Dodge & Cox Funds®

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Finding Opportunities in the Credit Markets

Adam Rubinson: Tony, let's talk about what's been happening in the credit markets recently. There's been a lot of issuance and March was the second largest volume month on record in investment grade corporates.

Tony Brekke: Yeah, that's right, Adam. At the same time we've seen volatility creep back into our markets over the course of the last six months or so. The rapid decline in the price of oil has created some issues in the Energy sector. You've seen a lot of economic weakness primarily outside of the U.S. and various geopolitical events are contributing to a much more volatile environment, uncertain environment for investors today relative to the last few years.

Adam Rubinson: Well let's review our current portfolio positioning in credit. Over the first nine months of last year we reduced our credit weighting as yield premiums contracted. In the fourth quarter of last year and in the first quarter of this year we legged back into credit and we saw some nice opportunities to add to our positions in banks and to some energy-related exposures. And as a result of those portfolio actions, at the end of March we had a 15% corporate overweight in the Income Fund versus the Barclay's Index, as well as a 5% weighting in below investment grade securities. And I suppose with that backdrop, it's worth asking how do we feel about credit valuations today.

Tony Brekke: Well, Adam, you know, we still like credit valuations generally speaking. Spreads, you know, the incremental return that an investor can receive for taking on credit risk, remain high relative to historical levels, making the case that credit, from a pure valuation perspective, remains attractive. Now, the other side of that, of course, is the risk you face as a credit investor, and we really view that fundamentals are quite strong still. Cash levels, profitability, and interest coverage are very high at the same time that capital intensity remains quite low. Now, this makes the case for investment grade companies to really have a high ability to meet their fixed charge coverage over the course of time. Now, all that being said, we do remain cautious about total return prospects from credit from this point going forward.

Adam Rubinson: Well that's an important point, Tony. Let's take stock of where we are today. Yields are very low, credit duration has extended and is very long. That means that future changes in interest rates could have a big effect on the total return for credit. As a result, we're very thoughtful about the credits we're putting in the portfolio right now. We rely on our bottom up research process to help us determine whether each credit offers a compelling risk-adjusted total return versus higher quality alternatives. It's also worth pointing out that we rely upon our team of global industry analysts who cover companies from both a debt and equity perspective to help us get comfortable with each credit investment. I guess one thing I also want to point out is that even with this conservative underwriting posture, we're still finding pretty attractive opportunities in the credit markets.

Tony Brekke: Two areas to highlight are acquisition related financing and opportunities associated with the turmoil we've seen recently in the energy markets. You know, historically low interest rates have really generated a large amount of mergers and acquisition activity. A lot of this is being funded through the debt markets. You know, it can be quite attractive to invest in a company at its maximum point of leverage, especially when there's strong strategic rationale for the combination of businesses and a reasonable path to a conservative balance sheet structure going forward. You know, several issuers have recently brought very large debt transactions to the market to fund these deals and we've participated in a couple of those.

Adam Rubinson: A good example is Kinder Morgan, which came to market in November of last year with a $6 billion offering to fund the rollup of its operating subsidiaries. Kinder is the largest natural gas pipeline company in the United States. It has a number of attractive credit qualities. It has a high recurring fee revenue base. It is expertly run by a long term CEO, who's been with the company since 1997 and owns a substantial portion of the stock. And very importantly for us, there's a commitment to maintaining an investment-grade credit rating. All of these factors, combined with a high valuation, led us to find the company an attractive addition to the portfolio.

Tony Brekke: You know, more recently we participated in new debt issuance from Actavis, a specialty pharmaceuticals company that recently issued over $20 billion of capital markets debt to fund an acquisition. You know, we really liked the yield premium on offer but we also liked the commitment made by management to investment grade and the company's ability to follow through on that commitment given its high free cash flow generation and its, you know, multiple sources of downside flexibility, not the smallest of which being a large portfolio of assets that could be sold should it be required to do so. Like Kinder Morgan, Actavis maintained its investment grade ratings notwithstanding a very large amount of debt issuance to fund an M&A transaction.

Adam Rubinson: Beyond the robust new issue market, we've seen a lot of volatility in the oil sector as a result of the decline in oil prices since November of last year. Now, this decline has meaningfully reduced the demand for oil field services at the same time that it has reduced the valuation of global energy resources. The effect in the investment grade energy space has been fairly significant. At the end of June last year, that space had a spread of 108 basis points to Treasuries. That has since widened as of the end of March to 180 basis points.

