For professional investors - **JUNE 2014**

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PERSPECTIVES

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BNPP IP is the source for all data in this document as at end of May 2014, unless otherwise specified.

Promising a lot, delivering even more

In the run-up to the ECB's policy meeting on 5 June, there was some concern that having expressed worries about the risks of a "pernicious negative spiral" of low inflation and a strong euro, that the ECB's package of measures would fail to meet the market's expectations. The immediate positive reaction after the announcement showed markets were positively surprised and that the subsequent decline should be viewed as normal profit taking rather than a sign of scepticism. One important indicator will be the take-up of the targeted long-term refinancing operation (TLTRO) by banks. This is a 'pull' strategy with liquidity being injected to the extent that credit demand picks up, so the ECB has less traction. Quantitative easing (QE) on the other hand is a 'push' strategy: the central bank's asset purchases determine the amount of liquidity to be injected. QE is, at least for the time being, a bridge too far for the ECB, although Mario Draghi did keep open the possibility of even that bridge being one day crossed. In the meantime, another bridge is being built by the decision to step up the efforts of creating a genuine euro-ABS market with the purpose of allowing QE of ABS paper. From a structural perspective, this is also an important step considering the need to improve monetary transmission in the eurozone where capital-market based financing will, in the future, play a bigger role.

The ECB's messages are clear: inflation will stay low and below their policy objective for quite some time; policy rates will stay low for years to come; if need be the ECB can do more but let's see first how this works. The investment implications are equally clear: eurozone bond and equity markets should be supported by these decisions. What is also clear is that for several months to come the ECB will now monitor the effects of its decisions implying that policy is now on hold.

6 June 2014

William De Vijlder
Vice-Chairman of BNPP IP

Joost van Leenders
Chief economist, Multi Asset Solutions team - BNPP IP, Amsterdam

Will the climate remain benign?

After a brief correction in January, equities, real estate and commodities have all rallied so far this year, while bond yields have fallen, most strongly in 'peripheral' eurozone economies. At this point, we do not see any strong signs that this benign investment climate could change soon, although we remain alert.

What do you see as the main factor for the benign investment climate?

I think monetary policy still plays a major role. The US Federal Reserve is steadily tapering its asset purchases. After some market unrest when the plans were first mentioned and when tapering actually started, there have been no further ripples. Although emerging equities are still lagging developed equities, they have done relatively well lately. Emerging currencies, which had suffered from the tapering talk, have also been less volatile. I expect the 'warm blanket' of monetary policy to remain in place for a while. The consensus view is now that the Fed will start hiking rates in the second quarter of next year, but will do so gradually with rates not rising as much as they typically have in previous cycles. The ECB is perceived to be about to resort to more stimulative reflationary measures. It is likely that the ECB keeps official rates on hold for a long time or that policy is loosened even further. The Bank of Japan (BoJ) has signalled that calls for additional quantitative easing are premature, but it may be too optimistic on the economic outlook. The People's Bank of China (PBoC) has implemented easing measures and while current inflation would allow it to do more, this looks unlikely since the PBoC is trying to slow credit growth.

Is it just about monetary policy?

No, I think the positive mood on markets is also due to yields being low (because inflation is low). This should not change in the eurozone. The return of Japanese inflation might not last. If inflation in Japan does turn up more decisively and yields follow, we think the BoJ will have no choice but to buy more bonds to keep the cost of servicing government debt manageable. The US is now in a strong rebound from the weak first quarter. The ISM manufacturing index, consumer confidence and capital goods orders have all improved. The labour market is doing well. Growth could slip in the second half, but this is not bothering markets now. If there is one positive aspect from the large slack in the European economy, it is that it can grow for a long time before reaching capacity constraints. Trade has done well and improving PMIs and consumer confidence could indicate that growth is broadening. There are signs of improvement in emerging markets such as a stronger PMI in China and stronger export growth in some cyclical Asian economies, but these signs are still meagre.

"For now, the growth outlook and monetary policy should support markets, but we are watchful."

Isn't it getting uncomfortable to be overweight equities after such a strong rally?

