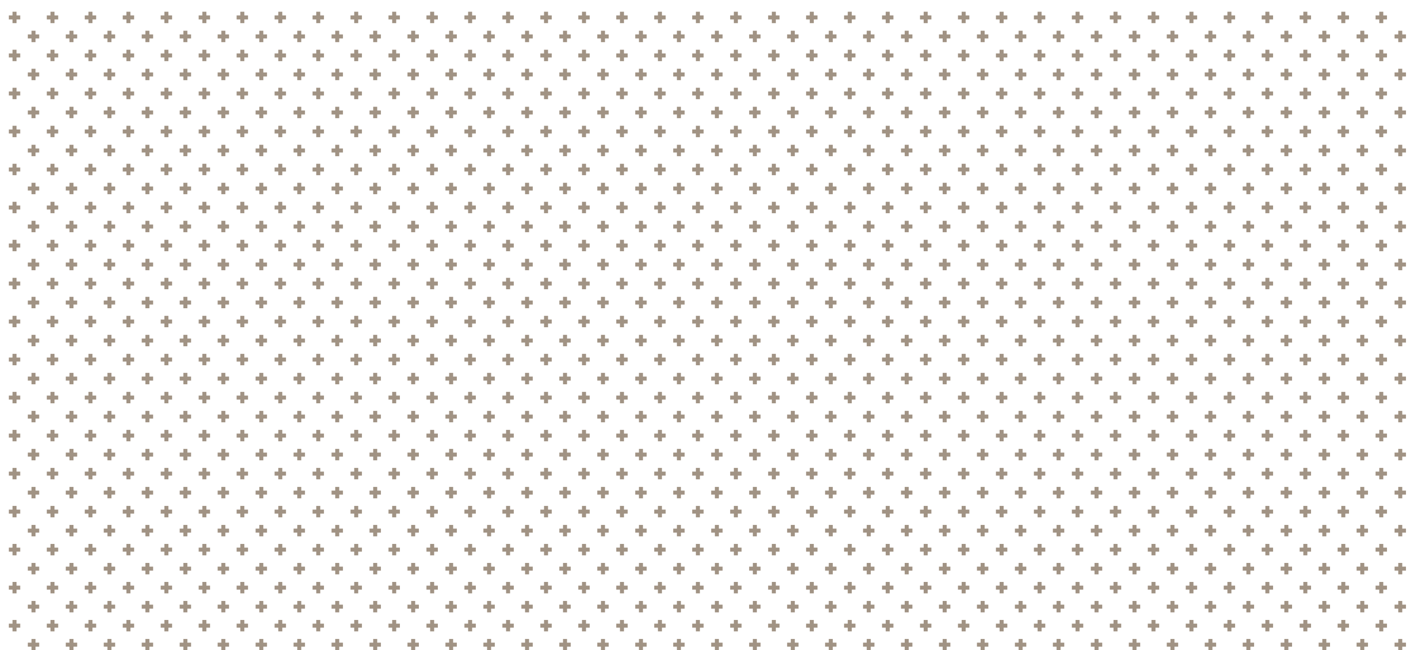
LOMBARD ODIER
INVESTMENT MANAGERS

RETHINK YOUR APPROACH TO CORPORATE CREDIT

In the new investment paradigm, the search for yield remains at the forefront of investors' objectives, increasing the appeal of corporate credit. However, traditional investment grade credit has become less attractive. We believe that increasing credit exposures by investing in the crossover segment "BBB-BB" offers a compelling alternative to investment grade. We believe that our fundamentals-based approach – centred on quality and low turnover – is better suited to the new environment.



Contents

Executive summary 1

The new investment paradigm is drawing investors to credit markets 2

Investment grade corporate credit has become less attractive 3

- The nature of duration has changed to make it less attractive for long term returns 3
- Duration brings fewer diversification benefits 4

The case for crossover credit 5

- Higher yield than investment grade portfolios 6
  - BB's: the sweet spot in the credit spectrum 6
  - The inclusion of "fallen angels" boosts returns 7
- A better balance between duration and credit risk than investment grade 8
- Positive dynamics in crossover relative to investment grade 8
  - Rating and sector allocation are converging to investment grade debt 8
  - Fundamentals of crossover bonds tending to improve 10
- Lower default risk exposure and drawdowns than high yield 10

Implementation matters 12

- The risks of traditional corporate bond indices 12
- A different way to explore the crossover segment: focus on quality and trade less 13
  - Level 1: Beta portfolio construction 13
  - Level 2: Credit overlay 15

Our experience in managing crossover portfolios 15

- Implementation using a buy-and-maintain framework 16

Conclusion 16

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Executive summary

- In the current environment of historically low government bond yields, investors should explore credit markets to help meet their return targets. However, investment grade credit has become less appealing in the new investment paradigm, given its high exposure to duration
- The direction of monetary policy points to limited potential for rates to move lower, damaging the return potential of duration. In the US, rate rises are increasingly likely post-election; in Europe, the ECB is intervening in credit markets and may seek to control yield curves: both are negatives for duration
- We believe that in this new investment paradigm investors should move down the credit spectrum and consider the crossover “BBB-BB” segment. The crossover universe offers the potential for significant return enhancement when compared with investment grade along with robust fundamentals, 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 not equipped to deal with the new reality as they tend to concentrate risks by rewarding leverage
- We recommend that investors bring quality to the heart of the portfolio construction process to mitigate credit default risk and facilitate lower turnover – a framework utilised within our fundamental fixed income approach.

The new investment paradigm is drawing investors to credit markets

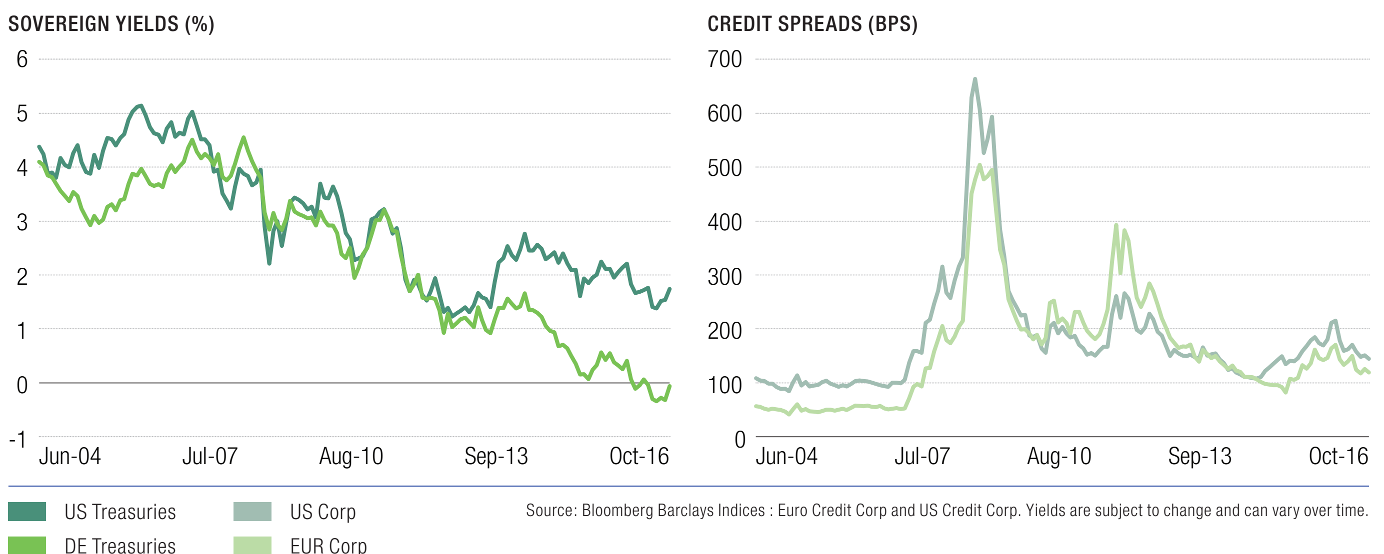
Investors are facing a number of important challenges when it comes to global fixed income investing.[1]

1. **Widespread low or negative yields in key developed markets**: Investors are facing a material cost of negative carry in their fixed income allocation and this is forcing investors to search for yield. Even though the US election has alleviated some pressure, the fundamental drivers of low rates in non-US developed markets remain, especially as a major fiscal stimulus in Europe still remains very unlikely
2. **Increased market risk:** Investors have extended duration to find positive yields and now face a heightened sensitivity to moves in interest rates. Bond markets are also now providing lower diversification benefits given the increased correlation with equities
3. **Fractured liquidity:** Liquidity is fractured in fixed income markets stemming from two main causes: (i) Central Banks buying large quantities of financial assets and (ii) tightening regulation such as Basel III which is strongly reducing banks' ability to hold and trade fixed income leading to a sharp drop in corporate bond inventories.

