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LOMBARD ODIER
INVESTMENT MANAGERS

Rethink your approach to corporate credit

– For professional investor use only –

Fundamental Fixed Income
May 2019

At a glance

- In the current investment paradigm, the search for yield remains at the fore, increasing the appeal of corporate credit
- However, traditional investment grade credit has become less attractive
- In our view, increasing credit exposure by investing in crossover bonds rated BBB to BB offers a compelling alternative to investment grade while avoiding the excessive risks of high yield
- Recognising the huge transition to a sustainable economy, we embed extra-financial information into our selection process
- We believe that our sustainable approach to portfolio construction – centred on quality, valuation and low turnover – is better suited to the present environment

The case for crossover credit

p.06

The crossover segment offers attractive returns with a moderate increase in risk.

Publication of Lombard Odier Investment Managers

For more information on fundamentals-based crossover strategies

Call Leslie Sita on +41 22 709 3093
Email leslie.sita@lombardodier.com
Or visit www.loim.com

Executive summary

- Amid historically low government bond yields, investors should explore credit markets to help meet their return targets rather than taking on risky, longer duration
- We believe that in the current environment investors should move down the credit spectrum and consider the BBB and BB rated “crossover” segment
- The crossover universe offers the potential to significantly enhance returns compared with investment grade debt, while avoiding the excessive credit risk of the high yield universe
- With credit risk at the forefront, implementation is key. We believe that market-cap benchmarks are ill-equipped to recognise current challenges as they tend to concentrate risks by rewarding leverage
- We recommend bringing quality to the heart of the portfolio construction process to mitigate credit default risk and facilitate lower turnover – as we do in our Fundamental Fixed Income approach

Investment grade corporate credit has become less attractive

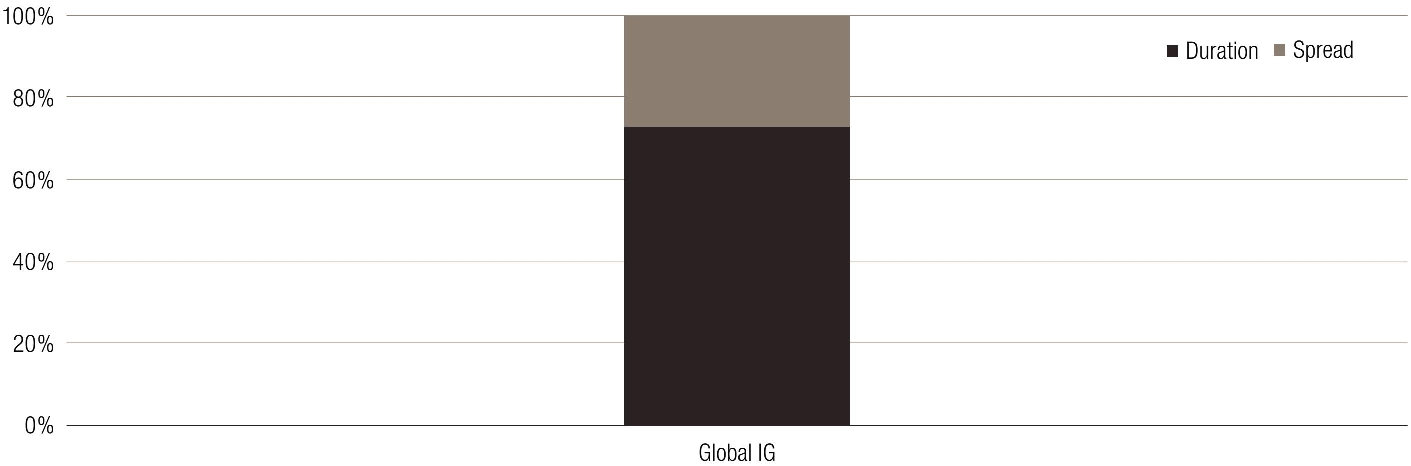
Investors are facing a number of important challenges when it comes to global fixed income investing.[1]

- **Historically low yields** in key developed markets remain widespread
- **Increased market risk** as investors have extended duration to find positive yields and now face a heightened sensitivity to moves in interest rates
- **Fractured liquidity** conditions in fixed income markets due to central bank interventions and a tightening regulatory environment
- **Sustainability** re-shaping risk and return, with trends such as demographics, climate change, scarcity of natural resources, inequality and digitalization

When investing in the corporate credit market, investors have historically turned to the investment grade segment due to the healthy fundamentals of the issuers and the resultant low credit risk exposure. They also benefited from a slightly enhanced yield relative to riskless treasuries. Since the global financial crisis of 2008, a regime shift in monetary policy with the resulting drop in interest rates provided a significant boost to investment grade portfolios, given their exposure to duration.

Today, duration remains the dominant driver of risk in a global investment grade corporate bond portfolio. Figure 1 shows that duration comprises about 70% of the total risk. However, the unprecedented monetary policy described earlier has changed the nature of duration, making the investment grade segment less attractive as a source of long term returns.

FIG. 1 RISK CONTRIBUTION FROM DURATION[2] AND CREDIT[3] COMPONENTS[4]



Source: Barclays POINT, Bloomberg Barclays Indices : Global Credit Corp, LOIM calculations. As at 28 February 2019.
Past performance is not a guarantee of future results. For illustrative purposes only. Yields are subject to change and can vary over time.

[2] Duration return is the return of the duration matched treasury over the risk free deposit rate. We use German treasuries for Euro denominated bonds.

[3] Credit spread return is the return of the corporate bond over duration matched treasuries. This measure of return takes losses from downgrades and defaults into account.

[4] Risk contributions take spread-duration correlations into account. We use equal weighted data over the last three years to estimate volatility. Spread volatility is estimated using current DTS and historical proportional spread volatility.

[1] See our research titled “A new paradigm in fixed income markets and implications for portfolio management,” September 2016, for more details.

Duration-driven returns are diminishing

History has been supportive of long term returns from duration exposure. However, we believe duration will prove to be much less attractive for investors going forward.

A key driver of duration's contribution to investment grade portfolio returns was the fall in interest rates – from 4% to 0% in the US and below 0% in the Eurozone. This trend has long since reversed in the US and has hit a floor in the Eurozone. However, the heavy fall in rates following the global financial crisis is unlikely to be repeated.