We have not changed our overweight in equities, although our conviction has deteriorated somewhat given the rich valuations in the US, lacklustre growth in the eurozone and the cooling housing market in China. For now, the growth outlook and monetary policy should support markets, but we are watchful. I think it is still too early for an overweight in emerging equities. While growth is stabilising and possibly improving, this is not widespread. Earnings growth is still low. But the improvements were enough for us to overweight emerging market bonds in local currency. They provide positive carry while the downside risks to growth are diminishing.

Written on 2 June 2014

Andrew Craig
Head of Financial Market Analysis, BNPP IP, Paris

Inflation falls out of bed in the eurozone

Inflation rates have fallen significantly in the eurozone this year and led the ECB to announce, on 5 June, a packet of measures to head off deflationary threats. The jury is now out on how effective these measures will be.

On 2 June came the news that headline inflation rates in the eurozone had fallen to 0.5% (down from 0.7% in April). This extended a fall that began last November with inflation remaining below 1% since. This level of inflation raises doubts about the credibility of the ECB's target for eurozone inflation of close to but below 2%.

On 5 June, Mario Draghi, President of the ECB, announced a series of measures aimed at countering falling inflation rates but also made a remarkable downgrade in the central bank's inflation forecast. The ECB's new projections show inflation is expected to remain well below its target up to the end of 2016, with a downgrade in the forecast from 1.7% to 1.5%. An inflation rate this low aggravates the task of reducing debt burdens and improving competitiveness across the eurozone.

"The ECB's new projections show inflation is expected to remain well below its target up to the end of 2016."

In light of the current situation, it is worth clarifying the different types of situation that can occur when prices fall in an economy, so as to differentiate between the extreme and more benign outcomes:

Chronic or malign deflation is the bogeyman that keeps central bankers awake at night. A deflationary 'death spiral', is characterised by a fall in the general price level and aggregate demand. This is the situation that the US found itself in between 1929 and 1933. During the Great Depression, consumer prices fell by a quarter, real gross domestic product dropped 30% and the unemployment rate rose to about 25%.

Benign deflation is different. In Japan it has been harmless (some would argue even beneficial - Japan's relatively slow growth in recent years being the result of demography not deflation). Prices remain fairly static and fall occasionally in a healthy economy, but modest wage increases sustain consumer spending and economic growth.

Price adjustment constitutes a third scenario of falling prices. Under this scenario prices readjust downward for a short period. Crucially, the period of falling prices neither becomes ingrained nor leads consumers to reckon with consistently falling prices.

Lowflation is a new term recently[1] coined by Christine Lagarde, managing director of the International Monetary Fund (IMF). Reading between the lines, it would appear that 'lowflation' is a crafty term designed to assist the IMF in implicitly making the case for raising inflation targets above 2%, which is the established target in most developed countries. Experience has taught the IMF that this is a highly sensitive subject that needs to be handled with great care. In 2010, Olivier Blanchard, the IMF's chief economist, broached the idea that central banks should target an inflation rate of 4% in order to ensure that they have scope to cut interest rates during more difficult times. This recommendation was partly based on analysis by the IMF of the Japanese experience, where the policy rate reached zero in the mid-1990s which was followed by a lost decade. However, Blanchard did not get much chance to explain his rational – the idea that an inflation rate of 4% could constitute a policy target for central banks went down like a lead balloon with more orthodox policymakers. Their thinking having been based on the idea that low or zero inflation was the appropriate long-run goal for monetary policy.

Now that continental Europe finds itself in a **lowflationary environment** it would appear that policymakers may be better placed to recognise the potential benefits of moderate inflation. In particular, the combination of a steady rate of inflation with low interest rates would create an environment of negative real interest rates and, over time, reduce debt burdens.

"Are we finished?" asked Mr Draghi, rhetorically, during his news conference on 5 June. "The answer is no. If need be, we aren't finished here." The question now is whether the ECB can get back ahead of the curve having appeared to have fallen distinctly behind it.