Tony Brekke: You know, as you know, Adam, most of our Energy sector holdings are related to the national oil companies of Mexico and Brazil, which are majority owned by their respective sovereigns. We've actually increased our exposure by over two times to about five and a half percent as of March 31st, really as a result of spread widening. Now, we've got some pretty strong fundamental views underpinning that credit thesis but it's also important to point out that we believe that both of these governments, Mexico and Brazil, have both the willingness and the ability to support these national oil companies should that be required. I'd also point out that the Income Fund doesn't have any exposure to those oil field services companies that, as you pointed out, have contributed the most to the spread widening in the sector over the course of the last six to nine months.

Adam Rubinson: These areas are quite topical but let's spend a moment talking about our biggest industry concentration, which is the Communications sector. Now the Communications sector is diverse. It includes three major subsectors: telecommunications, cable companies, and media companies. As of the end of the first quarter, the Income Fund maintained a four times overweight to the Communications sector. Now, there were a few reasons for this. We really like the credit fundamentals of these companies. First, they all have moderate leverage profiles, they have high levels of recurring revenue and operating cash flow, and they have limited competition. Let's spend a moment and talk a little bit more about cable.

Tony Brekke: Sure. As you know, the Income Fund has owned positions in Time-Warner Cable, Comcast, and Cox Communications for several years now. There are a number of reasons why we like those holdings and like them quite a lot, many of which you've already touched on. But ultimately, you know, the cable companies have invested in a network that offers an incredibly compelling data and video content offering to their subscriber base with superior network quality relative to what can be offered from their competitors in the Telecommunications space. Each of these companies is managed with a reasonable leverage profile and in our view, you know, this sector provides really long term asset value, great cash flow generation, and there's staying power there in a variety of different outcomes.

Adam Rubinson: Well we have a similar conviction about our Telecom exposure. In the United States, we have large positions of both AT&T and Verizon, who are the market leaders in wireless telephony. Now, it's important to point out that both of those companies have to spend more on maintaining and building out their networks than the cable companies do presently. In fact, just recently AT&T and Verizon spent a collective $30 billion to purchase additional spectrum, which will increase both the breadth and the depth of their networks nationally. We feel comfortable with those purchases, however, because that increases the deep moat around these market-leading franchises, even though it had the effect of increasing their leverage.

Tony Brekke: The Income Fund's holdings in the Communications sector really serve as a good example of how we view credit across the portfolio. The securities issued by these companies are priced at a very attractive valuation relative to alternatives. The companies themselves have incredibly strong franchises. The management teams maintain reasonable leverage profiles and have compelling reasons to maintain those leverage profiles. And the companies have the ability to survive a severe downside case scenario.

Adam Rubinson: One of the key risks today is the threat of increasing leverage of corporations. The combination of very low rates and high M&A activity is really giving corporate management teams the ability to increase leverage at relatively low cost and increase shareholder return. This risk is being exacerbated by the high presence of shareholder activists in some very large companies that we monitor. Typically, shareholder activists look for accelerated and high levels of shareholder return. Typically this takes the form of high dividends, an accelerated share repurchase program, or sometimes even spinoffs. Therefore, we're subjecting our portfolio to continuous review to ascertain whether management is subject to these pressures and what they're likely to do about it.

Tony Brekke: These are all really important points, Adam, but I do think it's worth pointing out that most of the M&A that's taken place over the last year or so has resulted in investment-grade ratings at the target company. Now this is a big departure from the last robust credit cycle that we saw back in 2007, when over half of the acquisition activity that occurred took the form of leveraged buyouts. We of course continue to closely monitor all of the holdings in the Income Fund for this risk but we're comfortable at this point that this risk is limited in the portfolio.

Adam Rubinson: On a more fundamental level, it's very important that all of our credit investments be capable of surviving a meaningful downside case scenario, as you mentioned earlier. As in our Equity portfolio, we invest for a three- to five-year timeframe and it's important that all of our investments be able to service their debt even with a combination of negative operational, financial, and liquidity developments. To get to that level of comfort, we work with our team of global industry analysts to create a nuanced and customized set of assumptions and projections for each company in the portfolio. So let's sum up some of the key takeaways from today's talk. We believe that credit investments offer attractive relative value opportunities compared to other fixed income asset classes, due to strong underlying fundamentals and reasonable valuations.

Tony Brekke: Well, and that's really something that underlies everything we do here at Dodge & Cox.

Adam Rubinson: That's right. Well thank you very much for joining me today, Tony.

Tony Brekke: Thank you Adam.