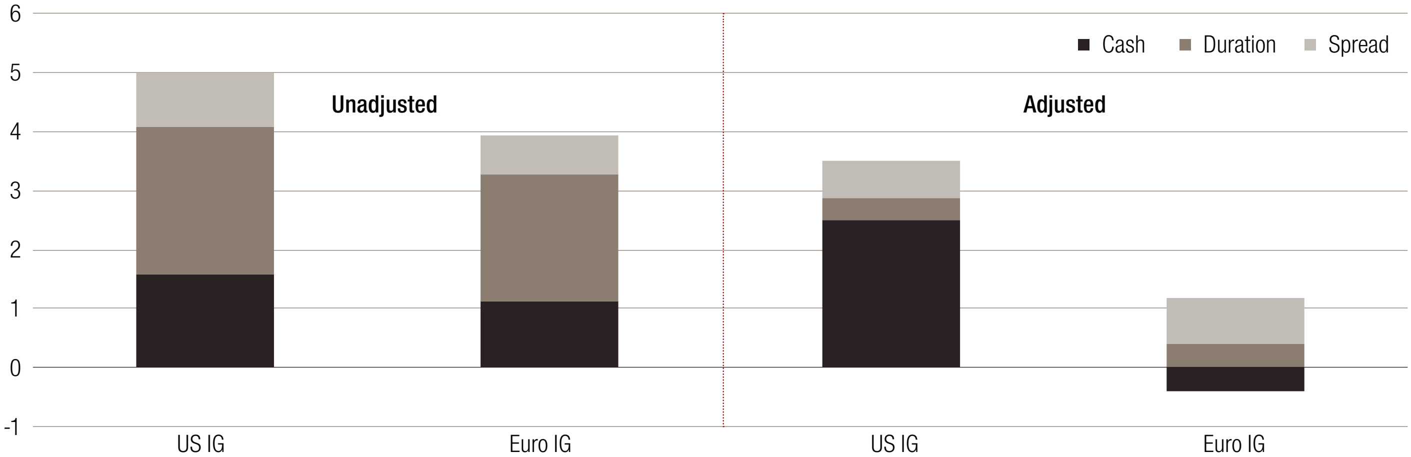
In other words, historical duration-driven returns, which have been supported by a tailwind of falling risk free yields, are not an appropriate predictor of future returns.

We decomposed the returns over the past 14 years of the Bloomberg Barclays US investment grade and the European investment grade indices into cash, duration and credit spread components. The left panel of Figure 2 demonstrates that a large fraction of historical returns has come from duration; spread returns have been less significant.

The right panel of Figure 2 adjusts the returns of the same indices to remove the effect of this decrease in rates.[5] In the absence of such a trend in rates,[6] duration returns would be much lower and credit spread, particularly in the Eurozone,[7] a much more important driver of performance.

Given that a fall in interest rates has been the dominant driver of duration-related returns and that this dynamic is no longer in play, we believe that the potential for investors to be rewarded for duration risk has strongly diminished.

FIG. 2 HISTORICAL RETURNS (ADJUSTED AND UNADJUSTED) SPLIT BY CASH, DURATION AND CREDIT SPREAD COMPONENTS (OCTOBER 2004 TO FEBRUARY 2019)



Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations. Past performance is not a guarantee of future results. For illustrative purposes only.

[5] We de-trend yields by removing the mark-to-market effect of declining yields. We also substitute historical carry (yield and roll-down) with current carry.

[6] This is a conservative estimate as the trend in risk free yields is likely to be upwards rather than flat as evidenced by yield movements post the US elections.

[7] For Euro investors currency hedging removes much of the return benefit from higher cash and duration returns in the US.

The case for crossover credit

As investors cannot rely on duration risk as a source of compensation going forward, they should consider rethinking corporate credit. By investing in lower-rated corporate bonds investors can increase their exposure to credit risk, which we believe can offer a higher reward in the current environment. We believe the crossover segment of the corporate credit market – comprising BBB and BB rated bonds – provides an attractive solution as it offers the potential for enhanced returns without excessive risk. Furthermore, we believe that the evolution of certain attributes of the crossover segment further strengthens the case for it as a suitable alternative to an investment grade allocation.

The potential benefits of the corporate crossover segment can be summarised as:

- Higher yield and return potential than investment grade portfolios
- Better balance between duration and credit risk than the investment grade universe
- Positive dynamics in crossover relative to the investment grade universe
- Lower default and drawdown risk than high yield

Yield and return potential

Figures 3 and 4 show that average yields for investment grade issuers are around 1% in Europe and 0.8% in the US. The crossover BBB-BB segment offers yields that are more than 50 bps higher than those of the investment grade universe.

While crossover bonds are not new, investing in the crossover segment becomes even more relevant to investors in the current low yield environment. There is significant added value potential from combining the lowest level of investment grade (BBB+ to BBB-) and the highest level of high yield (BB+ to BB-). In particular, BB rated bonds have provided substantially higher yields than investment grade or BBB rated credit. In addition, as we show in the section below, BB bonds have also provided a higher spread return than B rated bonds, making them the sweet spot in the credit spectrum.

FIG. 3 YIELDS – EURO UNIVERSE (%)

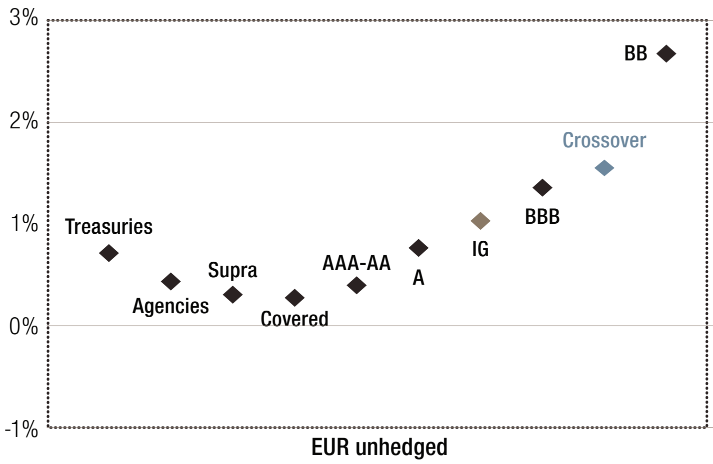
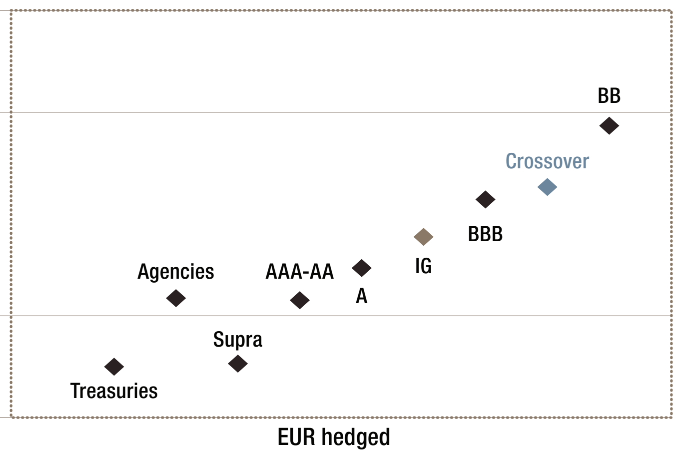


FIG. 4 YIELDS – US UNIVERSE (%)

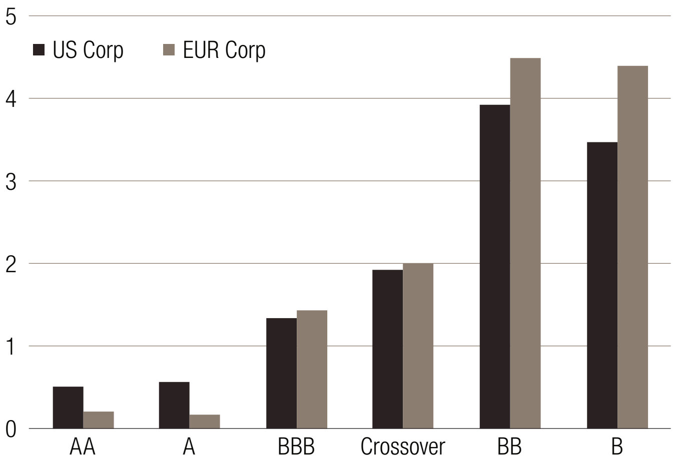


Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations as at 28 February 2019. Yields are subject to change and can vary over time. For illustrative purposes only.