1 Christine Lagarde, in a speech on 2 April 2014 ahead of the IMF's spring meetings. See also http://blog-imfdirect.imf.org/2014/03/04/euro-area-deflation-versus-lowflation/

Anand Shah
Chief investment officer, BNP Paribas Investment Partners India, Mumbai

The implications of India's election: an inside view

In last year's turmoil over the US tapering plans, India was labelled as one of the 'fragile five' emerging markets. Now, with the equity market rallying and the country having just completed a general election, Anand Shah, CIO of BNP Paribas Investment Partners (BNPP IP) India in Mumbai, provides a timely inside view on what to expect from the new government, and the implications for investors.

How would you summarise the outcome of the election and the economic context in which it took place?

The Bharatiya Janata Party (BJP) and National Democratic Alliance (NDA) coalition, led by Narendra Modi, chief minister of one of India's most prosperous and progressive states, Gujarat, won 337 out of the 544 seats in the Lower House, giving it the most decisive mandate in 30 years. The election took place as India faced stagflation: annual GDP growth has fallen from a sustained 8%-9% to 4.5% and inflation is around 8%-10%. The recovery since the financial crisis has seen huge fiscal and monetary stimulus, most of it spent on subsidies, entitlements and lower taxes. This has in essence led to a jobless recovery: between 2005 and 2010, India saw a net 1.1% fall in jobs.

What are the new government's priorities likely to be?

Its immediate priorities will be to control inflation and the fiscal deficit, and to invest in creating jobs. Food-price inflation – core to inflation overall – is largely due to distribution-chain bottlenecks, so investment is needed here. Key agricultural policies need changing too. We think the initial target will be to reduce inflation to 6%. The fiscal deficit needs firm management and both Mr Modi and the NDA have good track records on that. Mr Modi should benefit from the previous government having already taken difficult decisions to reduce the deficit and subsidies, so we do not expect the new government to try to quickly kick-start the economy via new monetary and fiscal policies.

In Gujarat, Mr Modi showed he knows that sustained growth is based on job creation. The focus will likely be on developing skills and boosting capital expenditure in labour-intensive industries such as textiles and tourism. In India's metals industries, for example, where capacity utilisation is not an issue, investment should yield a high return on equity (ROE) and return on investment (ROI), so this could quickly attract much of the capital that India now lacks in this sector. Investment is also needed to support the construction of 100 smart cities, urban transport and the completion of the national gas grid.

If the government starts to get things right, which equity sectors do you see as benefiting most?

We believe consumer non-durables can continue to do well, although market valuations have so far remained quite rich. Financials have great potential because the penetration level remains low. State-owned banks have been losing market share over the past decade to private banks and we believe this will continue. India has well-respected export companies. In IT, product quality is generally very good and we see growth continuing to benefit from the global recovery. The ROE is high in the pharmaceutical sector since costs are typically low and margins are very high. Among the cyclical sectors, we see a lot of benefits arising from near and long-term investment in infrastructure.

> "We do not expect the new government to try to quickly kick-start the economy via new monetary and fiscal policies"

And your overall outlook for the Indian equity market?

While foreign investors have participated in the recent market rally, the key to further gains will be domestic investors playing a greater role. This has already started to happen. India has much potential for faster growth, which could significantly boost the stock market. Furthermore, central bank credibility is generally strong with international investors. Among emerging markets, India has one of the most promising sets of fundamentals, making it very much a market to follow in the coming months and years, in our view.

Adeline Ng
Head of Asian fixed income, BNP Paribas Investment Partners Singapore

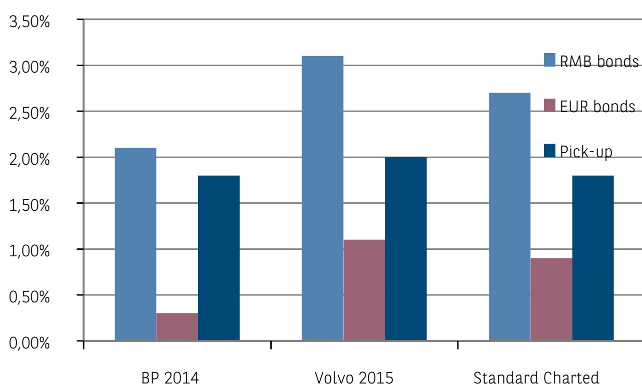
Shorter maturity renminbi bonds have more to offer

A renminbi short-duration bond strategy can offer investors a powerful blend of yields higher than those on comparable fixed-income issues, potential currency gains and diversification benefits, argues Adeline Ng, head of Asian fixed income. It provides access to an asset class suitable for investors concerned about the possible fallout from tightening US monetary policy.

