SWISS BONDS – OUR PRINCIPLES

Albin Kistler opinion piece
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Bonds have become much more attractive and gained much more attention since the global turnaround in interest rates. Here, we present the principles that we apply when investing in this asset class.

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Equity or debt?

When you boil it down, the investment world is pretty straightforward. Those who have capital can get it circulating in the economic system in one of two ways: by providing equity
or by lending their surplus cash to other market participants.

Of course, the realities get rather more complex than that. The financial industry is constantly expanding the array of seemingly exciting investment products on offer. However, those who do not succumb to the lure of such products will not only avoid unnecessary costs, but will also enjoy a greatly simplified life. This is when your portfolio structure comes down in large part to whether you want to put your money into equity investments (stocks, real estate) or into debt capital (bonds, bank deposits).

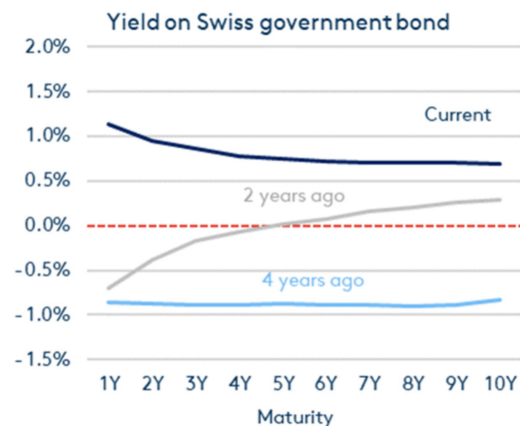
Reversal in interest rate policy

The years leading up to the Covid-19 pandemic were shaped by a global, decade-long process of interest rate easing. This culminated in 2019–2021, when the bond markets were dominated by negative interest rates.

The upshot was that anyone lending their capital had to content themselves with meagre investment income by historical standards. It comes as no surprise, then, that a large majority of investors favoured equities amid this environment. Investments in safe and solid bonds had a real image problem on their hands.

However, the seeming dearth of alternatives to equities came to an abrupt end with the recent rises in inflation and interest rates. Zero or even negative interest rates were consigned to history. Even one of the world's most solid issuers – the Swiss Confederation – has had to start paying its creditors a positive interest rate again.

Fig. 1: The end of negative interest rates



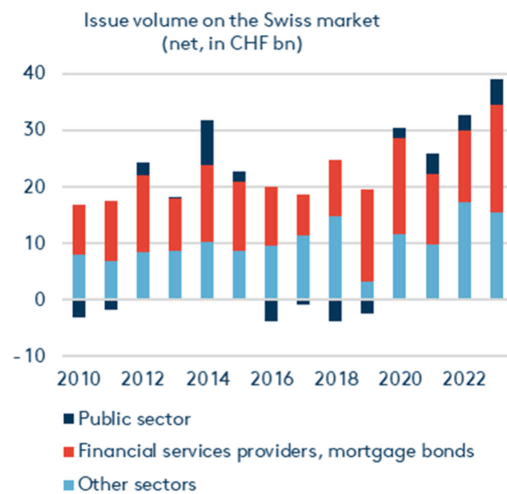
Source: Bloomberg, own presentation

Just as we do when stock picking, we base our actions in the bond markets on firm principles and a commitment to quality. This article will give you a brief insight into the world of bonds and explain the principles that we at Albin Kistler apply when selecting bonds.

How does a bond come into existence?

IPOs and capital increases are a rarity on the Swiss equity market. New bond issues are much more common, which is linked to a core feature of bonds: unlike equities, they have a fixed end date. When they reach this maturity date, the bond falls due and the debt must be repaid. At that point, issuers frequently opt to issue a new bond. The consequence is that the bond market is marked by a steady flow of new securities. Bonds are not just issued by companies; other bodies (governments, cantons, supranational organisations, etc.) also issue bonds to meet their need for capital.

Fig. 2: Steady flow of new bonds



Source: ZKB, own presentation

Fig. 3: Government bonds under stress

Source: Bloomberg, own presentation

Bond selection

We at Albin Kistler firmly believe that investments in established, well-run and financially sound companies are best-equipped to deliver long-term investment success. This goes not just for equities, but for bonds too. We need two things to put this conviction into practice: rigorous company analysis and clear principles for selecting securities. We will explain below three of these core principles forming the basis for the selection and management of bond investments at Albin Kistler:

1) Corporates, not governments

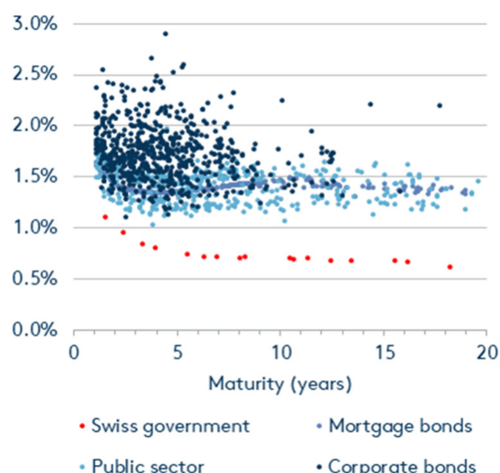
We all remember the euro crisis, when some European countries came under massive pressure because of their high levels of government debt. This translated into huge leaps in the interest rates that these countries had to pay on their borrowing. Ultimately, the then European Central Bank President Mario Draghi had to implicitly guarantee the government bonds concerned with his famous "Whatever it takes" statement of July 2012, to prevent the eurozone from falling apart.