BBs: the sweet spot

We focus here on credit spread returns as – unlike yields or spreads – this measure accounts for losses from downgrades and defaults which may be especially significant for lower rated portfolios. As investors move down the credit rating spectrum the general trend is for an increase in credit spread returns to reward the increased level of credit risk. However, counter-intuitively, BB rated issuers offer higher returns than the lower-rated B segment, as shown in Figure 5. The inclusion of "fallen angels" in the BB universe explains a large part of this outperformance to date.

FIG. 5 CREDIT SPREAD RETURNS (% PER YEAR, OCTOBER 2004 TO FEBRUARY 2019)



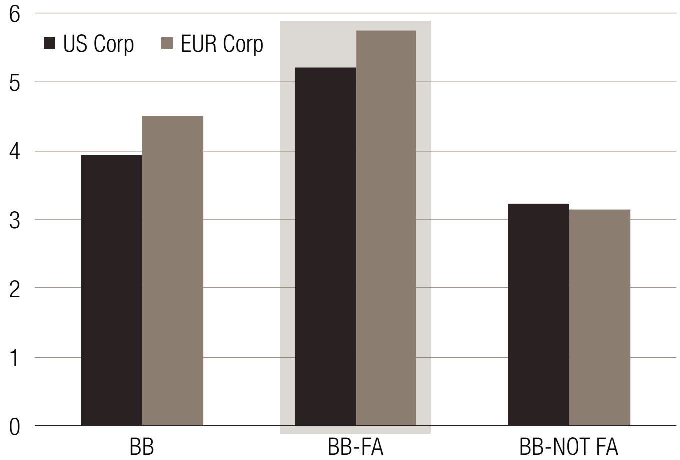
Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations. Past performance is not a guarantee of future results.

Including fallen angels boosts returns

An important driver of BB's being a sweet spot on the credit spectrum is the effect of so-called fallen angels. Fallen angels are bonds which have been downgraded from an investment grade rating to a high yield rating. At the time of the downgrade investment grade only funds are forced to sell, thereby increasing the supply of these bonds. The high yield investor community does not provide counterbalancing demand as such investors are usually smaller and less familiar with the issuer. The demand-supply mismatch results in fallen angels dropping below the "fair" price as suggested by fundamentals. Over time, as the selling pressure subsides, the price recovers and rises to the "fair" market price.

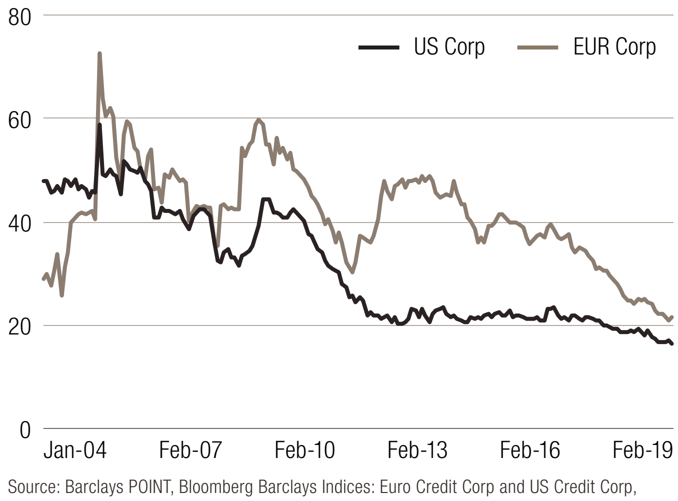
From Figure 6, we see that fallen angels have substantially outperformed other parts of the BB universe. Furthermore, fallen angels ("FA") form a significant part of the BB indices accounting for nearly 20% of the universe in the US and 22% in the Eurozone, as shown in Figure 7.

FIG. 6 CREDIT SPREAD RETURNS (% PER YEAR, OCTOBER 2004 TO FEBRUARY 2019)



Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations.

FIG. 7 PROPORTION OF FALLEN ANGELS IN BB PORTFOLIOS

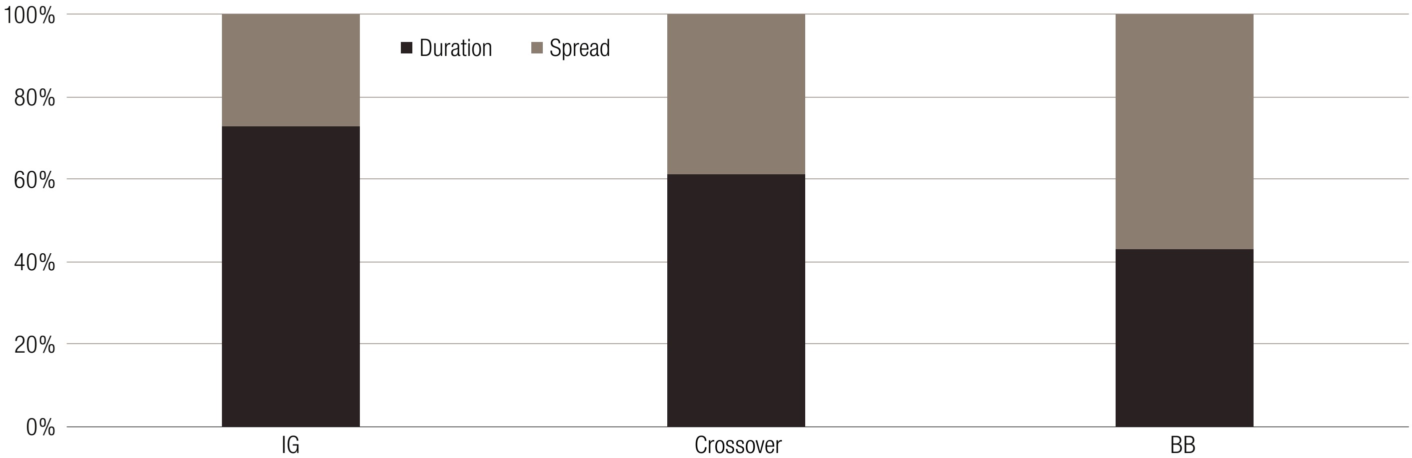


Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations.

Duration and credit balance
In addition to attractive returns, we believe the crossover segment offers a good balance between credit and duration risk. This is highlighted in Figure 8 which shows the contribution of duration and credit to overall risk within a global universe as we move across rating categories. The credit and duration risks for the crossover index are better balanced while an index comprising only BB rated issuers is dominated by credit risk.