The monetary policy backdrop facing investors is complex and dynamic. Focusing on the US, expansionary fiscal policy (or a fiscal bazooka) is now a strong possibility following the Trump win; the sharp rise in yields and the steepening of the yield curve following the election highlight the market's expectations on this front. Turning to Europe, the European Central Bank (ECB) has already expanded the scope of its Quantitative Easing program to include credit markets. The Bank of Japan (BoJ), on its side, introduced a new policy framework focused on yield curve control with an additional fixing of the long end of the risk-free curve. Given the need for further stimulus in the Eurozone and a scarcity of eligible assets, we believe the ECB is likely to echo the BoJ and control the yield curve. In the event that fiscal policy is also deployed in the Eurozone, this would create an additional headwind for yields.

More generally, sovereign yields have collapsed as shown in Figure 1, forcing investors to take more credit risk in their search for yield. Figure 1 shows that credit spreads are near their long-term averages and we believe that investors need to re-assess the attractiveness of owning duration risk versus credit risk, given the broader context described above.

FIG. 1 – SOVEREIGN YIELDS AND CREDIT SPREADS (JUNE 2004 TO OCTOBER 2016)



Source: Bloomberg Barclays Indices : Euro Credit Corp and US Credit Corp. Yields are subject to change and can vary over time.

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

See important information at the end of this document.

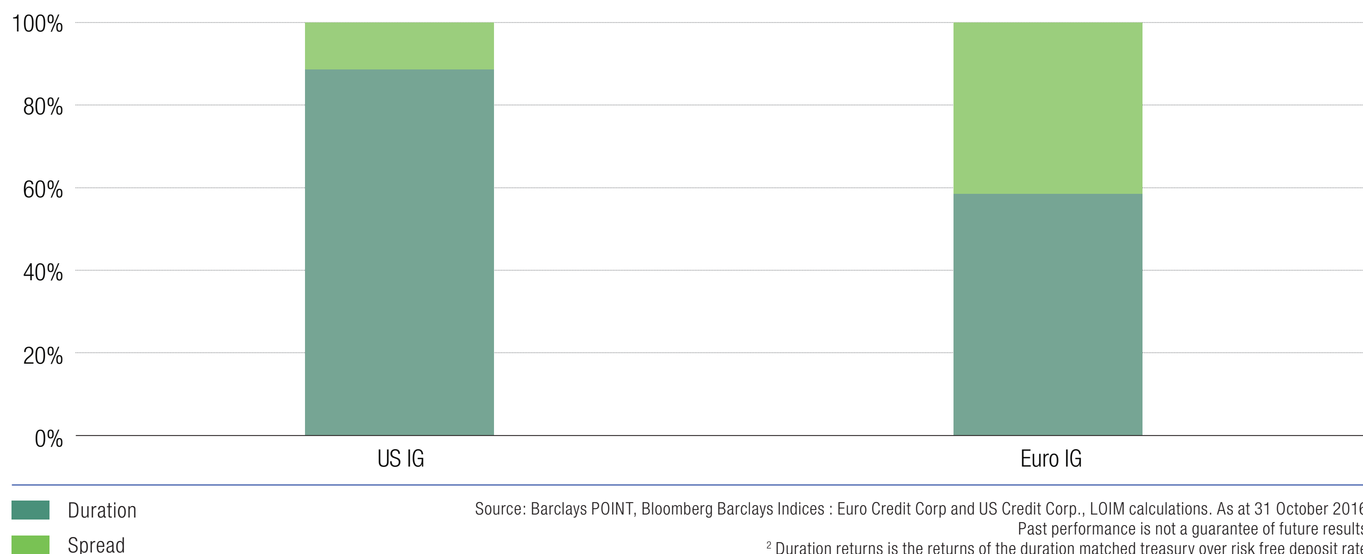
Investment grade corporate credit has become less attractive

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 both a slightly enhanced yield relative to riskless treasuries and diversification against equities. 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 an investment grade corporate bond portfolio as illustrated in Figure 2 where we see that duration contributes to nearly 90% of the total risk in the US and 60% in the Eurozone. However, the unprecedented monetary policy described earlier has changed the nature of duration making the investment grade segment less appealing for the following reasons:

- Duration exposure provided by investment grade credit is less attractive as a source of return for investors seeking long terms returns
- Duration exposure no longer provides diversification to equity risk.

FIG. 2 – RISK CONTRIBUTIONS BY DURATION[2] AND CREDIT[3] COMPONENTS[4]



Source: Barclays POINT, Bloomberg Barclays Indices : Euro Credit Corp and US Credit Corp., LOIM calculations. As at 31 October 2016. Past performance is not a guarantee of future results.

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

[3] Credit spread returns is the returns of the corporate bond over duration matched treasuries. This measure of returns 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.

THE NATURE OF DURATION HAS CHANGED TO MAKE IT LESS ATTRACTIVE FOR LONG TERM RETURNS

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

In the US, sentiment on rates has turned distinctly hawkish following the election results; the probability of fiscal interventions has increased, creating negative pressure around duration dynamics. In Europe monetary policy continues to be dovish with the ECB expanding its quantitative easing programme to include credit, hence extending the direct influence of monetary policy beyond duration. We believe the possibility of yield curve control is more likely now in Europe, given the spill-over from the US election.

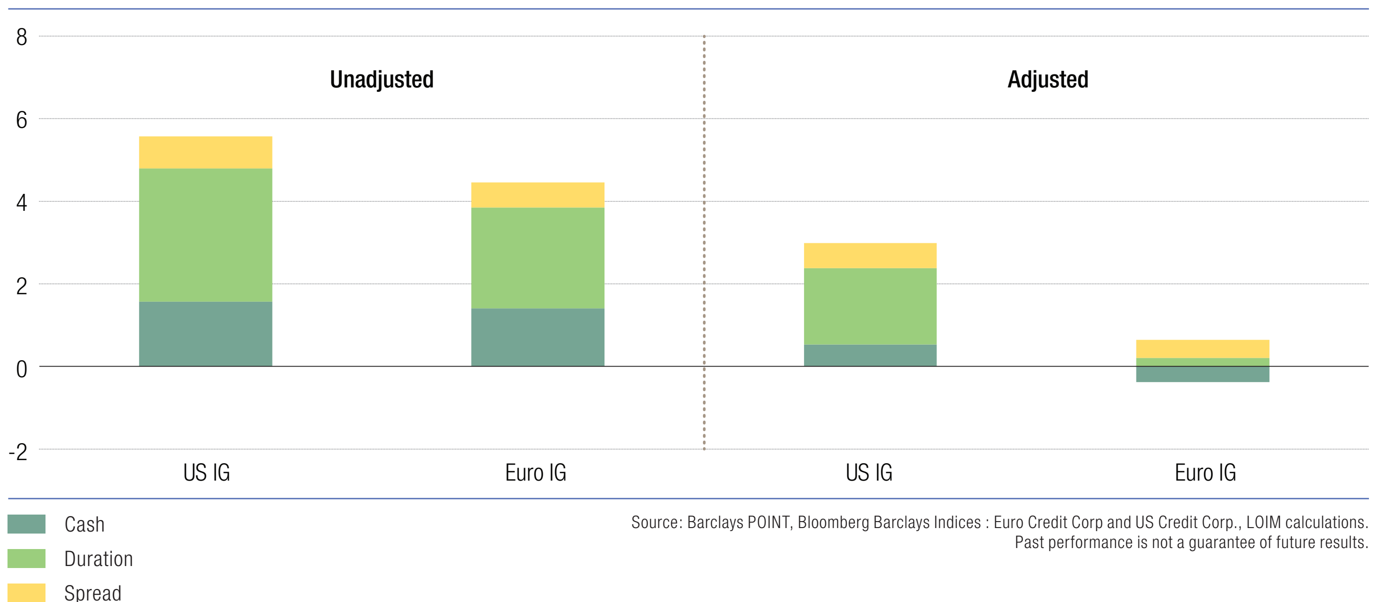
This would mean that duration ceases to adequately perform any of the key functions it has historically been associated with, namely: long term returns, capital preservation, diversification and liquidity.

