

Taking stock of 25 years of fixed income management Paper | October 2016



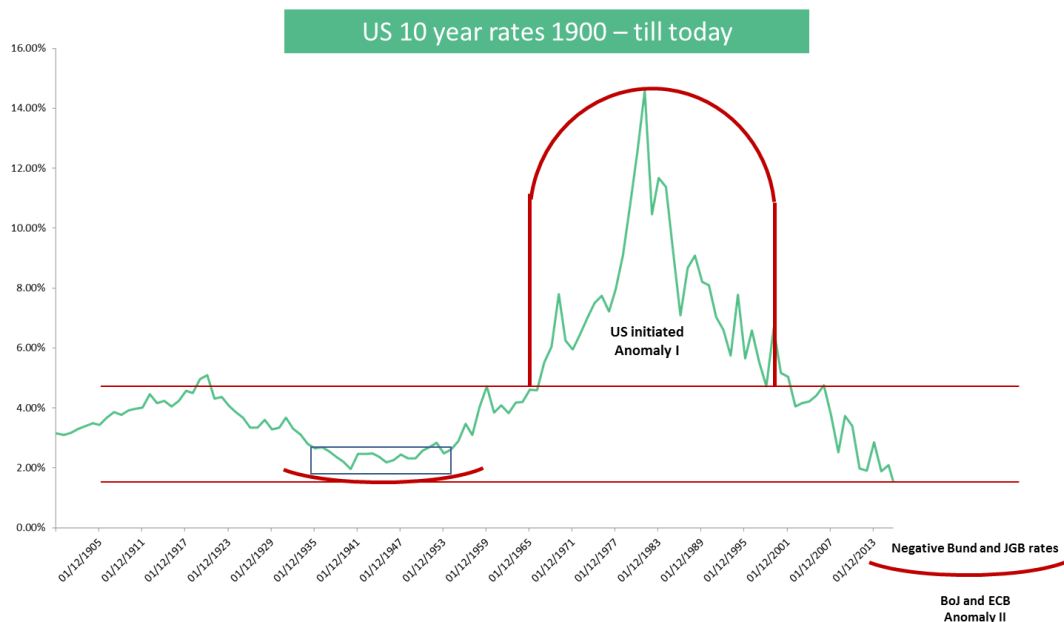
THOUGHTS AND VISIONS BY PETER DE COENSEL, CIO FIXED INCOME

I started working in financial markets exactly twenty-five years ago as a market maker in Belgian government bonds. At that time, the reference 10 year Bund stood at 8.30% and 10 year US Treasuries at 7.50%. Bond investing has been very rewarding over such a long period. Between 1995 and today European Government Bonds returned 5.55% annually.

LOOKING BACK

In the next paragraphs we will zoom in on this prosperous period for fixed income. We will describe the conditions that allowed for healthy bond returns as well as the extent to which these conditions have changed in markets today? We weigh overall future success factors of unconstrained bond strategies and finish with the specific drivers of performance for the Bond Universalis Unconstrained fund.

Looking back over the past 116 years we can make the assessment that at the end of 1981 with 10 year US rates at a 15.15 % high and German rates at a 9.85% high we witnessed an aberration or anomaly. Over this extended period US 10 year rates traded between 1.5% and 4.5% two thirds of the time i.e. during 75 out of the 118 yearly observations.



DIFFERENT CONSTELLATION

In retrospect it was comparable with equity valuation at the turn of the millennium just before an aggressive bear market ensued. Back in 1981 it was a long term bond bull market that took off. At the end of 2016 the constellation could not be more different with 10 year rates at -12bp in Germany, -10bp in Japan and – 57bp in Switzerland we are in the midst of a second aberration or anomaly.

Taking stock of 25 years of fixed income management Paper | October 2016

The questions we raise:

1. *How persistent is this low rates anomaly?*
2. *Is unconstrained bond investing part of the solution?*
3. *How has the Universalis Unconstrained fund coped over the years?*
4. *What is our current portfolio construction telling you?*

The first point will be addressed by comparing past with future monetary policy conduct.