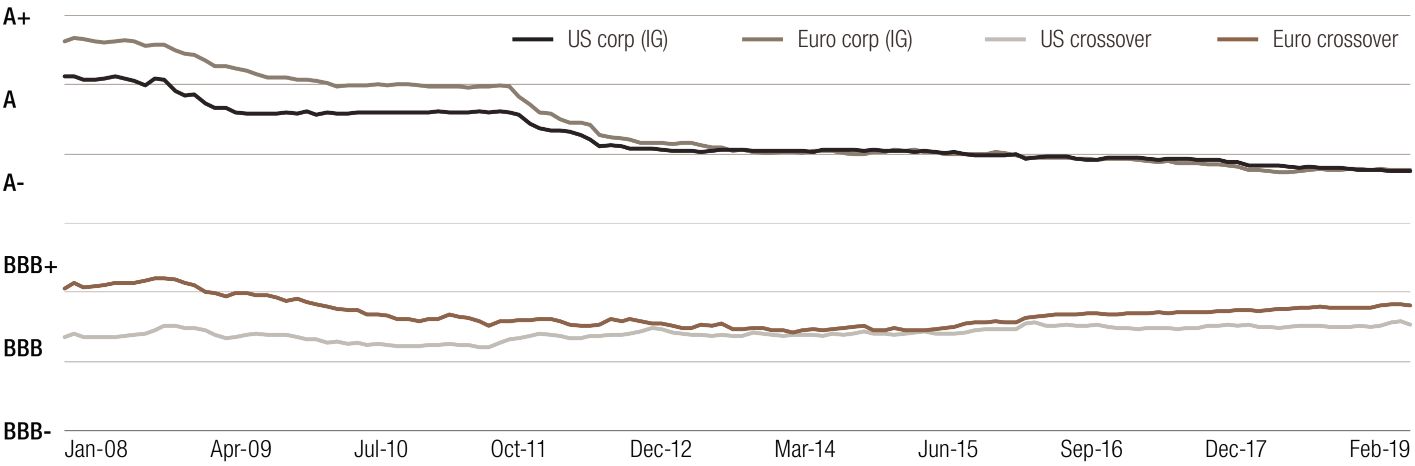
Positive rating and sector dynamics
The quality of the overall investment grade universe has been declining, with the average rating of investment grade issuers falling from A+ before the global financial crisis to A- currently as shown in Figure 9. In contrast, the average rating of the crossover index has been stable at BBB. The decline in quality of the investment grade index is largely explained by downgrades of issuers in the Financial sector.

FIG. 8 RISK CONTRIBUTIONS SPLIT INTO DURATION AND CREDIT SPREAD COMPONENTS



Source: Barclays POINT, Bloomberg Barclays Indices: Global Credit Corp, LOIM calculations. As at 28 February 2019. For illustrative purposes only.

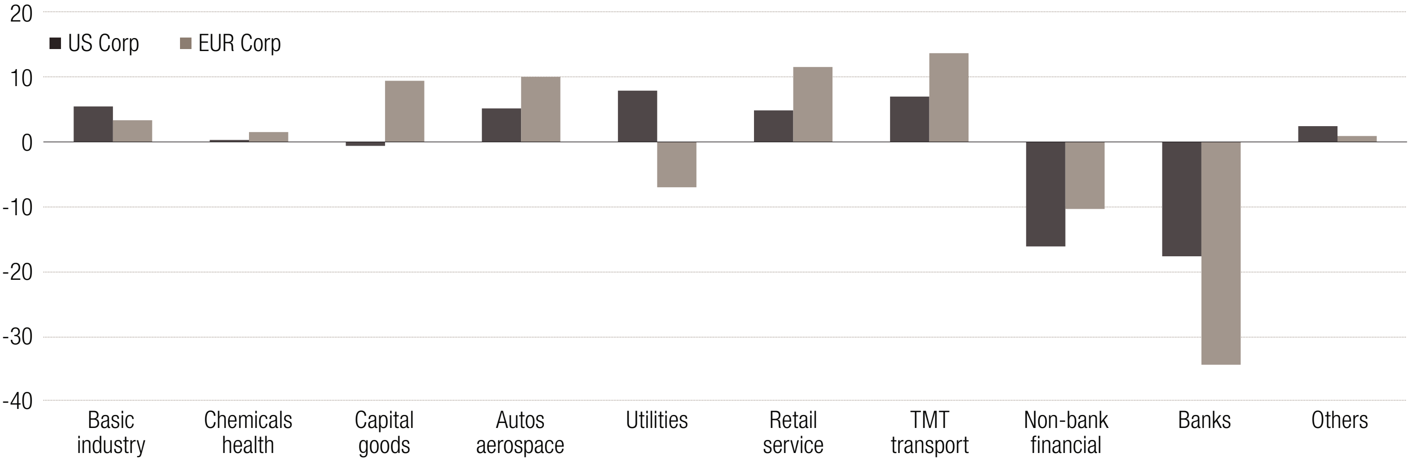
FIG. 9 AVERAGE RATING OF THE CROSSOVER INDEX VERSUS INVESTMENT GRADE (JANUARY 2008 TO FEBRUARY 2019)



Source: Barclays POINT, Bloomberg Barclays Indices: Investment grade universe (Euro Credit Corp; US Credit Corp) and crossover universe (composite index of Euro Credit Corp BBB & Euro High Yield BB; composite index of US Credit Corp BBB & US High Yield BB), LOIM calculations.

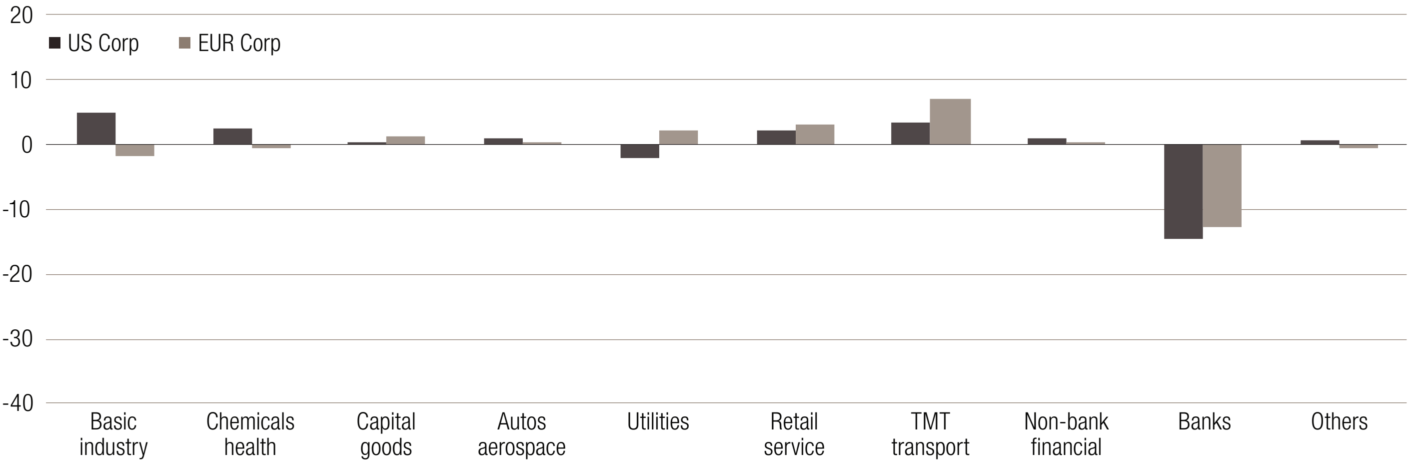
Sector allocations are another area of convergence between the investment grade and crossover universes over the past 12 years. For the crossover segment to be considered a suitable replacement for investment grade, sector allocation should be similar as large differences in the sector mix can lead to very different performance patterns over time. Figures 10A and 10B shows that the sector allocation within the two universes have converged.