Looking at yields, short-dated offshore renminbi bonds can offer investors an additional 150bp-200bp relative to similarly-rated government bonds from major markets such as the US, Japan, the UK and Germany. Corporate issues can offer a similar yield pick-up relative to bonds from the same issuer in other currencies. Usually, investors have to accept a lower credit quality or opt for a longer duration in return for a higher yield, but in the case of offshore renminbi bonds, about 85% are investment-grade, they generally have a short-duration profile and they still offer a yield pick-up.

We believe that being positioned in shorter maturities is a good way to reduce risk in a rising interest-rate environment, as such bonds should be less rate-sensitive than long-dated issues. Also, this market is fairly insensitive to external influences, as is clear from the historically low correlation with foreign monetary policy. The tightening of the US Federal Reserve's monetary policy has had little effect on rates in this market. This insensitivity reduces interest-rate risk and can be seen as a further cushion for investors should volatility rise.

Exhibit 1: Offshore RMB corporate bonds can offer an attractive yield pick-up versus EUR-denominated bonds



Source: Bloomberg, March 2014
Note: the securities mentioned are for illustrative purposes only; this does not constitute a recommendation to buy or sell.

As for credit risk, we use an in-house credit scoring model to assign ratings to issuers and make in-depth industry and company evaluations ourselves. Our robust, informed approach has meant we have not experienced a default event in any of our Asian strategies since we started covering hard and local currency Asian bonds, including Chinese issues, in 2002.

> "A strong presence on the ground gives us a great edge over competitors in covering local corporate credits"

Since the renminbi short-duration bond universe includes Asian and global issuers, a strong presence on the ground gives us a great edge over competitors in covering local corporate credits, while for global issuers, we can draw on our London, Paris and New York-based credit teams.

Our experience and resources help us to assess current investor concerns about a real-estate bubble in China bursting and the implications that – and any resulting bond defaults – would have for the economy, in particular for the highly-exposed financial sector.

Research and monitoring are key to evaluating any risks, but investors in this market should also ensure that they are adequately compensated in terms of valuation and diversify their exposure. Issues by financials need not be off-limits as there are reputable international issuers outside China, such as Import-Export Bank of Korea and Mitsubishi UFJ. Exposure to developers should in our view focus on the major companies that either have little or no exposure in the third and fourth-tier cities and that have a strong liquidity position.

In terms of the outlook for the renminbi, we believe the recent volatility and downside pressure was temporary. In our view, the renminbi could appreciate in the medium term, backed by China's substantial currency reserves, government surpluses, future 7%-7.5% economic growth and favourable interest-rate differentials versus the US dollar.

Market capitalisation could grow from USD 100 billion at the end of January to above USD 120 billion this year. Uptake of new issues should not be a problem given the high levels of renminbi deposits looking for higher yields, and growing international demand. We believe this is a market with a strong investment case that can offer investors plenty of opportunities.

Interview
SPOTLIGHT

Skander Chabbi
CIO convertible bonds, BNPP IP, Paris

Convertibles: still mileage left after bumper run

While the prospect of interest-rate rises and higher inflation could have many investors heading for the exits, these phenomena could brighten the outlook for convertible bonds as the asset class benefits from its position halfway between equity and straight bonds on the asset class continuum, adding another leg to its recent strong run. Skander Chabbi, CIO of the convertible bond team, explains.