Points 2 to 4 will be answered alongside four parameters that influence bond valuations and portfolio construction:

- Liquidity conditions
- Regulatory influence
- Volatility conditions
- Fixed income opportunity set

1. HOW PERSISTENT IS THIS LOW RATES ANOMALY?

The persistency is related to the level of commitment to conduct **optimal and transparent** monetary policies by G7 central banks. As soon as we passed the Great Financial Crisis (GFC) bond markets have been leading central banks in the assessment that an excessively indebted developed world would be deflationary on behalf of productivity, prices and potential growth rates. This has correctly been expressed by a continuous fall in rates, at times exacerbated or interrupted by the quality of implementation of QE programs.

Over the past year central banks have departed step by step from the belief that the **unique steady-state** narrative that aspires to reset towards macro-economic averages of the past: pushing output growth above trend, forcing unemployment rates towards historic levels, communicating on willingness to push inflation at or slightly above 2%. This narrative is summarized through the infamous Fed dot plots that have been continuously far above the policy rates expected by market participants. The above thinking on monetary policy is outdated.

The narrative becomes fixated on **regimes**. Monetary policy will be optimized against the background of a certain regime. The current regime we go through in developed markets is one of:

- low productivity growth
- low real rate regime
- low recession probability or prudent but steady business cycle

It is up to the financial market participant to assess the risks of a regime shift. Within the US, as long as we do not see inflation surprises (due to wage pressure), an increase in recession probabilities or upward pressure on real rates we will be stuck with accommodative or dovish FED monetary policy. The US Treasury yield curve will experience very little volatility with short, medium and long term rates anchored around current levels for long. The BoJ's decision to control not only the short end but the long end of yield curves as well points in the same direction. This will impact international capital flows and will reinforce the above condition.

If we would observe a rise in US recession probabilities the US Treasury curve will flatten and steer 10 and 30 year US Treasury rates even lower than the current 1.60% and 2.30% levels.

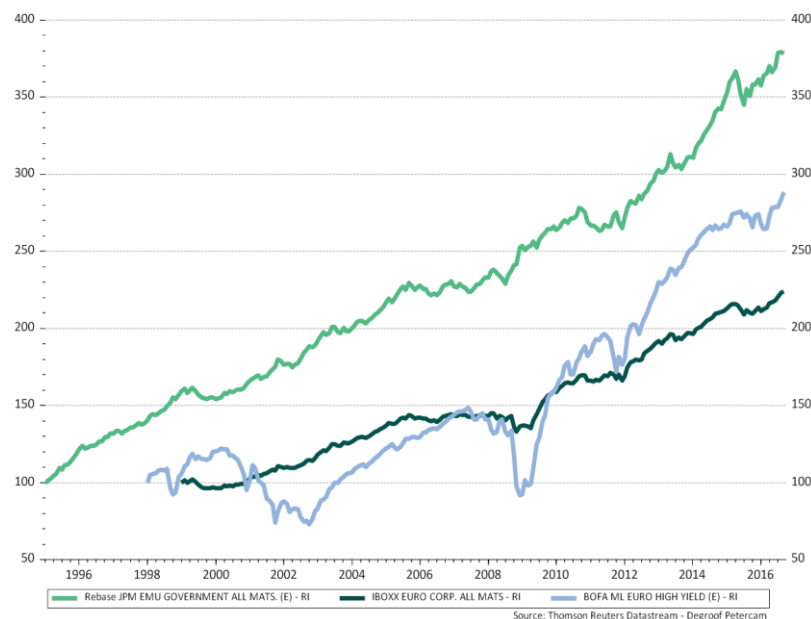
Taking stock of 25 years of fixed income management Paper | October 2016

Yield curves for the EU and Japan draw a somehow different picture. The aggressiveness of QE programs and negative interest rate policies have put these curves for 80% to 90% in negative territory. That releases stress onto EU banking and insurance businesses.

The BoJ and the ECB need to focus more on the health of the financial industry at large as they represent the credit channel par excellence in these regions. As such, the ECB should stop implementing the current QE program based on capital key, GDP weights of countries within the Eurozone. The ECB should adopt a *higher degree of flexibility* and *prevent scarcity issues*. That would propel faster convergence across EMU yield curves and go hand in hand with upside normalisation of the Bund reference curve. Under stable monetary policy conditions (deposit rate at -40bp, Refi at 0%) 10 year bunds would slowly grind towards a healthier 25bp to 50bp range over three years.

