and a sustainable business model, as well as factors that come out well in credit analysis, such as interest coverage and a strong balance sheet.

'We are searching for good quality businesses where we would want to own the shares. We don't need to define price because we are debt holders not shareholders. That makes our job easier than that of the equity analysts, where sometimes you can buy a very high quality business, but the share price can go down 20% or 30%.

'We are just looking at the credit, whether we can get paid and they stay in business. We don't mind if the dividend is cut by 50% or 70%, we just want to know that there is a good equity value in the company,' Smouha says.

DIGGING OUT RETURNS

An example of Smouha's shrewd approach to assessing a company's fundamentals is his play on mining group BHP Billiton. The manager predicted the company would change its dividend policy and, while equity investors have been staying away, he has slowly increased his exposure to make it his fund's 10th largest holding at 1.7%.

'We wrote in our December review that the dividend on the equity of BHP was too high and they would have to cut it. What happened next? They said we need to strengthen our balance sheet and we are revising our dividend policy.

'They are managing the business the best that they can. When times are tough, you cut, shrink and batten down the hatches. That is what they have done in revising capital expenditure, reducing the dividend and looking forward. This is what good management does, they want to maintain a very strong balance sheet, they are very highly rated,' he says.

Speaking before Moody's downgraded the company's debt rating from A3 to A1 in March, Smouha said that the resilient nature of the company meant that he would continue to receive a good return on the bonds.

'Even with a downgrade, they still have a very good investment grade rating. The moves that they take now will ensure that once the cycle turns, they can take advantage as they will be one of the stronger players. This is what we like, a top franchise which can capitalise on changes. We are getting a yield of well over 7% on these investment grade securities.'

Smouha's qualified bargain hunting also proved rewarding in recent years.

'In 2011 during the eurozone crisis, there was what I would call a dislocation of prices, where top quality franchises fell to levels which were not justified. Even Lloyds paper slumped to extremely low levels. We stayed with these names and we did very well. Not only getting the carry, but large capital gains,' he says.

This year, Smouha has spotted a similar opportunity, although the rewards are unlikely to be as big.

'This year we haven't had the same systemic crisis as 2011-2012 and we aren't expecting the same sort of returns that we had in 2012-2013.

'However, there has been another mini dislocation in prices and there are buying opportunities, not only for the carry, but also for the probable capital appreciation.'

As well as a keen eye for moments like this, investors can also take comfort from the fact that Smouha has his own capital invested in the fund.

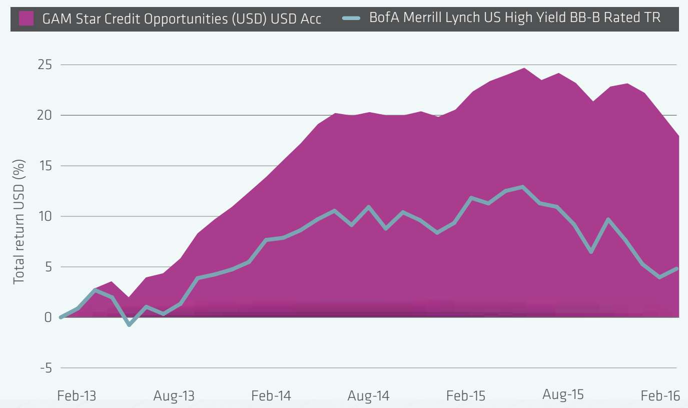
'We think it is a good time to be buying the fund, we have that very fat interest giving us gains. We remain vigilant on the credits, but they are in top quality franchises so we do not have many concerns,' he says.

'We measure the exposures that we have quite carefully. It's our own portfolio, it is our own money and we are very conscious of that.'

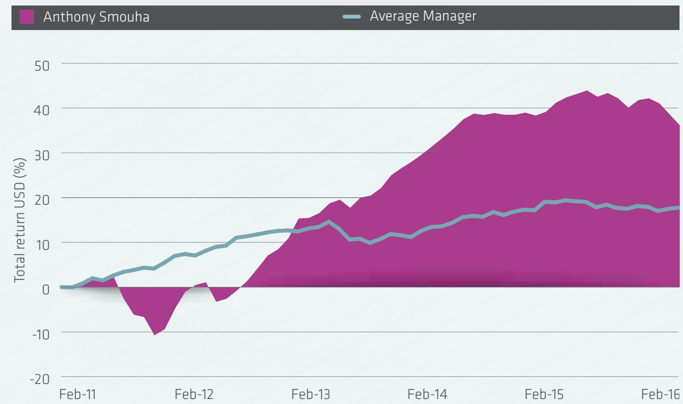
FAMILY TIES

Smouha is CEO of Atlanticomnium and Swiss asset manager GAM acts as distributor for his funds, but there is a strong family connection which also links to the two companies. Smouha's brother Jeremy was a founding member of GAM in 1983 and now works in Atlanticomnium's UK office. Their father, Richard Smouha, founded Atlanticomnium in 1976 and the firm continues to share office space with GAM in London.

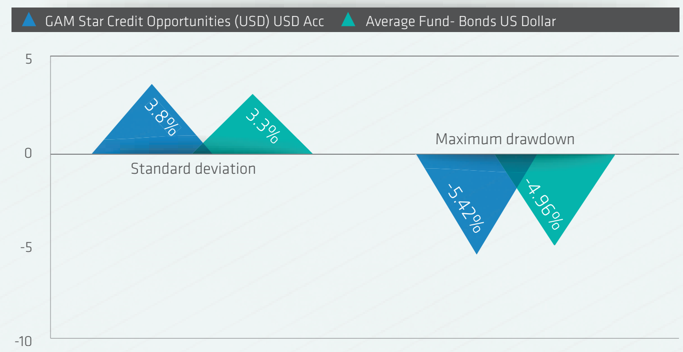
SMOUHA IS WAY ABOVE HIS BENCHMARK OVER 3 YEARS....



...AND HIS 5-YEAR RECORD IS EQUALLY IMPRESSIVE



SMOUHA TAKES A LITTLE MORE RISK THAN HIS AVERAGE PEER



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