You might imagine that this close shave would have resulted in greater budgetary discipline. That would be a long way wide of the mark. Government debts have instead continued to soar, hitting record high after record high. It would seem utopian to think that budgetary discipline can ever bring this mountain of debt down to reasonable levels. It is inconceivable that public spending cuts on the scale that would be required could win long-term majority support.

The corporate world, by contrast, looks in much better health, primarily thanks to the discipline of market forces. These force companies to take a sustainable, long-term approach to their borrowing. A company that fails to do so loses investors' trust and has to pay a much higher interest rate or, in extreme cases, loses access to borrowing altogether. Unlike states, companies cannot normally count on central banks coming to their aid either – not that a well-managed, financially sound firm would require this anyway. A profitable business model allows managers to be circumspect in their borrowing, meaning that they can easily bear the ongoing interest costs. What is more, the volume of outstanding bonds remains at a sustainable level.

Nevertheless, it is often the case on the bonds markets that even the healthiest companies must pay a higher coupon than heavily indebted countries. There are attractive opportunities here for security-minded investors with a long horizon: those who have faith in the resilience and growth prospects of the corporate world can earn a yield premium over government bonds by opting for bonds from the very best-quality companies.

Fig. 4: Yield premium for corporate bonds



Source: SIX Swiss Exchange, own presentation

2) Proprietary analysis of credit quality

This begs the question of how to identify such high-quality corporate bonds. Many investors rely on the opinions of the big rating agencies, with Moody's, Standard & Poor's and Fitch being the dominant names. These agencies assess the creditworthiness of bond issuers and issue scores in the form of credit ratings. The opinions of the rating agencies have a big influence on many market participants, and as such on prices on the bond markets. These days, it is all but impossible for issuers to borrow on a significant scale without a rating from a major agency.

However, an official credit rating does not come for free: issuers must commission and pay the agencies to produce them. This is not without its problems, as it gives rise to conflicts of interest. The global financial crisis that began in 2007 brought home the very real danger of such conflicts of interest, which have potentially devastating consequences for investors.

The alternative to relying on the official rating agencies is to form one's own opinion. This is the route we take at Albin Kistler: when selecting bonds, we produce our own credit ratings as well as referring to those of the rating agencies. Our ratings are based to a large extent on the same criteria that we use to select and evaluate equities.[1]

[1] You can read more in the studies on "Market leadership" and "Excellent management", which can be found on our website, www.albinkistler.ch.

Carrying out our own creditworthiness analysis brings other benefits besides avoiding conflicts of interest. Small and medium-sized Swiss companies are repeatedly treated with much greater scepticism (or not rated at all) by the official rating agencies. There could be many reasons behind this, but we think that it is rarely justified. On the contrary, Switzerland has many good-quality companies with highly profitable business models and very healthy finances. These companies offer attractive investment opportunities not just via their equities, but via their bonds too.

Fig. 5: Own opinion (examples)

Issuer	Public rating*	Albin Kistler rating	Difference (Notches)
Johnson & Johnson	AAA	A+	-4
Colgate	AA-	A	-5
Lindt & Sprüngli	A+	AA+	+3
Emmi	A-	AA-	+3
Givaudan	BBB+	AA-	+4
Lonza	BBB+	AA-	+4
Barry Callebaut	BBB-	A	+4

*Lowest available rating (S&P, Moody's or ZKB)

Source: Bloomberg, ZKB, own presentation

3) Participation in new issues

When a bond is issued, it is first offered to market participants. The issuer and the bank leading the issue want to ensure that the bond being offered will meet with sufficient investor interest and the new issue will be a success. This can best be achieved by offering an attractive yield relative to the market. This 'new issue premium' is extra interest to reward the first buyers of a bond in what is termed the 'primary market'.

For investors to be able to participate in new issues, they need the in-depth knowledge to evaluate the attractiveness of the offered bonds and they must constantly monitor the bond market. The time window to participate in new issues can often be as short as a few minutes. This means that those who wait until an new issue is announced to perform their analysis will miss out or run the risk of taking poor, overly hasty investment decisions.

By contrast, those that put the work into corporate analysis and monitoring the market will be rewarded with the opportunity to participate in attractive, sought-after new issues.

Conclusion

The recent reversal in monetary policy has brought about a rapid normalisation of the global interest rate environment and has made bonds much more attractive.

This applies also to Switzerland, a currency area with consistently low inflation and interest rates. The structural strengths of the Swiss franc and the fast-growing, healthy corporate landscape should more than make up for the apparent disadvantage of lower nominal yields compared with other bond markets. Bond investors would be well-advised to focus strongly on the Swiss franc and the corporate universe.

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The periodically published studies are available to download in PDF format on the Albin Kistler website: www.albinkistler.ch.