2. IS UNCONSTRAINED BOND INVESTING PART OF THE SOLUTION?

Honesty obliges us to say that over the past twenty-five years **constrained** or **benchmarked** bond strategies have been the overall winners. Long duration government bonds solutions have beaten all other fixed income sectors on a risk adjusted basis. No photo finish needed:



However, revisiting the above graph learns us that, in order to protect and grow capital, continued exclusive investments in the winners over the past twenty-five years will become problematic as buying into negative rate territory will turn bond investors into subsidizers of governments & strong corporates alike instead of receivers of coupon income. If current valuations in rates and IG credit persist, institutional and retail investors are advised to reassess their overall fixed income allocation.

What are the success factors in this journey ?

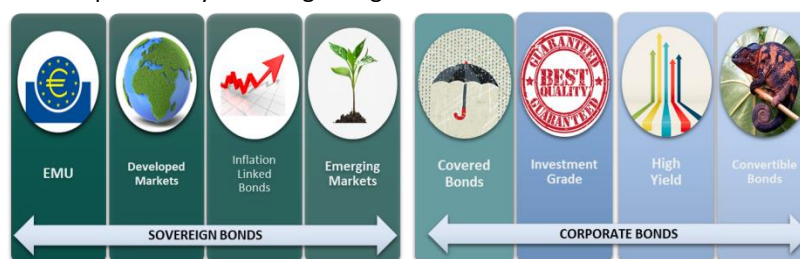
- I. In order to construct promising fixed income portfolios investors are invited to go global. Bond markets were more or less bipolar before the 2008 GFC and dominated by the US and EU bond universe. Today, sell-side bond operations have nearly equal focus on DM vs. EM markets.

Taking stock of 25 years of fixed income management Paper | October 2016

These multi region bond teams offer good liquidity, however, at times of stress this provisioning can quickly dissipate. The situation cannot be compared to the past when liquidity was abundant as market makers ran deep trading books, for proprietary reasons as well as to service institutional and retail clients. Investors who thus seek access to a global opportunity set have to pass through professional investment managers.

- II. Around 70% of liquid and transferrable fixed income assets are still located in Government Bonds and IG credit. In government bonds a colourful pallet opens up through nominal vs inflation linked issues, DM vs EM issuers. In IG credit we source value in financials (covered bonds, senior unsecured, Bank T2, Insurance paper and REITS issues) vs. non-financials.

We track and analyse EM corporates in the same way as we weigh the quality of DM corporates. We introduce an 'equity like component' by investing in High Yield as well as Convertible bonds.



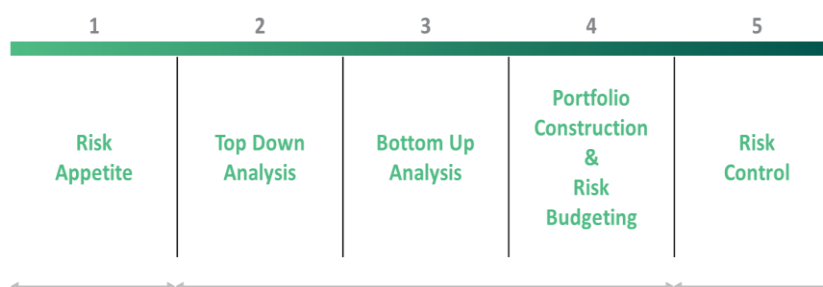
- III. Beyond our **flexibility** across fixed income sectors, we introduce exposure to non-Euro currencies in order to increase diversification & risk control as well as entering an all-important return contributor to the equation.

The opportunity set across fixed sectors has improved a lot over the past 7 years. Emerging markets witnessed a steep learning curve in local currency government bond issuance and trading. EM corporates followed suit.