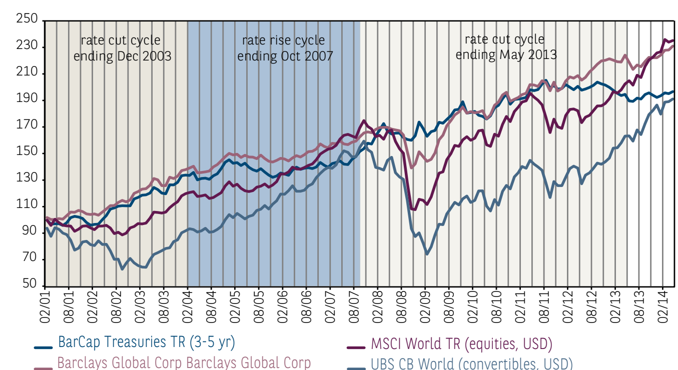
***Perspectives (P):** Convertible bonds have come a long way – what have been the main factors?*

Skander Chabbi (SC): Indeed, it has been quite an impressive run. The global asset class gained nearly 17%[1] in 2013, almost keeping pace with equities, but it was certainly well ahead of the main fixed-income asset classes. Convertibles' performance was more than double that of global high-yield bonds and even further ahead of global investment-grade bonds, while leaving global government bonds – with a negative return in 2013 – in the dust. So far, global convertibles are almost half way on the road to our 8%-10% expected return for 2014. The asset class's equity-like characteristics featured large in 2013 as the underlying equities benefited from growing signs of economic recovery, while so far this year – bond-like – the asset class has been able to benefit from concerns over the outlook for the Chinese economy and volatility related to geopolitical risk. This underscores the asset class's convexity: its ability to capture most of the gains in rising equity markets and hold up well at times when equity markets are flat and investor uncertainty and market volatility cause appetite to swing towards the relative safety of fixed income.

***P:** Are convertibles still interesting in a market environment where the next moves in interest rates are likely to be up?*

SC: Yes, we believe so. Historically, convertibles were able to benefit from their asymmetrical return profile at such times. In the March 1999-June 2000 and the December 2003-October 2007 rate-hike cycles, the asset class outperformed both aggregate bonds and equities[2], as illustrated by Exhibit 1, and we have no reason to assume that this will not happen again when official rates rise, even though we do not expect any significant policy tightening until the second half of next year, and then first of all in the US. It is worth noting that the convertible bonds we invest in have a duration of just over four years on average, which should limit their sensitivity to interest-rate risk. Given that we generally target convertible bonds whose performance has roughly 50% equity sensitivity and 50% bond sensitivity, we believe that we can be optimistic about risk-adjusted returns, even if the scenarios for 2014 are marked by uncertainty. You should remember that the likely interest-rate increases are made possible by the ongoing recovery in economies around the world, which is a factor that typically supports equity markets and by extension convertibles.

Exhibit 1: An asymmetric risk/reward profile, also when interest rates rise



Source: Bloomberg, UBS, Barclays Capital; May 2014

***P:** One driver in the run-up by convertibles has been persistent demand in a market marked by fewer and fewer new issues – do you expect supply to improve?*

SC: It is true that amid inflows of investor money, tighter supply, particularly on the investment-grade side, has skewed prices. With nearly USD 100 billion in new issues, 2013 was ahead of 2011 and 2012, but volume was almost half that of 2007 which was a peak year marked by booming equity markets. So far, 2014 has seen USD 28 billion in primary-market activity. If this is maintained, issuance could match the 2013 total. That will not bring much relief in terms of liquidity in a market where one of two issues mature every month and are not replaced. Some 50% of issues are now being held by long-only funds, which provides a cushion for prices, as well as structural demand from institutional investors such as insurers who are buying convertibles to bolster

1 Data from Bank of America; end-March 2014
2 Reflected by the Barclays Global Aggregate index and the MSCI World index; data from Bloomberg, UBS, Barclays Capital, MSCI; January 2014

their capital structure. For issuance to pick up, we would have to see definitive signs that interest-rate hikes are imminent, underscoring that now is the time for issuers to benefit from still cheap financing and rock-bottom issuing costs. A pick-up in capital spending as economic growth accelerates could also boost issuance. We believe a pipeline of quality issues is building up. Again, the US – already the world's largest convertible bond market[3] – is most likely to be in the lead here in the near term.