A key driver of the contribution of duration to investment grade portfolio returns has been a fall in interest rates - from 4% to 1% in the US and below 0% in the Eurozone. The probability of this trend continuing is low in our opinion as treasury rates are likely to be approaching their lower limits. In other words, historical duration-driven returns, which have been buffeted by a tailwind of falling risk free yields, are therefore not an appropriate predictor of future returns.

We decomposed the returns over the past 12 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 3 demonstrates that a large fraction of historical returns has come from duration; spread returns have been less significant.

The right panel of Figure 3 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.

FIG. 3 – HISTORICAL RETURNS (ADJUSTED AND UNADJUSTED) SPLIT BY CASH, DURATION AND CREDIT SPREAD COMPONENTS (OCTOBER 2004 TO OCTOBER 2016)



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

Given that a fall in interest rates has been the dominant driver of duration-related returns and that rates are now approaching their lower limits, we believe that the potential for investors being rewarded for duration risk has strongly diminished.

DURATION BRINGS FEWER DIVERSIFICATION BENEFITS

In addition, from the point of view of an asset allocator, the diversification benefits of investing in investment grade have eroded.

[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.

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In the Eurozone, duration no longer diversifies equity risk as evidenced in Figure 4. This can be explained by the reduced potential for further reductions in Eurozone treasury yields (and, conversely, the reduced potential for bond price increases); investors can no longer count on bond prices rising in risk-off environments to counteract equity market falls.

While, diversification is still available in the US, its efficiency has been declining since 2012. Correlations with equities have increased from -60% in 2012 to 0% in Europe and from -60% to -20% in the US.

FIG. 4 – CORRELATION OF DURATION RETURNS WITH EQUITIES – 36 MONTHS ROLLING

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

Overall, the risk and return attributes of an investment grade portfolio have changed in the new investment paradigm, with investors being rewarded less for taking duration risk and duration risk providing fewer diversification benefits than before.

In this context, we strongly believe that investors looking for yield should prudently move down the credit spectrum and consider the crossover space which can offer attractive risk-adjusted return potential underpinned by solid corporate fundamentals.

The case for crossover credit

As investors cannot expect duration risk, to be compensated going forward or to provide a hedge against equities, 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 strengthen the case for it being a suitable alternative to an investment grade allocation.

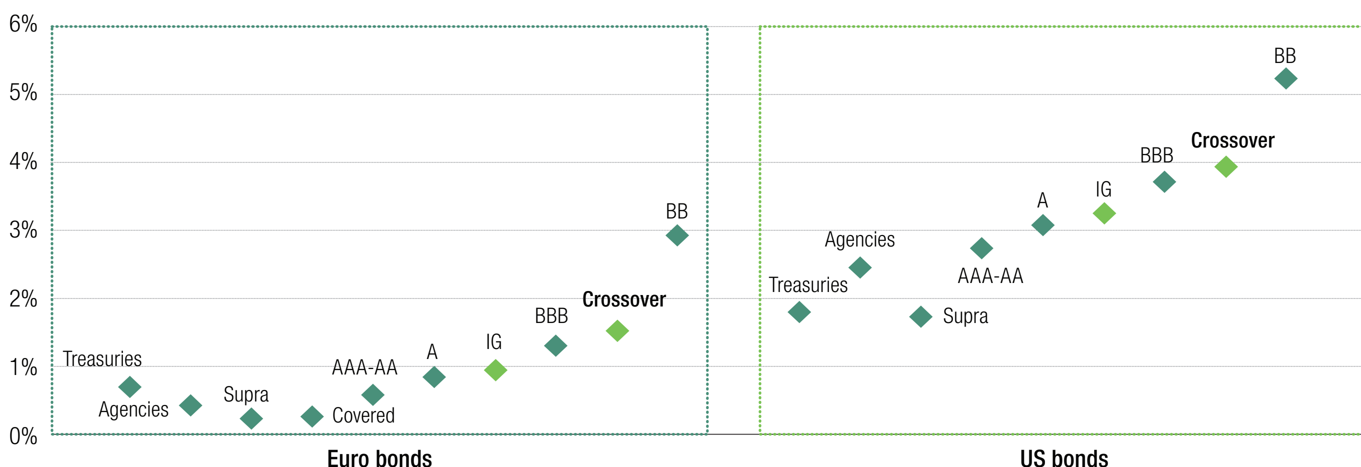
The potential benefits of the corporate crossover segment can be summarised as:

- Better balance of duration and credit risk than the investment grade universe
- Higher yield and return potential than investment grade portfolios
- Positive dynamics relative to the investment grade universe
- Lower default and drawdown risk compared with the high yield universe.

HIGHER YIELD THAN INVESTMENT GRADE PORTFOLIOS

Figure 5 shows that yields for investment grade issuers are around 0.90% in Europe and 3.3% in the US. The crossover BBB-BB segment offers yields that are more than 60 bps higher than those of the investment grade universe.

FIG. 5 – YIELDS (%)[6]



Source: Barclays POINT, Bloomberg Barclays Indices : Euro Credit Corp and US Credit Corp, LOIM calculations as at 14 November 2016. Yields are subject to change and can vary over time.

[6] Yields do not take into account hedging costs. For a Euro investor cost of hedging USD is almost 1.7%. Hedged yields for the US are similar to Euro.

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.

BB's: the sweet spot in the credit spectrum

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 6 overleaf. The inclusion of "fallen angels" in the BB universe explains a large part of this outperformance to date.

