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Finding Fixed Income Opportunities Abroad

Tom Dugan: Hi. I'm Tom Dugan, Associate Director of Fixed Income at Dodge & Cox. With me today is Lucy Johns, a fellow member of our Fixed Income Investment Policy Committee, with a focus on corporate credit and non-U.S. issuers. Hello, Lucy.

Lucy Johns: Hello, Tom.

Tom Dugan: Recently we've made a number of investments in companies and countries from outside the U.S., who issued debt denominated in U.S. dollars. As an example, the Dodge & Cox Income Fund now has 10% weighting in these types of securities versus a mere 2% five years ago. So this is a growing area of focus for us. Today we're going to discuss the nuances of these opportunities and some of the unique risks associated with them and how we seek to mitigate those risks. Lucy, the financial crisis of 2008 and 2009, sent ripples globally, created a lot of financial market and economic uncertainty and volatility and also created a number of interesting fixed income opportunities both in the U.S. and overseas.

Lucy Johns: That's right. And at the same time we've never had better access to international issuers than we do now, given the growth and growing interconnectedness of markets. Just looking at the numbers, today there is over $2 trillion in the debt of international issuers and this is about 37% of the investment grade market so it's a very large piece of the universe that we look at. A couple notable drivers of this growth are the increased amount of issuance we're seeing from emerging market companies, as emerging market countries are becoming a larger part of the global economy. We're also seeing the continued shift where companies are borrowing less from banks and more from the capital markets. And finally, we're seeing a continued interest by issuers to borrow in the U.S. market. It is the largest and deepest market and allows issuers to diversify their sources of funding.

Tom Dugan: Uh-huh. So we're seeing a nice confluence of opportunity and access and, importantly, we feel very well prepared to take advantage of this. Twenty or thirty years ago at Dodge & Cox, as you know, we had only a very limited number of small investments in our fixed income portfolios and equity portfolios in companies that were domiciled outside the U.S. Our increased exposure, experience and comfort with investing outside the U.S. has mirrored the globalization of both economies and markets

And so in 2001, we launched the Dodge & Cox International Stock Fund, which has since grown to over $50 billion in assets. That fund is a shareholder of over 70 non-U.S. companies and between that and the hundreds of other companies that are followed by our team of 28 global industry analysts, that presents us with a wide and broad investment universe to choose from from the fixed income side.

Lucy Johns: That's right. And we supplement that research with our own credit focused analysis on the Fixed Income team.

Tom Dugan: So Lucy, our investment in Naspers might be a good illustration of this.

Lucy Johns: That's right. Naspers is a company that we recently bought in our portfolios in July. It is a multinational internet and media company based in South Africa, and it's a great example of how we leverage that international research team. We have owned the stock of Naspers in our equity portfolio since 2007. We're one of the largest shareholders of Naspers and we know the company extremely well. So when they came to the U.S. new issue market in July, while much of the market was unfamiliar with Naspers, we were willing, ready and able to act given that strong research background. A couple things that we like about Naspers from a credit perspective are its strong pay–TV operating business in Africa. There it has dominant market positions and very strong cash flows. In addition to being a strong operator, Naspers has been a tremendously successful investor, now owning large stakes in Internet companies throughout the emerging markets. And very importantly for debt investors, the value of those stakes is very large at over 35 billion and this dwarfs the size of the debt that Naspers has, which is only 3 billion. So this provides tremendous downside protection.

Tom Dugan: So this sounds like classic Dodge & Cox credit research: deep fundamental understanding of a company, its business and its industry, coupled with real downside risk analysis. What are the unique attributes of doing this kind of work in – for companies domiciled outside the U.S.?

Lucy Johns: Whenever we're thinking about an investment in an international issuer or even thinking about our U.S. companies with a significant exposure, country risk is something that we think about a lot, and whether or not there are factors that could influence the returns of our investments. We have a group that looks at these types of issues. We've built up this expertise in recent years and as part of this process when looking at a country, we do a full macroeconomic assessment of the country, thinking about any potential for tail risk. We look at the durability of the political and legal institutions. In essence, we do a full credit review of the country, just like we do for the company, and pair that – those two types of analysis – together. Now the degree to which we bring in the country analysis or weight the country analysis depends on the relationship of the country with the company.

Tom Dugan: Are there investments in our current portfolios where there's a particularly tight linkage between the sovereign and either the company or the industry?

Lucy Johns: A couple things come to mind. First, I think banks are a strong example. With banks, because of their unique and important role in the economy, they're often very tightly linked to the creditworthiness of the country so we spend a lot of time looking at them there. Another more specific example would be the Export/Import Bank of Korea, which we own. That entity is 100% owned by the Korean Government. It is really a policy tool. So as we were evaluating that opportunity, we spent a lot of time focused on the macroeconomic and geopolitical situation in Korea.

Tom Dugan: And of course sovereign credit research can sometimes yield its own benefits. Just last March we invested in debt from the Kingdom of Spain, which came at a very attractive yield. Our investment thesis there is that the growing commitment and power of the European Central Bank, really makes, the probability of the Euro Zone breaking up considerably lower and that there is a nascent recovery in the Spanish economy. Those two factors and a very attractive valuation make that a compelling opportunity in our mind. So to sum things up, we believe that the interconnectedness of markets and economies is likely to continue going forward, that this is going to continue to generate very interesting fixed income opportunities for us and that we're well prepared from our experience in non-U.S. investing and broadening and deepening out some of the sovereign credit research to take advantage of these opportunities. Thank you for joining me today, Lucy.

Lucy Johns: Pleasure to be here.

Tom Dugan: And thanks for joining us as well.