FIG. 10A SECTOR MISMATCH (%): CROSSOVER VERSUS INVESTMENT GRADE (29 SEPTEMBER 2006)



Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations. For illustrative purposes only.

FIG. 10B SECTOR MISMATCH (%): CROSSOVER VERSUS INVESTMENT GRADE (28 FEBRUARY 2019)



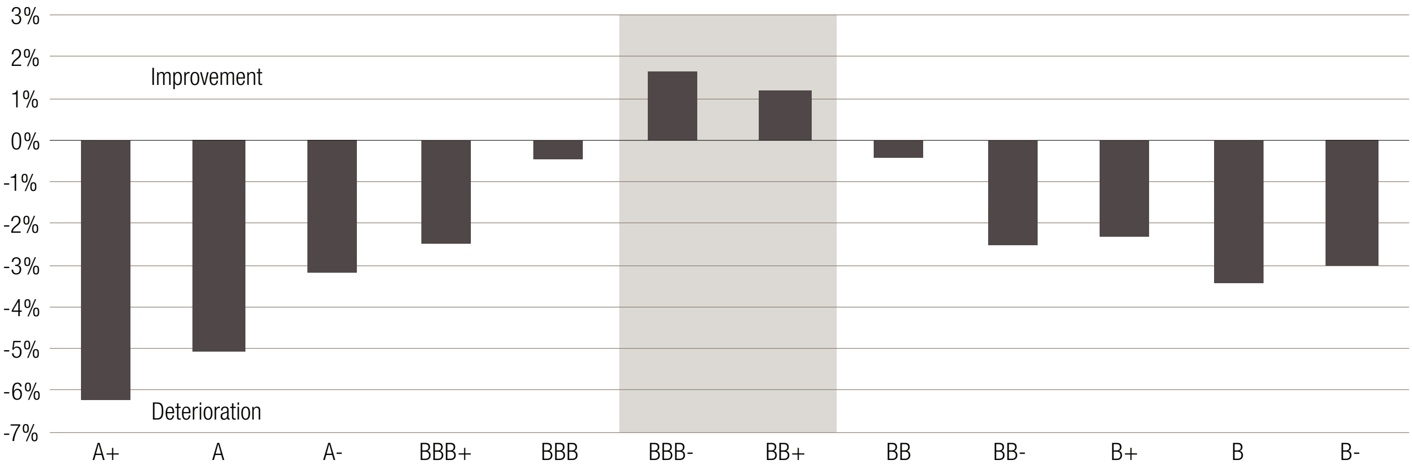
Source: Barclays POINT, Bloomberg Barclays Indices: Euro Credit Corp and US Credit Corp, LOIM calculations. For illustrative purposes only.

Fundamentals of crossover bonds tending to improve

We now turn our attention to changes in the fundamental credit quality of companies. We find that the rating of lower rated investment grade (BBB-) and BB+ issuers appears to improve over time whereas the opposite is true for all other rating buckets. This is demonstrated in Figure 11, where we show the average annual upgrade rate less downgrade rate by rating bucket as reported by Moody's.

The results reflect a general trend among higher rated companies to seek to optimise their balance sheets, invariably leading to an increase in debt and leverage. The penalty – whether through price or amount of debt available – is low, therefore the company does not take action to restore its metrics. In contrast, issuers with a rating of BBB- and BB are conscious that the price of their debt would increase and access to additional debt could reduce as a result of such action. They are therefore more likely to take steps to support their balance sheet. In other words, access to funding reduces and the cost of such funding rises significantly through the high yield rating spectrum, meaning most issuers (particularly those with a high debt burden) will look to at least maintain a stable credit rating or even improve it. These trends favour the crossover segment which, on average has improved fundamentals relative to the investment grade universe.

FIG. 11 CHANGE IN FUNDAMENTAL CREDIT QUALITY: ANNUAL UPGRADE RATE (%) LESS DOWNGRADE RATE (%) FROM MOODY'S (1983 TO 2017)



Source: LOIM calculations. Moody's Annual Default Study: Corporate Default and Recovery Rates, 1920-2017.
There is an overall net downgrade rate as companies in general deteriorate in quality from the natural process of creative destruction.

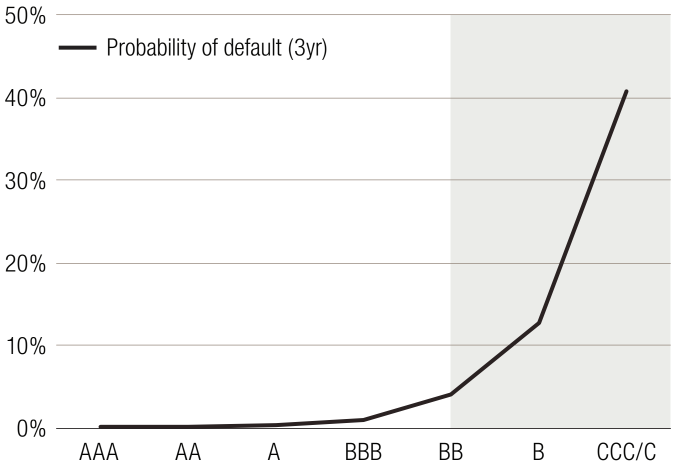
Default and drawdown risk

We argue in this paper that in order to increase their exposure to credit risk, investors should move down the credit spectrum. However, in doing so, they need to exercise caution as the high yield segment can entail a particularly large credit risk exposure. As shown below, as we go further down the rating spectrum to single B rated issuers and lower, default risk rises precipitously. In our view, this reduces the rationale for allocating to issuers rated below BB, especially in buy-and-hold type mandates.

Another characteristic that highlights the riskiness of the high yield universe is the historical drawdown witnessed in this segment. Indeed, the high yield universe has experienced significant drawdowns over the past 14 years, -33% and -38% for the US and the Eurozone respectively, as shown in the Figure 13 below. In contrast, the drawdowns of the crossover segment are similar to those of investment grade bonds.

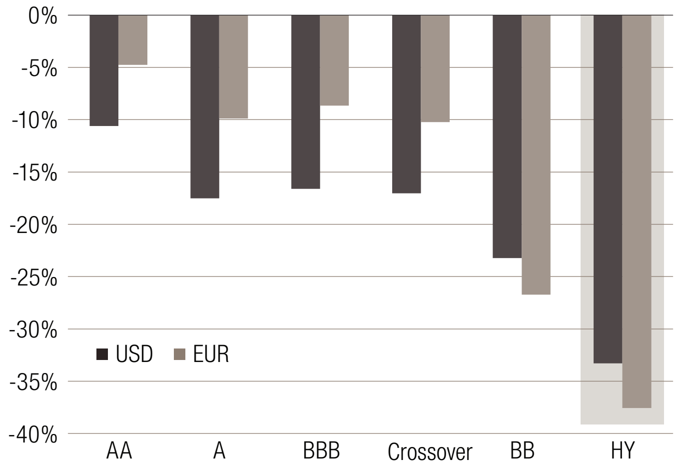
Overall, we believe that the crossover portion of the corporate universe provides the potential for a significant return enhancement over the investment grade universe while avoiding the excessive credit risk that is a feature of high yield universes. We believe that higher risk-adjusted return potential combined with improving fundamentals and converging sector allocation make the crossover segment a very attractive alternative to investment grade debt in today's markets. However, we believe that the portfolio construction process is a key issue for investors to consider when embracing credit risk.