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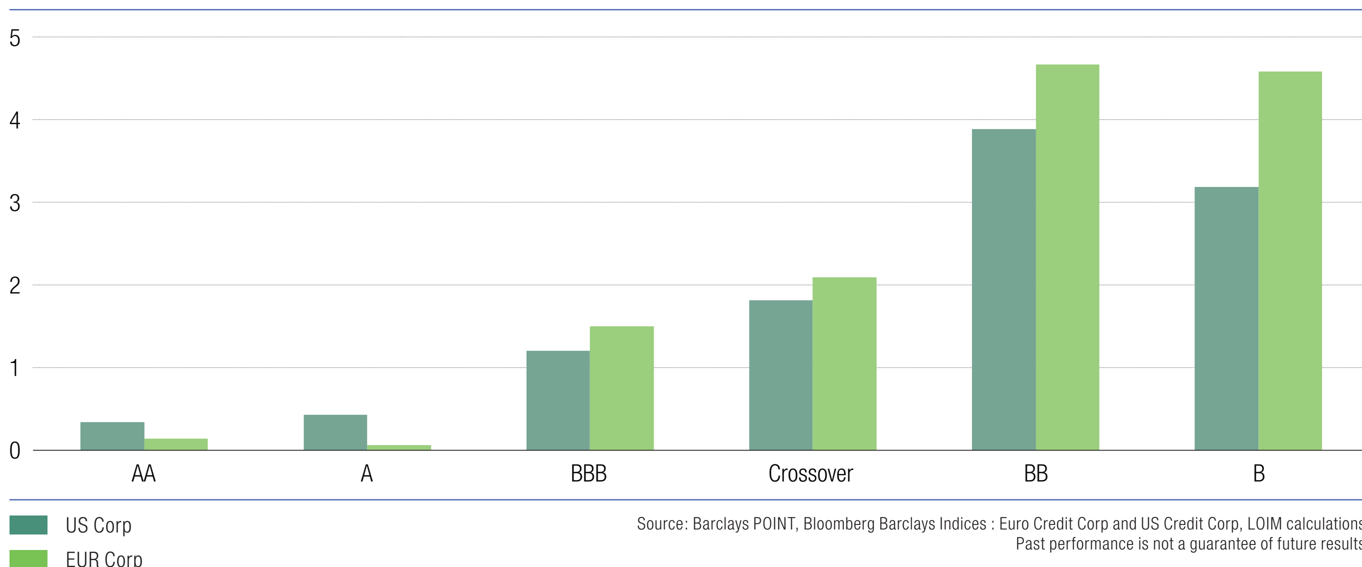
FIG. 6 – CREDIT SPREAD RETURNS (% PER YEAR, OCTOBER 2004 TO OCTOBER 2016)



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

The inclusion of "fallen angels" boosts returns

An important driver behind 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 the bonds thereby increasing supply of these bonds. The high yield investor community does not provide a 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 7, 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 40% in the Eurozone.

FIG. 7 – CREDIT SPREAD RETURNS (% PER YEAR, OCTOBER 2004 TO OCTOBER 2016)

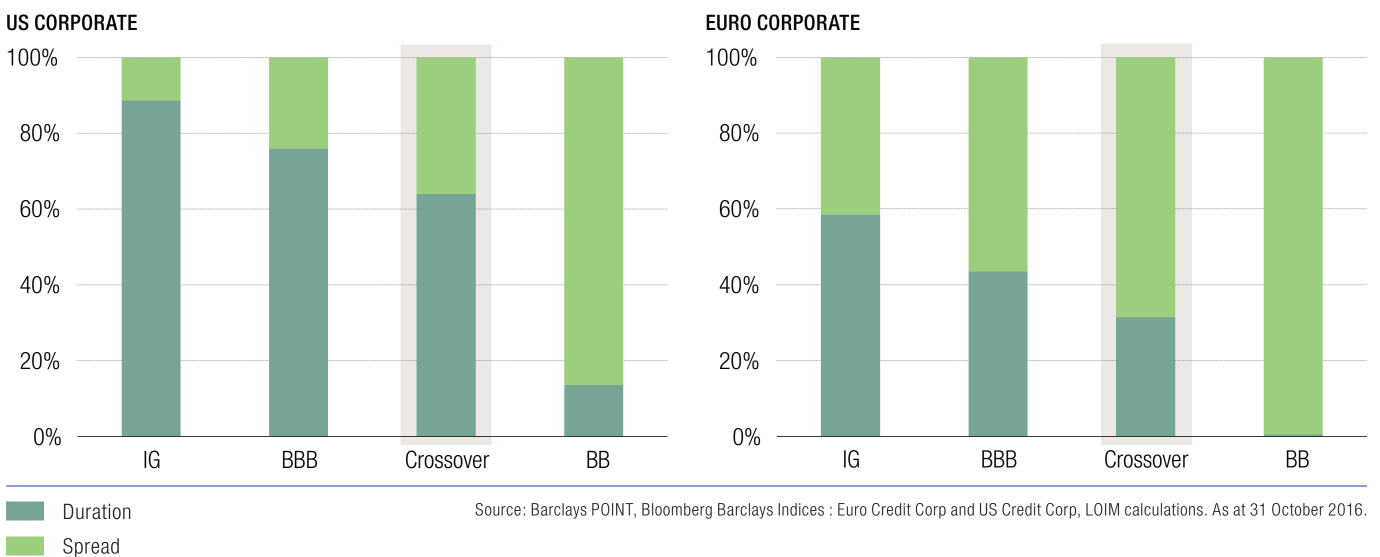
FIG. 8 – PROPORTION OF FALLEN ANGELS IN BB PORTFOLIOS

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

A BETTER BALANCE BETWEEN DURATION AND CREDIT RISK THAN INVESTMENT GRADE

In addition to attractive returns, we believe the crossover segment of the corporate credit universe offers a good balance between credit and duration risk. This is highlighted in Figure 9 which shows the contribution of duration and credit to overall risk as we move across rating categories. The credit and duration risk for the crossover index is balanced in the US where duration still offers some return potential while in the Eurozone – where duration provides little return or diversification benefits – credit risk is the dominant component. In contrast, an index comprising only BB rated issuers is dominated by credit risk in both markets.

FIG. 9 – RISK CONTRIBUTIONS SPLIT INTO DURATION AND CREDIT SPREAD COMPONENTS



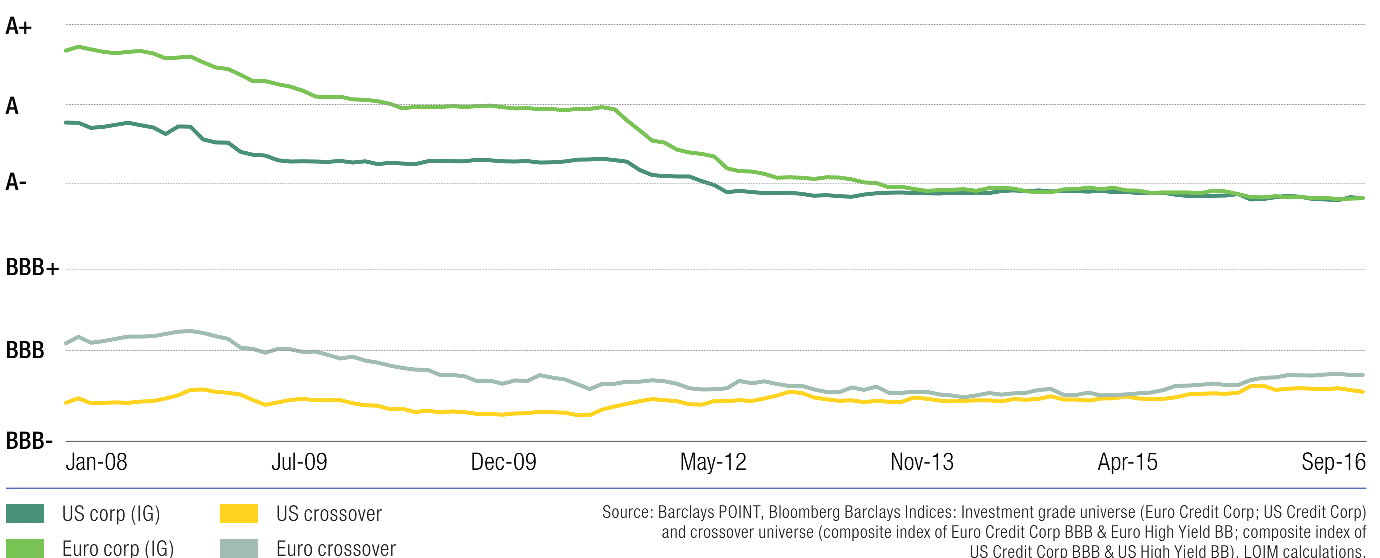
Source: Barclays POINT, Bloomberg Barclays Indices : Euro Credit Corp and US Credit Corp, LOIM calculations. As at 31 October 2016.

