

Equities or corporate bonds?

By Tom Stevenson, 14 October 2009

2009 has been a bumper year for credit, will equities take up the running now?

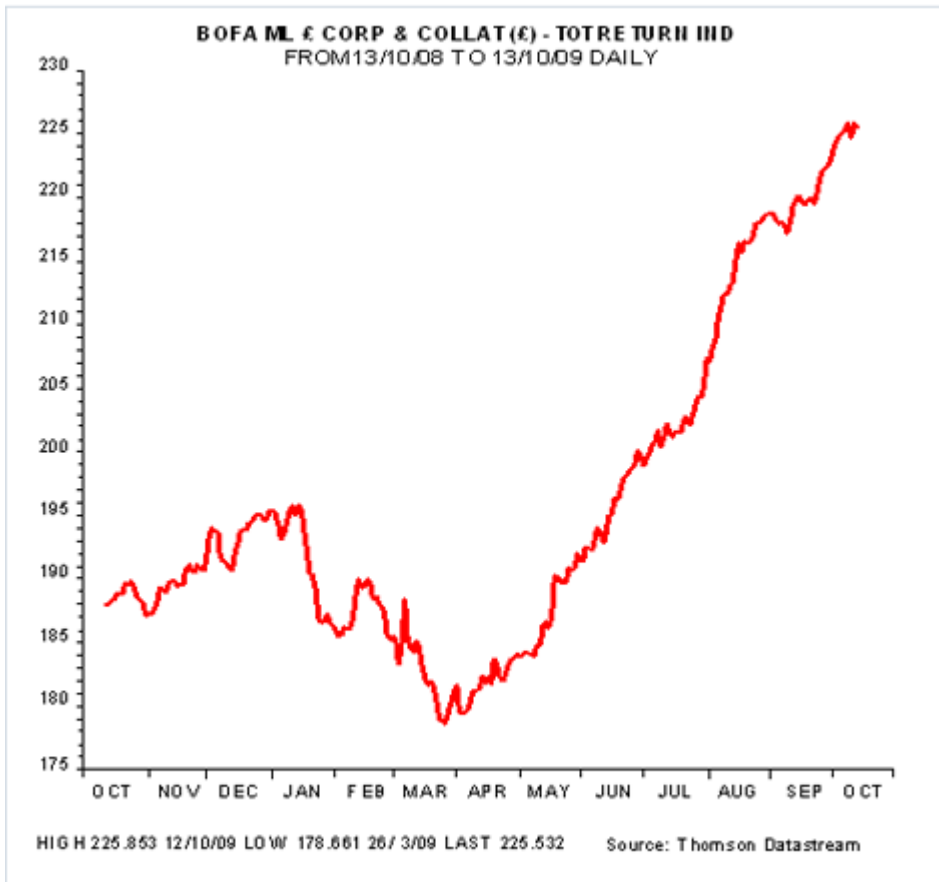
At the beginning of 2009 many pundits were advising investors to buy corporate bonds. At the time, the income available from this kind of company debt was very high by historical standards – in absolute terms and when compared with the income that an investor could pick up from a government bond or, even more so, a cash deposit.

Investment commentators don't always get it right with their end-of-year forecasts. Indeed, a cynic might say that their predictions are a pretty good indication of what not to do in the year ahead. This year, however, they were spot on and corporate bonds have been a fantastic investment. As Morgan Stanley put it in a recent note: "equity like returns with credit-like risks".



"Investment commentators don't always get it right with their end-of-year forecasts." Tom Stevenson

As it became clear that the end of the world was not nigh, and that the levels of corporate bankruptcy implied by bond prices was unlikely to materialise, investors demanded less of a yield premium to invest in bonds. Because the price of a bond moves in the opposite direction to its yield, this resulted in strong capital gains for bondholders as the chart below of the performance of an index of sterling corporate bonds shows.



Corporate bonds, or credit, tend to do better than shares in phases like the one we have just been through in which companies are repairing their balance sheets, perhaps raising money through rights issues to repay their debts. There follows a sweet spot in which both asset classes do well during a full-blooded recovery phase. Then when things heat up again there is a period when equities are still firing on all cylinders but nervous bond investors start to take their money off the table.

Where are we now? Probably somewhere in the middle of that recovery process, the sweet spot, with both assets holding their attractions but equities gaining momentum. Here are four reasons why:

- With the third quarter earnings season upon us, we can expect some good news on corporate profits over the next few weeks. This phase of the cycle tends to favour equities and if things surprise on the upside, which they could easily do if analysts have underestimated the impact of the monetary and fiscal stimulus that has been thrown at the financial crisis, then shares could do relatively well.
- A lot of money has flowed into corporate bond funds this year. Between November 2008 and August 2009, according to the Investment Management Association, the sterling corporate bond sector was the best-selling fund sector in every single month. In August 2009, retail sales of sterling corporate bond and sterling strategic bond funds totalled more than £500m while the next best sector – absolute return – was less than

half as much. It rarely pays to chase a sector that has been so well supported in recent months. As the late Jimmy Goldsmith once said, "when you see a bandwagon it's too late".

- This has driven prices to a level where some analysts believe equities look relatively cheap. A comparison of the yields on offer from both shares and corporate bonds shows that European bonds are yielding only around 1 percentage point more than shares on average. This is very low by historical standards and arguably does not really reflect the fact that a share's dividend income will tend to rise over time while that of a bond is fixed. For this reason, bonds should yield more than equities and the average over the past 10 years, according to Morgan Stanley, is for corporate bonds to yield about two and a half percentage points more than equities. If today's gap were to widen towards the long-run average then shares would outperform bonds.
- Another reason why equities might look better value today is the fact that the recovery in the stock market this year has been led by some of the most cyclical and less robust companies while, for good reason, bond investors have tended to favour businesses with the strongest balance sheets. Overall, there are more good quality companies available at a reasonable price for equity investors than for credit investors. If the market moves back towards rewarding quality then there's more to go for in the share market than the bond market.

The good news is that in today's recovery phase there are good reasons to stay invested in both equities and corporate bonds. But as the cycle matures investors need to think about maintaining the right balance. After a bumper year for bonds that might tilt more towards equities.

Please note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in Tom Stevenson's weekly column are his own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.