***P:** What opportunities are left in the convertible bond market?*

SC: On the face of it, you might say that Asia Pacific ex Japan is the region with the greatest promise since it is currently the only area that is undervalued[4]. But it is essential to be choosy here since this is also the region with the highest percentage of high-yield and non-rated issues and with the lowest sensitivity to equities compared with North & Latin America and Europe[5]. Globally, we still see selective opportunities – pockets of undervaluation – driven by regional and country-specific scenarios. Credit spreads are likely to tighten further and equity markets could strengthen, which should support corporate issuers in 'peripheral' countries and investment-grade names in the eurozone. Equity market strength could benefit convertibles in the US and Japan; in the US, it could be appropriate to switch out of information technology names, which have had a bumper run, and head for industrials, which have lagged. Asian convertibles could benefit from spread narrowing in the near term and, further out, from equity market strength. Away from this regional perspective, the prospect of (more) mergers and acquisitions, for instance among internet companies in China or in the tech and media segments in Europe and the US, should support the convertibles market. Growth in the US, the recovery in Europe, the real estate boom in the UK and Asian consumer demand are other themes we see as favourable for this asset class.

***P:** What do convertibles add to an investor's portfolio?*

SC: We believe this asset class can add better risk-adjusted returns to an equity portfolio given the asymmetrical nature of its return profile, while bringing down overall portfolio volatility.

> "When times are uncertain, convertibles can be a good place to be for any investor"

For fixed-income investors, it can add diversification potential to the portfolios of those investors who are nervous about the outlook for bonds when rates rise, but who are also reluctant to take direct exposure to (the volatility of) equities. For bond investors in general, the inclusion of convertibles can soften the blow when interest rates rise since convertibles should hold up well, while straight bonds are likely to suffer. Relative to corporate bonds, we believe convertibles have more upside potential given the expectation of further equity market gains.

And as said, when times are uncertain, convertibles can be a good place to be for any investor since they can participate to a large extent in equity market gains and have mitigated downside during setbacks. Overall, we believe convertibles with their ability to 'smooth the ride' should be part of the core portfolio.

3 Based on data from UBS, May 2014
4 Based on the current richness/cheapness level of the Barclays Capital Convertible Bond index relative to the US, EMEA and Japan; source: Barclays Capital, April 2014
5 Based on data from UBS, May 2014

Expert's view
SPOTLIGHT

Ben Steiner
Senior portfolio manager – FFTW, New York

Fixed income: why absolute return makes sense now

Given the current expectations of rising interest rates, it could be opportune now to choose an absolute-return strategy to diversify a traditional fixed-income portfolio. In this précis of a more detailed article[1], Ben Steiner, senior portfolio manager at FFTW in New York, the dedicated global fixed-income specialist partner of BNP Paribas Investment Partners, explains why.

The current interest-rate environment will no doubt give many investors pause for thought in anticipating that interest rates are likely to rise, while knowing that fixed income will still feature in their asset allocations.

Most investors view fixed income as relatively safe and as being a lower-risk allocation compared with, say, equities. However, when rates rise, the mathematics of bonds means US dollar prices need to fall for fixed-income securities with a positive duration. Most investors benchmark their fixed-income portfolios against a positive-duration index, which leaves them facing a conundrum: even if they can consistently outperform a bond-market index, the total return in a rising-rate environment may still be negative.

> "In an absolute-return framework, portfolio interest-rate risk can be positioned to benefit in both falling and rising-rate environments."

Broadening traditional core fixed-income strategies to 'plus' sectors may not help in rising-rate environments, either, because such portfolios are still benchmarked to a positive-duration index, and because spread compression can only help to enhance relative returns. To compensate for this, some investors may allow their managers to manage portfolio duration asymmetrically – for example, to have it range from 0 years to the benchmark duration plus two years – but this still does not entirely solve the problem that negative returns are likely to be realised.

A further step takes us to an absolute-return framework, where portfolio interest-rate risk can be positioned to benefit in both falling and rising-rate environments. This means portfolio duration is managed within an absolute duration constraint, for example plus or minus three years.

How do absolute and relative-return strategies compare?