POSITIVE DYNAMICS IN CROSSOVER RELATIVE TO INVESTMENT GRADE

Rating and sector allocation are converging to investment grade debt

The quality of the overall investment grade universe has been declining with the average rating of the investment grade issuer falling from A+ before the global financial crisis to A- currently. 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. 10 – AVERAGE RATING OF THE CROSSOVER INDEX VERSUS INVESTMENT GRADE (JANUARY 2008 TO OCTOBER 2016)



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.

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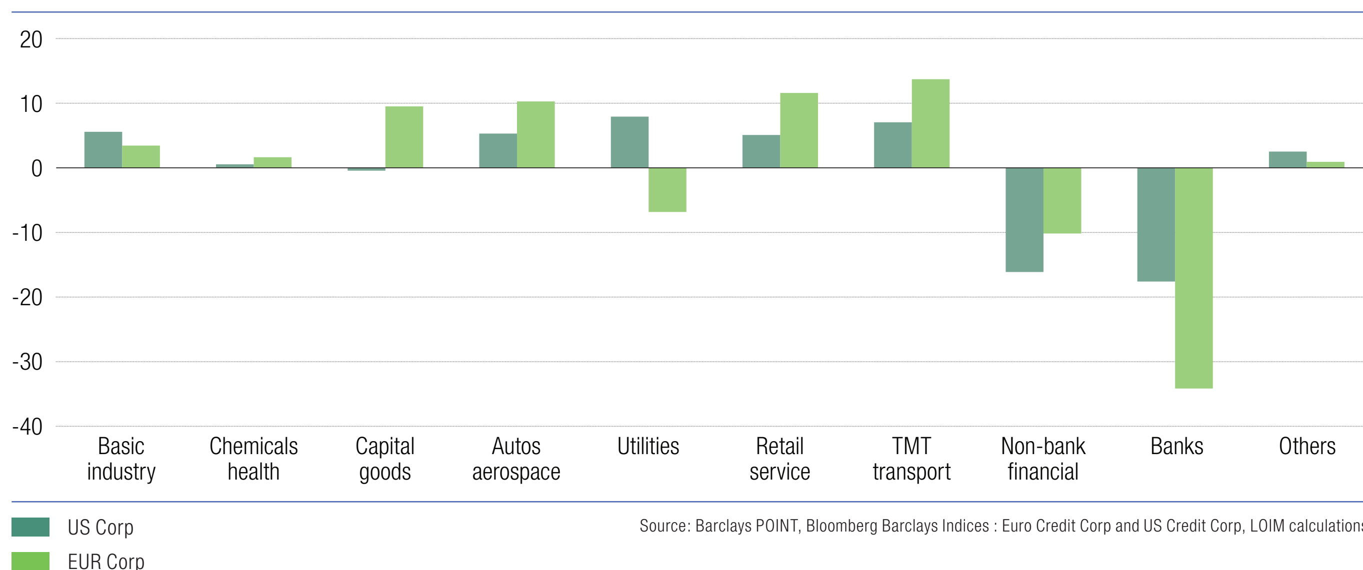
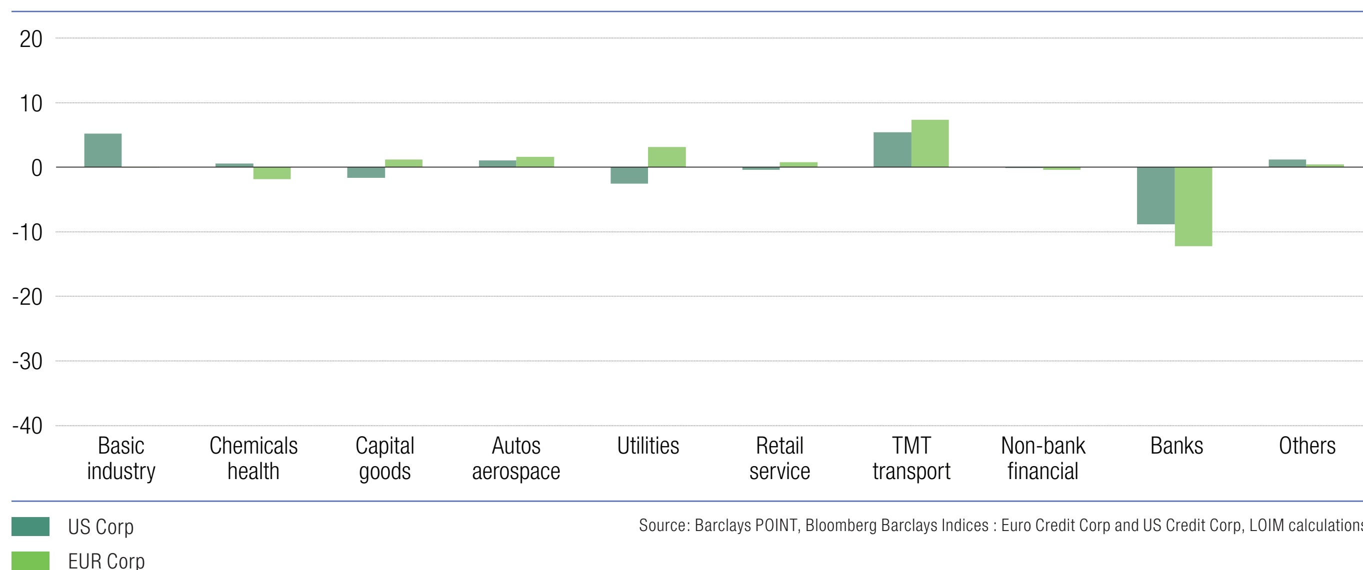
Another area in which we observe convergence between the investment grade and crossover universes is in the sector allocations over the past 10 years. For the crossover segment to be considered a suitable replacement for investment grade, sector allocation should be similar as large differences in the sector mix can lead to very different performance patterns over time. Figures 11A and 11B shows that the sector allocation within the two universes have converged.

FIG. 11A – SECTOR MISMATCH (%): CROSSOVER VERSUS INVESTMENT GRADE (29 SEPTEMBER 2006)



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

FIG. 11B – SECTOR MISMATCH (%): CROSSOVER VERSUS INVESTMENT GRADE (30 SEPTEMBER 2016)

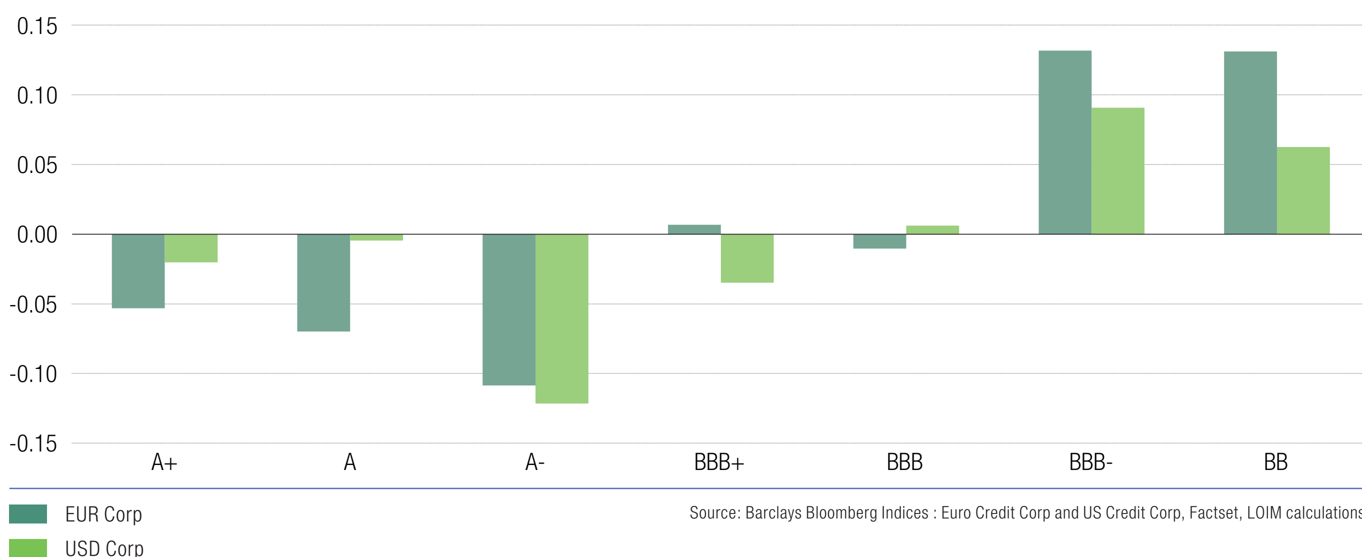


Source: Barclays POINT, Bloomberg Barclays Indices : Euro Credit Corp and US Credit Corp, LOIM calculations.

