

Unconstrained European Fixed Income

FIXED INCOME | GLOBAL FIXED INCOME TEAM | INVESTMENT INSIGHT | 2019

The European Fixed Income Opportunities strategy is designed to provide investors with competitive returns in the current low-yield environment, be a store of value in times of market volatility, and act as an important element of portfolio diversification.

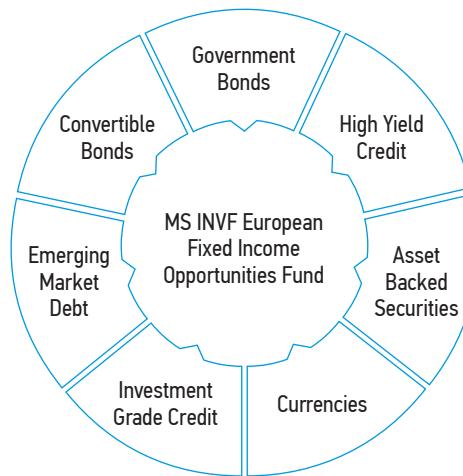
Investing in European fixed income remains challenging, given the low nominal bond yields which have been suppressed by central bank bond buying programmes. With nearly €15 trillion of bonds now trading with a negative (double the amount at the end of 2018), generating attractive European fixed income returns is problematic.

Nonetheless, European fixed income can provide important portfolio diversification, with the potential to generate positive returns when riskier assets, like equities, do poorly. It is our view that in general, European fixed income has performed well since the creation of the Economic and Monetary Union of the European Union (EMU). Despite the fact that German and other high-quality government bond yields are trading close to all-time lows, we believe that European fixed income offers a wide range of “other” government and “off the beaten path” euro bond issuers that should appeal to all investors.

Unconstrained, Active and Flexible

The European Fixed Income Opportunities investment philosophy is centred on being flexible and opportunistic. Central bank quantitative easing programmes have not only suppressed yields in the government bond market, but also in covered bonds and investment grade credit. While quantitative easing has boosted fixed income returns in the past, we believe there is a risk that quantitative easing has pushed bond valuations to unsustainably rich levels, so that future returns will ultimately be disappointing.

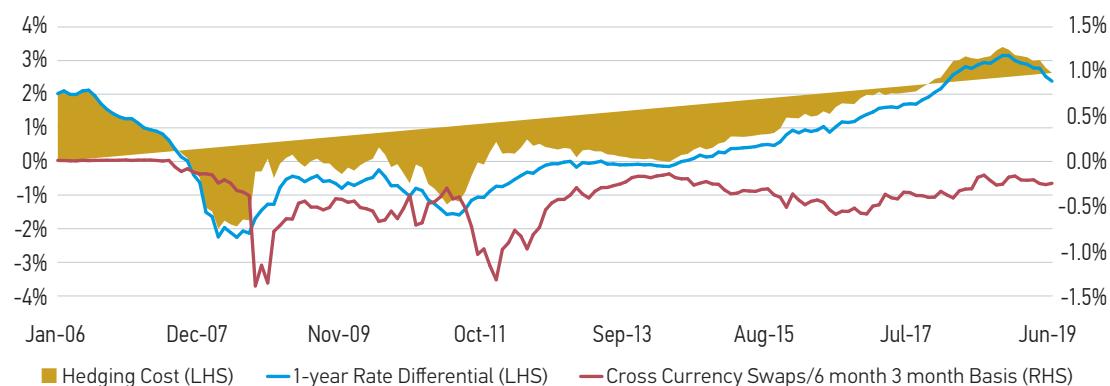
We believe it is important for investors to identify opportunities in areas which have not been targeted by central banks, including asset backed securities, emerging market debt and high yield. The European Fixed Income Opportunities strategy is unconstrained and hence enables access to these diversifying bond markets. The strategy also has the flexibility to invest in bonds denominated in local currencies (other than the Euro), both in the developed and emerging worlds. Our commitment to active management and flexibility provides us the opportunity tactically to increase the portfolio’s exposure to these types of investments, especially when they offer the greatest potential value.

DISPLAY 1**Our Investment Philosophy**

It is important to note that we do not manage to a benchmark, giving us the necessary flexibility to allocate across the fixed income universe. Our absolute duration range is set between zero and 6 years, so that we can adjust our duration exposure in the portfolio as the cycle evolves, with an overall objective of capital preservation.

Efficient Portfolio Construction and Internal Hedges

The European Fixed Income Opportunities strategy uses an unconstrained portfolio construction process that relies on internal hedging mechanisms designed to minimise significant price drawdowns in adverse market conditions. The management team scours the markets for fixed income opportunities with uncorrelated risk premia, designed to provide internal diversification and smooth the overall return stream of the portfolio. Furthermore, our approach to hedging can contribute positively to fund returns, either through positive carry or by owning undervalued securities offering attractive relative value.

DISPLAY 2**Hedging Cost of USD vs. EUR**

ITEM	BLOOMBERG INDEX	VALUE
		31/12/18 31/05/19
(A) 1-year USD swap rate	USSW1 Index	276 bps 224 bps
(B) 1-year EUR swap rate	EUSA1 Index	-23 bps -28 bps
1-Year Rate Differential = -(A) + (B)		299bps 252bps
(C) 1-year cross currency swaps	EUBS1 Index	-10 bps -18 bps
(D) 3s6s basis	EUBSVT1 Index	6 bps 8 bps
-(A) + (B) + -(C) + (D)	FX hedging carry (per annum)	-315 bps -278 bps

Source: Bloomberg Barclays. Data as of May 31, 2019.

A Focus on Minimising Currency Hedging Costs

Economic cycles across geographies and a divergence in central bank policies have increased the cost of currency hedging in countries where the policy rate is low or even negative. This has adversely impacted many European investors, where negative policy rates have resulted in substantial foreign currency hedging costs for bonds denominated in currencies other than Euro, most notably the U.S. dollar. Over the past year, this cost of hedging has reached 3% per annum, as seen in *Display 2*. We believe that investing in Euro-denominated securities can maximise the return potential for Euro-based investors, by avoiding this hedging obstacle. While hedging costs often have a negative impact for Euro-focussed investors; they have the potential to augment returns for overseas investors, increasing returns in non-Euro currencies.

In Conclusion...

While the current fixed income environment is challenging, we believe that a core fixed income holding can be an essential allocation to a portfolio. We believe our European Fixed Income Opportunities strategy is the perfect antidote to current market conditions, offering an unconstrained investment approach with the ability to diversify into investments unaffected by central bank policies. The fund is actively managed, with a focus on internal hedges, designed to maximise the diversification benefits of duration ranges and limit portfolio drawdown through efficient portfolio construction.

Risk Considerations

Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest rate environment, the portfolio may generate less income. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

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