In short, absolute-return strategies are not managed relative to an index of assets. The table below summarises the main differences:

		RELATIVE RETURN	ABSOLUTE RETURN
1	PERFORMANCE TARGET	Combination of assets in universe (traditionally market-cap weighted)	Something else (e.g. cash + x)
2	NEUTRAL OPINION	Hold at benchmark weight	Do not hold at all
3	NEGATIVE OPINION	Underweight or off-index: both have consequences that limit the ability to express a negative view	Freely express negative views (probably via derivatives)

Source: FFTW

To take those points in turn, the performance of a relative-return strategy is typically measured against an index of assets from the permitted universe. By contrast, an absolute-return strategy is measured against an index that is typically not a combination of assets (instead it could be measured against cash, a risk-free rate or the rate of inflation).

Secondly, in a relative-return strategy, if the manager is neutral on an asset or asset class, it will be held at the benchmark weight, whereas an absolute-return manager will not hold the asset or asset class at all.

The third point is that, with a relative-return strategy, if the manager has a negative opinion on an asset or an asset class, he can either underweight it relative to the index or take an off-index position. But neither option comes free. Underweighting is limited to the amount in the index (so small index weights restrict the degree of negative conviction that can be expressed) and an off-index position could significantly contribute to benchmark tracking error. By contrast, an absolute-return manager is able to freely express negative options, most likely via derivatives.

The case for absolute-return fixed income

As investors allocate assets in the context of a total portfolio, in the full version of this article, we can show how an absolute-return allocation can improve the risk-reward profile of a fixed-

1 For a copy of the full-length article, please contact the Publication Centre at publicationcentre@bnpparibas-ip.com

income portfolio. For simplicity, we take a situation where investors originally invest only in a US-core strategy and show the risk-reward characteristics that can come from adding incremental allocations of 25% to one of our absolute-return strategies.

Moving away from 100% in the US-core strategy to a combination including 25% or 50% of an absolute-return strategy would significantly reduce volatility, but only marginally reduce return. The impact of this would be to increase the risk-adjusted return of an investor's fixed-income portfolio.

We can also plot monthly returns versus yield changes when comparing a US-core strategy with an absolute-return strategy. When we do this using historical data covering a period of falling interest rates, it shows this rate environment to be a headwind for the absolute-return strategy and a tailwind to traditional strategies. We are now, however, in a period in which rates are generally expected to rise over the medium term, so we need to consider the risk-reward surface on a forward-looking basis. Under these circumstances, the headwind could easily become a tailwind for absolute-return strategies.

"Moving away from 100% in the US-core strategy to a combination including 25% or 50% of an absolute-return strategy would significantly reduce volatility, but only marginally reduce return."

In terms of the relationship between portfolio duration, yield change and the resulting return of a portfolio, portfolios with durations near zero experience no return, regardless of yield change. Portfolios with positive duration experience losses as yields rise. Portfolios with negative duration experience gains as yields rise. So in a period of rising rates such as is now expected, an absolute-return allocation – with the ability to take short-duration exposure – could improve the total return of a fixed-income portfolio.

FFTW has developed an absolute-return capability that is implemented within a robust risk-controlled environment. In addition, FFTW's independent investment risk management function monitors and measures portfolio risks using a dynamic set of tools, an approach that has yielded positive absolute and risk-adjusted returns[2]. This has been the case over a prolonged period, with an absolute-return strategy that has delivered positive returns in 24 out of 30 quarters since its inception. And, given the consensus forecasts for a rising rate environment, it is worth noting that the strategy has also performed positively in six of the 10 months in which the largest rate rises occurred between 2007 and 2013, whereas the traditional strategy was positive only twice.