Fundamentals of crossover bonds tending to improve
We now turn our attention to fundamentals, using the net-debt to ebitda ratio - also called leverage - as a proxy for the balance-sheet strength of non-Financial companies. We find that the leverage of lower rated investment grade (BBB-) and BB issuers appears to improve over time whereas the opposite is true for A rated and high BBB rated issuers.

This is demonstrated in Figure 12 where we calculate the average annual reduction in net leverage after adjusting for the business cycle.[7] We believe this reflects a general trend among higher rated companies to seek to optimise their balance sheets which invariably leads 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, therefore making them more likely to take steps to support their balance sheet. In other words, access to funding reduces and the cost of such funding increases significantly through the high yield rating spectrum so 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 have improved their fundamentals relative to the investment grade universe.

FIG. 12 – AVERAGE ANNUAL IMPROVEMENT (REDUCTION) IN MEDIAN NET-DEBT-TO-EBITDA (DECEMBER 2005 TO OCTOBER 2015)



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

LOWER DEFAULT RISK EXPOSURE AND DRAWDOWNS THAN HIGH YIELD

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.

[7] We adjust for the business cycle by comparing fundamentals at the same point-in-time. We compare the median leverage of two bonds universes constructed using a specified rating at the start and at the end of an annual period. Fundamentals (net leverage) for these universes are calculated at the end of the annual period. The difference in the fundamentals for the two universes is a proxy for improving/worsening fundamentals. The analysis is done on a monthly rolling basis and averaged over time.

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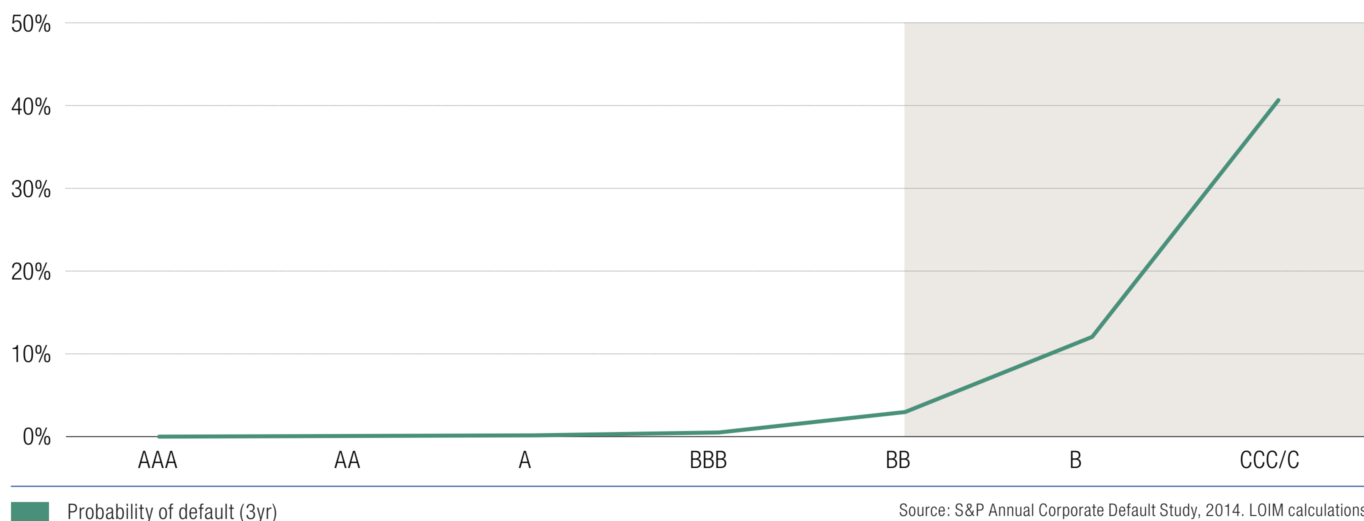
FIG. 13 – DEFAULT PROBABILITY ACCORDING TO CREDIT RATING (1996 TO 2014)

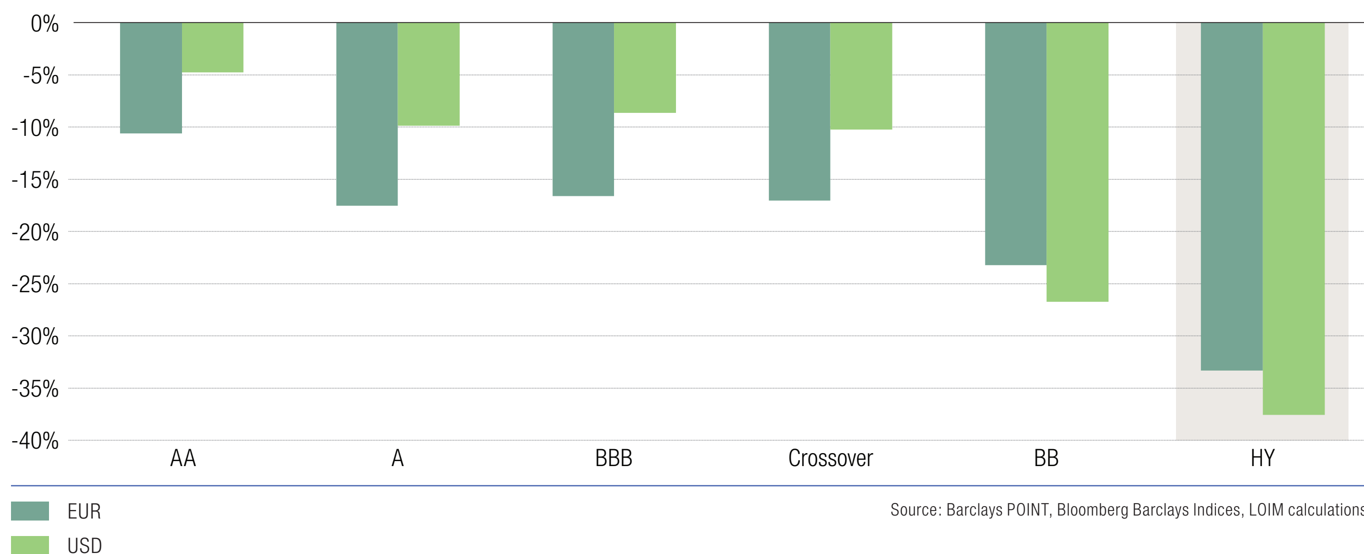


Probability of default (3yr)

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

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 12 years, -33% and -38% for the Eurozone and the US respectively, as shown in the Figure 14 below. In contrast, the drawdowns of the crossover segment are similar to those of investment grade bonds.

FIG. 14 – DRAWDOWN BY RATING CATEGORY (OCTOBER 2004 TO OCTOBER 2016)



EUR
USD

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

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.