FIG. 12 DEFAULT PROBABILITY ACCORDING TO CREDIT RATING (1996 TO 2014)



Source: S&P Annual Corporate Default Study, 2014. LOIM calculations.

FIG. 13 DRAWDOWN BY RATING CATEGORY (OCTOBER 2004 TO FEBRUARY 2019)



Source: Barclays POINT, Bloomberg Barclays Indices, LOIM calculations.

Implementation matters

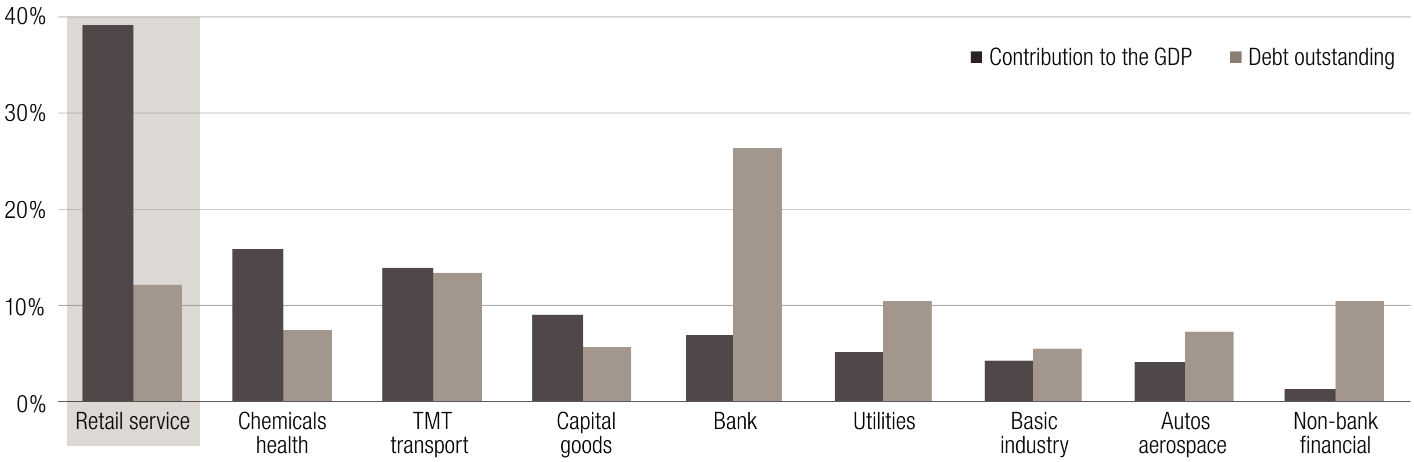
While we believe the case for crossover is very compelling, investors should be aware of the implementation risks involved in increasing credit risk in a regime of declining liquidity. Traditional market-cap benchmarks have dominated the fixed income landscape for a number of years. However, a market-cap based approach entails a number of flaws that we believe should be considered, particularly in the current investment paradigm. Market-cap indices tend to reward leverage and are therefore concentrated in highly-indebted sectors. Furthermore, by predominantly favouring a market-cap approach, investors are “herding” in common positions which we believe increases the risk of liquidity shocks given the fractured liquidity we see today.

The risks of market-cap indices

We believe that traditional bond indices are flawed as they weight issuers based on their capacity to borrow. By design, a traditional market-cap approach over-weights the most indebted issuers without taking into account their underlying credit fundamentals.

Traditional corporate bond indices, even today, have a high concentration in sectors such as Financials. This should raise a red flag to bond investors as sector weightings are determined regardless of their economic value-added. Sectors with a large contribution to the economy, such as the Retail service sector, are under-represented as shown in Figure 14 below:

FIG. 14 MARKET-CAP WEIGHTS IGNORE SECTORS’ CONTRIBUTION TO THE ECONOMY



Source: LOIM/Barclays for Euro BBB-BB universe, based on the last hard rebalancing in December 2018. Note: Contribution to the GDP is based on Eurostat as at December 2018.
For illustrative purposes only.

Another observation is the lack of stability in sector allocation when using a market-cap based benchmark, as highlighted in Figure 15. Specifically for the euro crossover universe, sector exposure has been particularly volatile over the past 18 years, primarily driven by rating transitions. The TMT sector's weights have declined from nearly 60% in 2001 to around 20% today while financials, largely absent in the market-cap index in 2001, now represent the largest sector within the index.

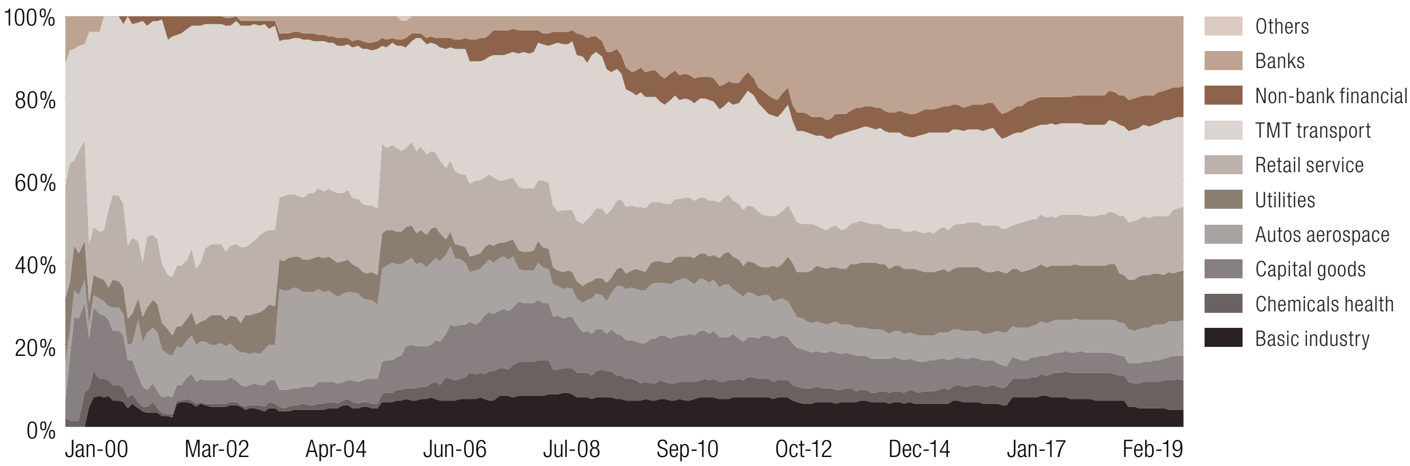
Overall, we believe that market-cap weighted benchmarks may expose investors to significant risks that should be considered when building fixed income exposure. Although traditional bond indices have benefited from a 30-year bull market, going forward we believe investors should rethink their starting point when it comes to portfolio construction.