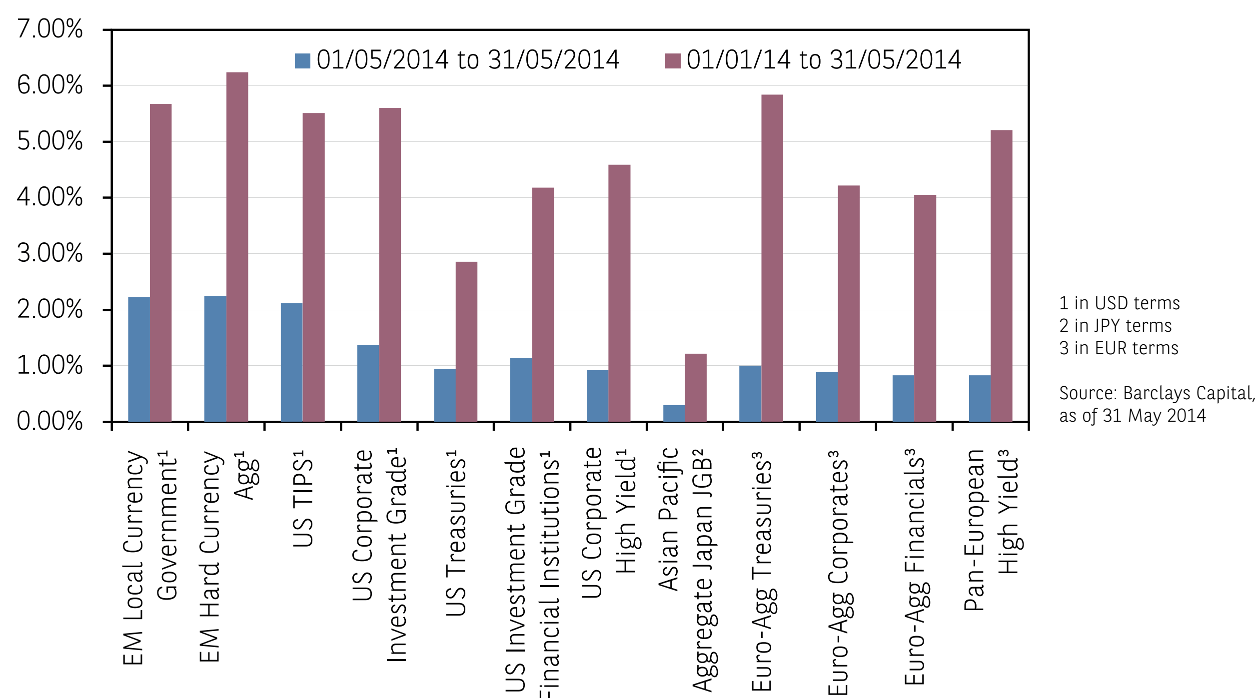
2 Past performance is no guarantee of future returns.

Performance focus

SPOTLIGHT

Performance of selected equity and bond markets for the period from 1 January to 31 May 2014

Performance of different fixed income segments YTD and from 1 May to 31 May 2014



1 in USD terms
2 in JPY terms
3 in EUR terms

Source: Barclays Capital, as of 31 May 2014

Performance of selected equity markets YTD

	Absolute return. in euro currency terms year-to-date through May 2014	Absolute return. in US dollar terms or where indicated. in local currrency terms year-to-date through May 2014
S&P 500	5.20%	4.07%
Nasdaq	2.68%	1.58%
EURO STOXX 50	4.36%	3.24%
Shanghai SE Comp	-5.62%	-3.63% (in Chinese yuan renminbi terms)
Brazil IBOVESPA	6.07%	-0.52% (in Brazilian real terms)
Japan TOPIX	-3.65%	-7.75% (in Japanese yen terms)
South Korean KOSPI	3.70%	-0.81% (in South Korean won terms)
Indonesia - Jakarta Comp	21.29%	14.50% (in Indonesian rupiah terms)
Russia MICEX	-8.93%	-4.79% (in Russian roubleterms)
Turkey BIST 100 Index	21.20%	16.94% (in Turkish lira terms)
India S&P BSE 500 IDX	23.55%	17.44% (in Indian rupee terms)

Source: Bloomberg, as at 31/05/2014. All indices price change only (excluding dividends)

Performance of selected equity/bond markets is shown in local currency terms in order to provide an indication of whether these currencies have appreciated or depreciated versus the euro and/or the US dollar during the period concerned.

Past performance is not indicative of current or future performance.

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