Implementation matters

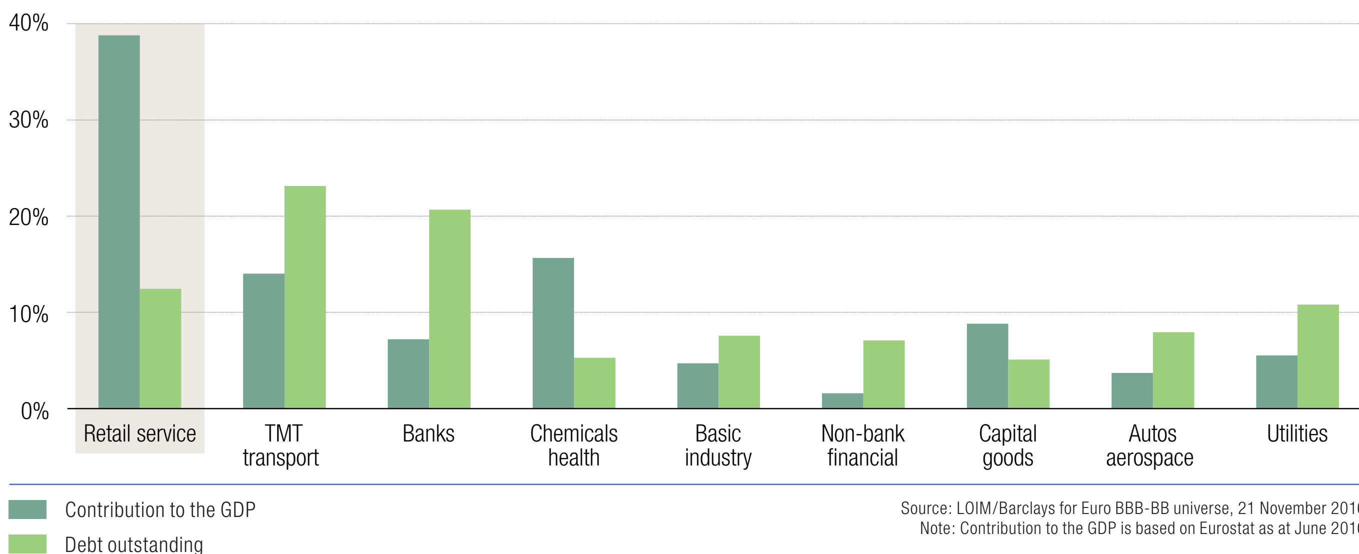
While we believe the case for crossover is very compelling, investors should be aware of the implementation risks involved in increasing credit risk in a regime of declining liquidity. Traditional market-cap benchmarks have dominated the fixed income landscape for a number of years. However, a market-cap based approach entails a number of flaws that we believe should be considered, particularly in the new 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 TRADITIONAL CORPORATE BOND 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 15 below:

FIG. 15 – MARKET-CAP WEIGHTS IGNORE SECTORS' CONTRIBUTION TO THE ECONOMY



Source: LOIM/Barclays for Euro BBB-BB universe, 21 November 2016.
Note: Contribution to the GDP is based on Eurostat as at June 2016.

Another observation is the lack of stability in sector allocation when using a market-cap based benchmark as highlighted in the Figure 16 overleaf. Specifically for the euro crossover universe, sector exposure has been particularly volatile over the past 15 years primarily driven by rating transitions. The TMT sector's weights have declined from nearly 60% in 2001 to around 20% today while the Banking sector, largely absent in the market-cap index in 2001,now represents the largest sector within the index.

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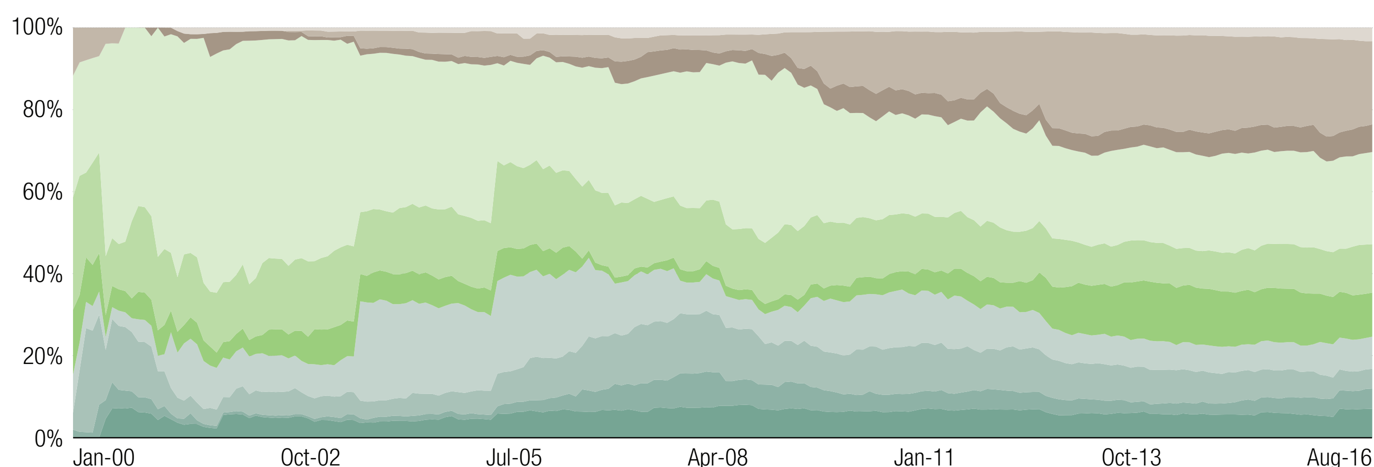
FIG. 16 – SECTOR ALLOCATION OF MARKET-CAP BASED EURO BBB-BB INDEX (JANUARY 2000 TO AUGUST 2016)



Source: Barclays POINT, as at September 2016.

Overall, we believe that market-cap weighted benchmarks may expose investors to significant risks that should be considered when building a 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 WAY TO EXPLORE THE CROSSOVER SEGMENT: FOCUS ON QUALITY AND TRADE LESS

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 underlying credit risk fundamentals of issuers. As a result, our investment process aims to provide our clients with safer portfolios with quality at the heart of the portfolio construction process. By building a high quality starting portfolio our approach requires less frequent trading than traditional approaches; it aims to mitigate credit default risk while trading less. We follow a two-step process:

- At level 1, we perform a systematic top-down and bottom-up assessment of the investment universe
- At level 2, we perform a further fundamental bottom-up assessment of issuers' credit default risk

Level 1: Beta portfolio construction

Our proprietary methodology centres on a systematic fundamentals-based 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 downgrade risk.
- For issuer selection, we believe that focusing on an issuer's credit quality rather than the amount of debt it has outstanding can reduce the portfolio's downgrade and default risk.

Together, these components determine the economic allocation of the portfolio, accounting for 60% of the final allocation. We then add a market-based allocation (40%) which incorporates liquidity and yield adjustments; for a given economic value, we favour sectors and issuers with higher yield and higher liquidity. The table below shows the various factors that we use to build our crossover corporate bond portfolios.