From a bipolar condition we passed into a multipolar fixed income space. ***Investors should not be afraid, but embrace this development.***

3. HOW DID THE BONDS UNIVERSALIS UNCONSTRAINED FARE IN THE PAST?

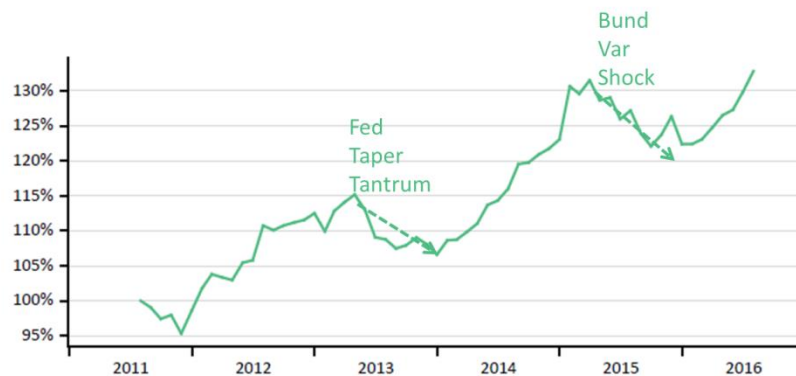
The fund was launched in 1984. Since inception the fund has been managed without any benchmark consideration. I took over as lead manager amidst the GFC in January 2009. The investment process got reinforced by the introduction of strict risk guidelines. Our investment process combines a top down assessment of economic and financial conditions with a, credit analyst approved, bottom up security selection.



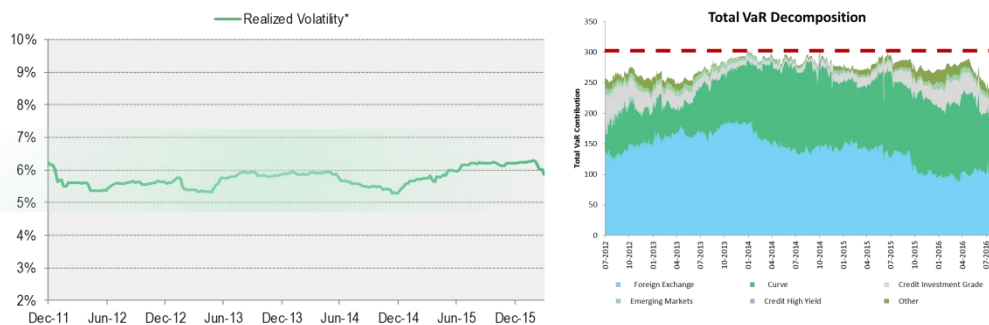
Taking stock of 25 years of fixed income management Paper | October 2016

In order to increase robustness when passing higher market volatility regimes plain vanilla rate and credit derivatives are used to dampen fund volatility. That allows for higher resistance to rate shocks and/or periods of heightened credit stress. Below we find the cumulative performance of the Bonds Universalis fund (institutional class) over the past five years.

The average net annual return between September 2011 and 2016 stands at 6.50%. Adjusted for volatility the fund positions in the very top of the 1st quartile of genuine unconstrained peers.



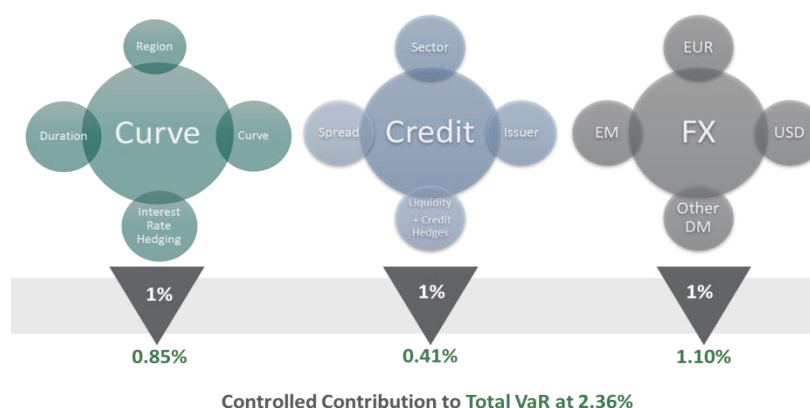
A consistent application of the investment process is key in recovering from short or at times longer drawdown periods. On a daily basis, monthly VaR is monitored across rates, curve, spread, FX and liquidity risk factors. We deliver value within a realized volatility range between 5% and 7% over a 3 year rolling horizon. Ex-ante we do not exceed a 3.00% monthly VaR budget. We track and manage against above Barclays Point modelled risk factors.



4. WHAT IS OUR CURRENT PORTFOLIO CONSTRUCTION TELLING YOU?

Investors own or can buy a high quality, average single A, bond portfolio that yields 1.85%. We adopt a conservative interest rate sensitivity by hedging away rate risk by shorting 10 year German and Japanese bond futures. Our duration risk measures 3.04% end of September 2016. **Monthly VaR runs at 2.36% at the 90% confidence threshold.** That provides investors with a sensible estimate indicating that he can expect that 1 month out of 12 the fund NAV might go up or down 2.36% in value.