A different approach: embedding sustainability

Our approach to investing in the crossover universe is different. To seek to overcome the shortcomings of using market-cap indices as a basis for constructing portfolios, we focus instead on the quality of debt, rather than the quantity. We believe it is vital to rethink fixed income investment to embed a greater degree of safety, by focusing on quality. In addition, we aim to further mitigate risk by assessing extra-financial factors. We do this by favouring companies with better business practices and those we believe are more resilient to the challenges created by the transition to a more sustainable economic model. We also believe it is vital to assess the resilience of issuers in the face of climate change as we believe this is a major risk in fixed income portfolios. We do this by favouring companies with a lower carbon intensity to reduce the carbon exposure of the portfolio, and through carbon avoidance by adding exposure to climate aligned-bonds. By building a high quality starting portfolio our approach considers financial and extra-financial information; it aims to mitigate risks without compromising on the returns. We follow a two-step process:

- First, we perform a disciplined/systematic top-down and bottom-up assessment of the investment universe
- Secondly, we carry out a forward-looking fundamental bottom-up assessment of issuers' credit default risk

FIG. 15 SECTOR ALLOCATION OF MARKET-CAP BASED EURO BBB-BB INDEX (JANUARY 2000 TO FEBRUARY 2019)



Source: Barclays POINT, Allocations are subject to change. For illustrative purposes only.

Disciplined analysis

Our proprietary methodology centres on a systematic allocation.

- For sector allocation, we believe that focusing on the contribution of each sector to GDP can deliver a more stable and efficient sector allocation by reducing the exposure to sectors that are facing a high potential of downgrade risk
- We further tilt the allocation to favour sectors with a lower carbon intensity
- For issuer selection, we believe that focusing on an issuer's credit quality and its ability to transition to more sustainable business practices/models can reduce the portfolio's downgrade and default risks

At both top-down and bottom-up levels, we adjust the allocations with market information. To do so, we favour sectors and issuers with higher credit spreads and better liquidity. The table below shows the various factors that we use to build our crossover corporate bond portfolios.

FIG. 16 A SUSTAINABILITY-DRIVEN PORTFOLIO CONSTRUCTION

FUNDAMENTAL ALLOCATION		ESG ALLOCATION
Investing in sectors with a high contribution to the economy, attractive credit spreads and good liquidity	TOP DOWN: **SECTOR**	**Favouring extra-financial strength: Low-carbon intensive sectors**
↑ Higher GDP contribution increase the weight ↓ When the spread drops the weight is reduced ↑ Sectors with better liquidity receive a higher weight		Lower carbon intensity increases the weight ↑

FUNDAMENTAL ALLOCATION		ESG ALLOCATION
Investing in issuers with strong fundamental credit quality, higher credit spread and good liquidity	BOTTOM UP: **ISSUER**	**Favouring extra-financial strength: Companies that boast sustainable business practices**
INDUSTRIALS/UTILITIES ↑ Companies that generate cash and use debt to fund long-term growth receive a higher weight		Issuers with good business practices (ESG and controversies), low carbon intensity and a willingness to issue climate bonds receive a higher weight ↑
BANKS ↑ Banks with stable funding sources and adequate asset quality receive a higher weight		
FOR ALL ISSUERS ↓ When the spread drops the weight is reduced ↑ Issuers with better liquidity receive a higher weight		

Source: LOIM. For illustrative purposes only.

The resulting sector allocation for our euro crossover fundamentals-based strategy provides greater sector diversification than a traditional market-cap corporate bond benchmark, as shown in Figure 17. Our allocation reflects each sector's economic importance by increasing exposure to the Retail and Chemical sectors and limiting exposure to the Financial sector.

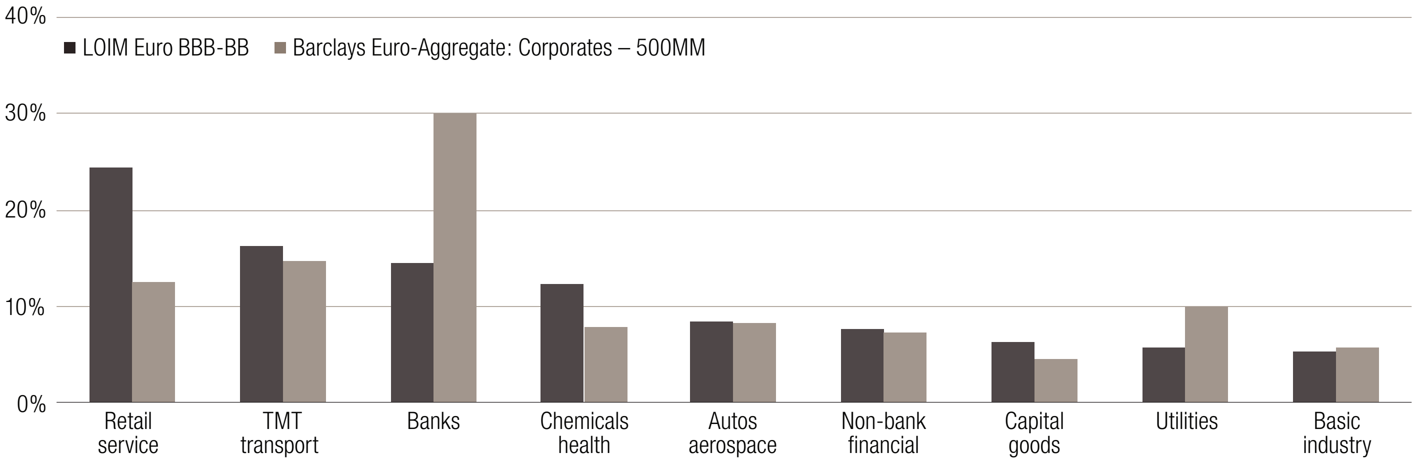
We believe this fundamental approach provides a robust portfolio that investors can hold with limited turnover. Our approach re-balances every six months; the construction process employs investment criteria that aim to assess issuer credit strength over the long term – this contributes to keeping the turnover of the portfolio low.

Fundamental analysis

Drawing upon the expertise and in-depth research of our credit analysts, our forward-looking fundamental approach aims to further mitigate the portfolio's default risk exposure by continually monitoring issuer credit risk, taking into account both financial and extra-financial metrics.

In addition, real-time monitoring of the market enables our credit analysts to identify and exploit opportunities at the issuer and issue level while preserving the fundamental top-down allocation. Indeed, we believe that the market for BBB-BB rated bonds is inefficient, as technical factors and market overreactions often lead to mispricing of these bonds as they migrate from one rating category to another. Our dedicated credit analysts are specialised by industry in both developed and emerging markets, and follow companies across the ratings spectrum from investment grade to BB rated corporate bonds.

FIG. 17 A FUNDAMENTALS-BASED APPROACH IMPROVES DIVERSIFICATION



Source: Bloomberg. LOIM. Based on the last hard rebalancing in December 2018. Holdings and/or allocations are subject to change. For illustrative purposes only.