FIG. 17 – A FUNDAMENTALS-BASED PORTFOLIO CONSTRUCTION

ECONOMIC ALLOCATION 60%

TOP DOWN

SECTORS

Investing in sectors that contribute the most to the economy

- GDP contribution

↑ Higher contribution increase the weight

BOTTOM-UP

ISSUERS

Favouring financial strength: companies that boast sustainable leverage and solid revenues

INDUSTRIALS/UTILITIES

- Looking for companies that generate cash and use debt to fund long-term growth

BANKS

- Looking for banks with stable funding sources and adequate asset quality

↓ Higher leverage and lower cash flow reduce the weight

MARKET-BASED ALLOCATION 40%

YIELD

Favouring sectors and corporates with attractive yields

- Option adjusted spreads

↓ When the spread drops (price increased) the weights are reduced

LIQUIDITY

Favouring the most liquid sectors or corporates

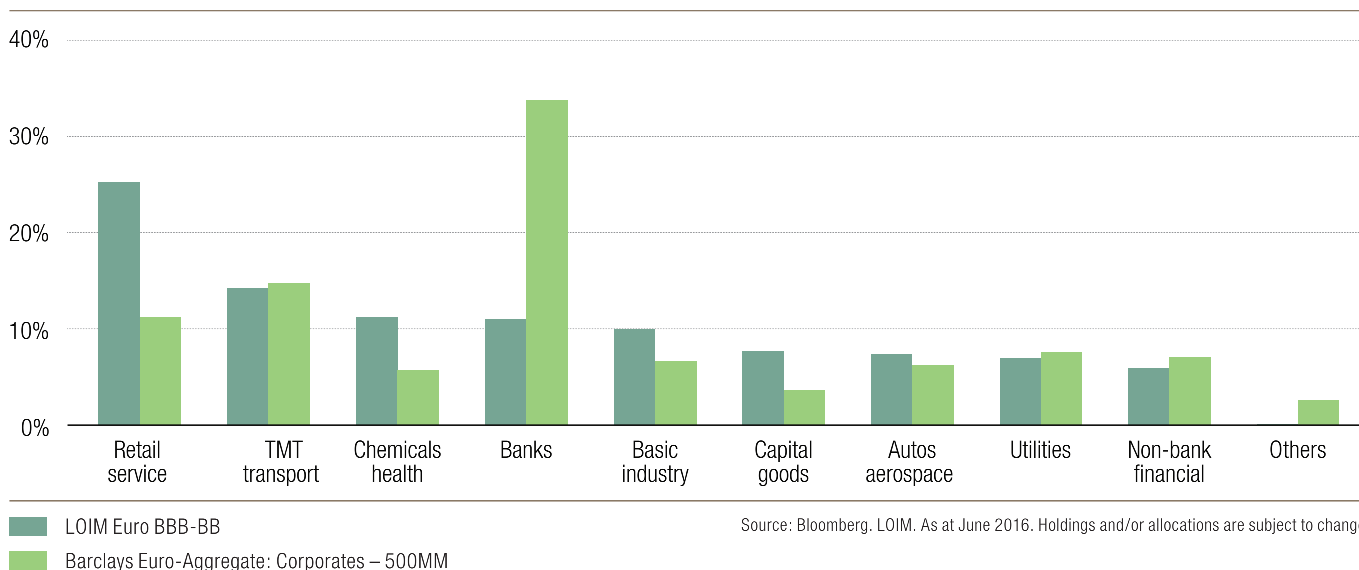
- Average bid offer spread

↑ Issuers with better liquidity receive a higher weight

Source: LOIM. For illustrative purposes only.

Figure 18 shows that the resulting sector allocation for our euro crossover fundamentals-based strategy provides greater sector diversification than a traditional market-cap corporate bond benchmark and reflects each sector's economic importance by giving a larger exposure to the Retail and Chemicals sectors and limiting the exposure to the Financial sector.

FIG. 18 – A FUNDAMENTALS-BASED APPROACH BRINGS BETTER DIVERSIFICATION



Source: Bloomberg. LOIM. As at June 2016. Holdings and/or allocations are subject to change.

See important information at the end of this document.

We believe this systematic rules-based 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 issuers' credit strength over the long term and this contributes to keeping the turnover of the portfolio low.

Level 2: Credit overlay
Drawing upon the expertise and in-depth research of our credit analysts, our credit overlay approach aims to further mitigate the portfolio's default risk exposure by continually monitoring issuers' credit risk.

In addition, real-time monitoring of the market allows our credit analysts to identify and exploit market inefficiencies 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 the mispricing of these bonds as they migrate from one rating category to another. Our dedicated credit analysts are specialised by industry across developed and emerging markets; and follow companies across the ratings spectrum from investment grade to BB rated corporate bonds.

Our experience in managing crossover portfolios

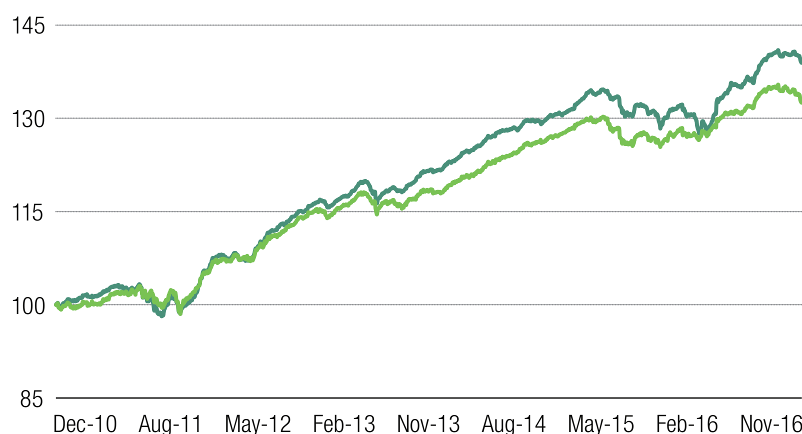
We began managing crossover bonds in 2010. As of September 2016, we managed USD 8.5 billion according to our fundamentals-based methodology, of which USD 1 billion is in euro and global crossover strategies.

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.

The Figure 19 below shows 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 underweight to duration relative to investment grade (4.5 versus 5.4 years for IG) that has detracted from historical performance over a period of falling risk-free yields.

FIG. 19 – PERFORMANCE OF LOIM EURO BBB-BB FUNDAMENTAL STRATEGY, GROSS OF FEES

LOIM EURO BBB-BB FUNDAMENTAL STRATEGY – CUMULATED PERFORMANCE



LOIM Euro BBB-BB Fundamental strategy
Barclays Euro-Aggregate: Corporates – 500MM

PERFORMANCE STATISTICS

	ANNUALISED			
	INCEPTION DATE: 1 DECEMBER 2010			
	SINCE INCEPTION		3 YEARS	
	STRATEGY	MC BENCH[1]	STRATEGY	MC BENCH[1]
Return	5.66%	4.84%	4.58%	3.86%
Volatility	4.28%	3.62%	3.63%	2.77%
Sharpe ratio	1.2	1.2	1.3	1.4
Max. DD	-4.20%	-3.66%	-4.17%	-3.33%
Excess return	0.82%	–	0.72%	–
TE	1.68%	–	1.82%	–

Source: Bloomberg. LOIM. As at 15 November 2016. Past performance is not a guarantee of future results.
[1] Barclays Euro-Aggregate: Corporates – 500MM.

IMPLEMENTATION USING A BUY-AND-MAINTAIN FRAMEWORK

For certain investors, a "trading less" framework can be extended further to a buy-and-maintain approach. 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-step fundamentals-based approach 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:

TABLE. 1 – GLOBAL CROSSOVER BUY-AND-MAINTAIN: 5 YEARS MODEL PORTFOLIO CHARACTERISTICS

SPREAD (BPS)	DURATION (YRS)	YIELD			
		UNHEDGED	USD HEDGED	EUR HEDGED	CHF HEDGED
235	4.2	3.06	3.96	2.21	1.72

Source: LOIM. As at 14 November 2016.

Conclusion

In their search for yield, 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, in the new investment paradigm where liquidity is scarce, investors need to be particularly mindful of the investment approach they employ. We believe a fundamental approach to portfolio construction – which seeks to avoid the pitfalls of market-cap approaches – can generate a robust crossover portfolio that requires less frequent trading and is better suited to the new paradigm in fixed income investing.

See important information at the end of this document.

IMPORTANT INFORMATION

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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.

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