Taking stock of 25 years of fixed income management Paper | October 2016



Exposure to government bonds sits at 24.5%, composed of 15% inflation linked (10% US TIPS, 5% Spanish and Italian linkers) and 9.5% nominal government paper (6.1% US Treasuries, 0.6% New Zealand, 2.8% Brazil). Over past months we doubled our exposure to inflation linked bonds. Central banks effectively become more aggressive in their guidance for inflation. We want to be prepared for the moment that inflation expectations by markets converge towards these required by central banks but also these received through consumer surveys. Consumers have a sense of higher current inflation compared to market based inflation expectations. US TIPS are favoured.

Financial credit accounts for 28%:

- Senior unsecured: 9.80%
- Bank T2: 9.90%
- REITS: 4.60%
- Insurance Sub: 2.60%
- Auto: 1.10%

Given increased regulatory scrutiny, we see long term value in attractively priced Senior unsecured bank credit. Before 2009, financial institutions enjoyed a free pass when it came to regulatory scrutiny. Non-financials adopted more conservative balance sheet management after the telecom credit crisis of 2001. We claim that roles have switched: financials will start to lead given better capitalization versus non-financials. Non-financials issuers are invited by central banks to engineer their balance sheets and take on more leverage. We favour US and Swiss financial institutions on Senior level (6.5% vs 3.3% EU). Exposure to bank T2 is diversified across market leaders in the region (KBC, Argenta Bank, ING, Rabo, ABN Amro and BNPP). Internationally we carry value in Standard Chartered and Wells Fargo T2 debt.

Our strong credit coverage of REITS assembles investments across Vonovia, Prologis, Unibail and Aroundtown Properties. Through NN group, Axa, Allianz and Swiss Re we clip quality coupon income out of the Subordinated Insurance sector.

Non-financial credit represents 45% of the fund:

- Low beta corporates: 34.6%
- High beta corporates: 6.30%
- EM corporates: 2.75%
- Convertibles: 1.30%

Taking stock of 25 years of fixed income management Paper | October 2016

In the course of 2016 we adopted a tilt in favour of European IG credit. Partial profit was taken on US IG credit and reinvested in TIPS (see above). In the high beta corporates category we find corporate hybrid bonds from EdF, Engie and Total. During the year we reduced our exposure to EM corporates from 6.5% to 2.75%. Anglogold Ashanti is our top pick. Companies that run a clear business strategy and exhibit a good balance between equity and convertible capital providers reach our interest. Ingenico and Bekaert convertibles possess those features.

Our choice of currency exposures reveals a distinct conviction. The EUR and USD pair dominates our fund for 52.5% and 40.5% respectively. During 2015 we took this road as smaller currencies might be negatively impacted by beggar thy neighbour central bank policies. **SEK, NOK, AUD, CHF, GBP all fall into this category.** As long as the Fed, the ECB and the BoJ balance out each other and refrain from currency war language we are wary that smaller CB's might experiment more, not less, and get away with stealth currency devaluation. The 40% USD allocation leans against the high USD duration contribution. If US long rates would, against our expectation, **adjust to the upside aggressively** we should be protected by a strengthening dollar.

Apart from EUR and USD, we add some BRL and ZAR exposure to the mix. Fundamentally, but also bond technically, these exposures add correct risk/adjusted carry.

CONCLUSION

Our portfolio construction includes a credit tail risk hedge and acts as an insurance contract for unexpected credit stress. Through a long protection Itraxx Crossover position we want to sacrifice some returns in order to cruise through credit storms. When equity sell-offs occur or idiosyncratic events within specific sectors and/or names impact credit markets negatively, we can remain focused and calm. This credit hedge served us well during risk-off markets between Q4 2015 and Q1 2016.

In general we believe that financial markets might be gentle to those who are prepared. The Bond Universalis has a proven track record in this respect. We welcome investors that believe in the value of exposure to a diversified global UCITS regulated bond fund and the value of a consistent and robust investment process.

Taking stock of 25 years of fixed income management Paper | October 2016

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