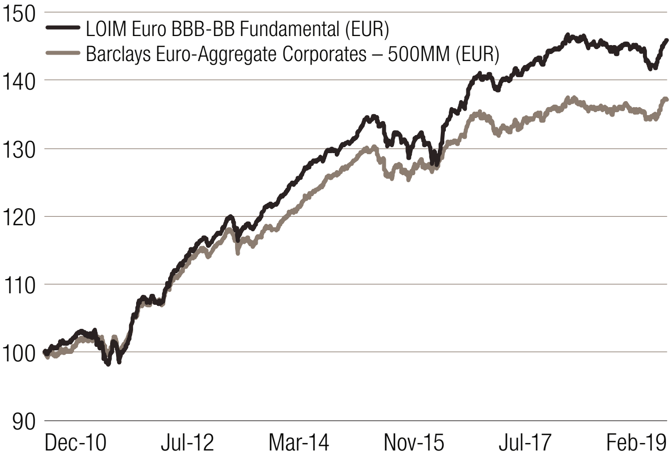
Our experience managing crossover portfolios

We began managing crossover bonds in 2010. As at February 2019, we managed USD 7.4 billion according to our fundamentals-based methodology, of which nearly USD 1 billion is in euro and global crossover strategies.

For all our crossover strategies, we use an investment grade market-cap benchmark reflecting our aim to provide investors with an alternative to investment grade portfolios but with an enhanced yield.

Figures 18A and 18B show that our quality-based crossover diversified portfolio delivered higher returns than investment grade debt with a similar risk profile. This is especially significant given our shorter average duration relative to investment grade that has detracted from historical performance over a period of falling risk-free yields.

FIG. 18A PERFORMANCE OF LOIM EURO BBB-BB FUNDAMENTAL STRATEGY, GROSS OF FEES[1] (UNHEDGED IN EUR)

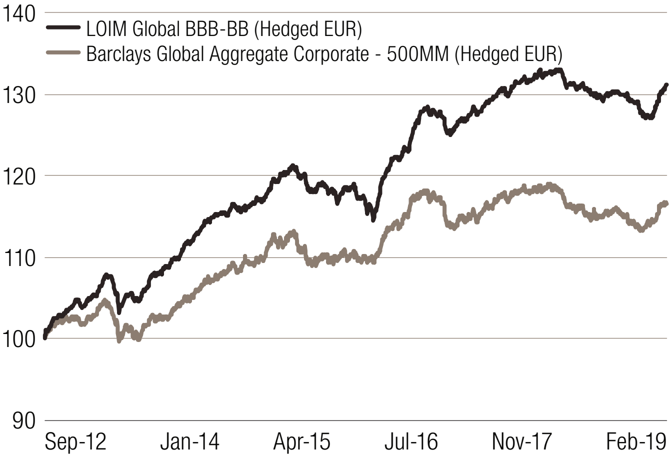


Source: Bloomberg. LOIM. As at 28 February 2019. Past performance is not a guarantee of future results.

	ANNUALISED			
	INCEPTION DATE: 1 DECEMBER 2010			
	SINCE INCEPTION		3 YEARS	
	STRATEGY	MC BENCH[2]	STRATEGY	MC BENCH[2]
Return	4.69%	3.91%	4.05%	2.25%
Volatility	3.87%	3.26%	3.01%	2.20%
Sharpe ratio	1.21	1.20	1.46	1.18
Max. DD	-5.35%	-4.36%	-3.58%	-2.66%
Excess return	0.78%	–	1.80%	–
TE	1.53%	–	1.49%	–

[1] Gross fees refer to net performance minus the total expense ratio (TER) of the strategy.
[2] Barclays Euro-Aggregate Corporates – 500MM (EUR).

FIG. 18B PERFORMANCE OF LOIM GLOBAL BBB-BB FUNDAMENTAL STRATEGY, GROSS OF FEES[1] (HEDGED IN EUR)



Source: Bloomberg. LOIM. As at 28 February 2019. Past performance is not a guarantee of future results.

	ANNUALISED			
	INCEPTION DATE: 17 SEPTEMBER 2012			
	SINCE INCEPTION		3 YEARS	
	STRATEGY	MC BENCH[2]	STRATEGY	MC BENCH[2]
Return	4.83%	3.95%	4.07%	2.59%
Volatility	3.88%	3.31%	3.12%	2.32%
Sharpe ratio	1.2	1.1	1.4	1.3
Max. DD	-4.2%	-3.7%	-2.0%	-1.9%
Excess return	0.88%	–	1.48%	–
TE	1.52%	–	1.68%	–

[1] Gross fees refer to net performance minus the total expense ratio (TER) of the strategy.
[2] Barclays Global-Aggregate: Corporates – 500MM.

Crossover for a buy-and-maintain framework

For certain investors, a "trading less" framework can be extended further to a buy-and-maintain approach.[8] A buy-and-maintain framework brings fixed income back to basics: an investor buys a bond with the intention of holding it to maturity and receiving the coupons, as well as receiving the notional at maturity.

Our two-stage analysis aims to mitigate the credit risk exposure of investors holding bonds until maturity. Below we show the characteristics of a 5-year global crossover buy-and-maintain strategy.

GLOBAL CROSSOVER BUY-AND-MAINTAIN: 5 YEARS MODEL PORTFOLIO CHARACTERISTICS

		YIELD			
SPREAD (BPS)	DURATION (YRS)	UNHEDGED	USD HEDGED	EUR HEDGED	CHF HEDGED
268	4.2	3.79	5.53	2.41	1.99

Source: LOIM as at 28 February 2019. Allocations and holdings are subject to change. For illustrative purposes only. Past performance is not a guarantee of future returns.

[8] See our research titled "Crossover as credit complement: a risk-return profile", March 2019, for more details.

Conclusion

In their search for yield,[9] investors are increasingly being drawn to corporate credit markets. However, traditional investment grade credit portfolios have become less appealing as a result of monetary policy-driven shifts in the market. Investors can no longer count on duration – a key component of investment grade credit – to generate long-term returns. We believe that investors should seek to increase their credit risk exposure at the expense of their duration exposure by moving down the credit rating spectrum.

In our view, the many positive attributes and dynamics of the crossover “BBB-BB” universe of corporate credit make it an attractive investment opportunity. We believe that the crossover segment offers the potential for significant return enhancement relative to investment grade, while avoiding the excessive credit risk that is a feature of lower rated debt.

However, scarce liquidity means investors need to be particularly mindful of the investment approach they employ. We believe a sustainable approach to portfolio construction – which seeks to avoid the pitfalls of market-cap approaches – can generate a robust crossover portfolio that delivers higher risk-adjusted returns over time and is better suited to the current paradigm in fixed income investing.

[9] Yields are subject to change and can vary over time.

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High yield, lower rated securities involve greater price volatility and present greater credit risks than higher rated fixed income securities.

The Strategy's investments in Fixed Income securities are subject to the risks associated with debt securities including economic conditions, government regulations, market sentiment, and local and international political events. In addition, the market value of fixed income securities will fluctuate in response to changes in interest rates, currency values, and the creditworthiness of the issuer. If an issuer's financial condition worsens, the credit quality of the issuer may deteriorate making it difficult for an investor to sell such investments.

Securities of issuers held by the Fund may lack sufficient market liquidity to enable the Fund to sell the securities at an advantageous time or without a substantial drop in price.

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17 96

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