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INVESTMENT MANAGERS

TargetNetZero fixed income

Q1 2023: Investing in quality credit for net zero

For professional investor use only • Fixed Income

Q1 2023

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Key points

- The first quarter of 2023 got off to an eventful start on the macro front as inflation proved sticky, markets weathered a banking crisis and financial conditions tightened. We see a normalisation of markets from here after a decade of easy credit and near-zero rates
- The European Union (EU) unveiled its Green Deal Industrial Plan to rival the US Inflation Reduction Act. Together with other climate-friendly measures, policy action should drive increased global spending and innovation towards a low-carbon economy
- The shift to net zero offers attractive alpha opportunities for savvy credit investors able to navigate the new policy and market landscape
- Our approach aims to build a diversified portfolio of higher yielding positions than the corporate bond market index using in-depth credit analysis to choose net-zero-aligned issuers within the investment-grade (IG) bucket
- For our high-conviction TargetNetZero Global IG Corporate fund, we move down the capital structure in preferred IG issuers or invest directly in BB issuers in order to enhance potential returns
- We consider Q1 investment policy in action – including developments in primary markets, how we tilted towards ice cubes[1] and our outlook for the real-estate sector – and explore why it's the right time to invest in a high-quality decarbonisation strategy

An eventful macro start to 2023

The year began with markets euphoric, buoyed by strong economic data and indications that inflation was starting to peak. However, by February, central banks were becoming anxious amid signs that inflation had in fact become entrenched, and markets repriced in anticipation of further hikes. By March, the Collapse of Silicon Valley Bank (SVB) threw markets again.

In macroeconomic developments, investors turned far more cautious, with the consensus view pricing in rate cuts by the end of the year. For us, these expectations are overstated, and we see sticky inflation potentially preventing central banks from reducing rates in the near term.

[1] Ice cubes are companies that are taking concrete and verifiable steps towards the net-zero transition, and whose progress, as monitored by our implied temperature rise (ITR) metrics, is aligned with a Paris trajectory.

As detailed in our Q2 issue of *Alphorum*, we consider the banking sector as being bruised rather than broken following the demise of Silicon Valley Bank and Credit Suisse; and the tightening of financial conditions should help to temper a somewhat irrational level of market exuberance. The financial market needs to normalise after a decade of easy credit and near-zero rates, though growth could weaken due to an overall tightening of conditions in the broader financial system.

Irrespective of the precise path of rates over the coming months, opportunity knocks for savvy fixed income investors ready and able to exploit changing market dynamics.

Fresh EU policy impetus as climate competition escalates

European companies reacted to the 2022 US Inflation Reduction Act, which earmarked USD 260 billion for the climate transition mainly in the form of tax credits. The likes of Italian energy company Enel, German auto manufacturer Volkswagen and Swedish battery manufacturer Northvolt[2] expressed interest in relocating future production to the US to benefit from the measures.

The potential move of European companies to the US raised concerns among European policymakers that they would lose competitiveness in the transition to a low-carbon economy. In February 2023, the European Commission presented the bloc's Green Deal Industrial Plan, aiming to: "enhance the competitiveness of Europe's net-zero industry and support the fast transition to climate neutrality". The plan includes targets onshoring at least 40% of the net-zero manufacturing capacity needed for the EU's net-zero transition by 2030, and ensuring secure and sustainable supply chains for the region's net-zero transition to reduce dependence on foreign nations for the EU's decarbonisation and energy security.

The increased focus on net zero in both the US and the EU should drive increased global spending and innovation towards a low-carbon economy. This further supports our belief that the transition will unfold more quickly than the market currently anticipates.

Transition risks in the market have clearly increased over the last 12 months. Additional fiscal support for the net-zero transition will reduce production costs for green or transitioning companies. In addition, the EU has suggested extending the scope of the EU Emissions Trading System (ETS) and introducing a Carbon Border Adjustment Mechanism (CBAM), an import tariff on carbon-intensive material, which aims to increase the cost for polluting firms. Lastly, monetary policy within the EU has begun to shift towards alignment with the Paris Agreement. For its involvement in the corporate bond market, the European Central Bank (ECB) has introduced a climate tilt, which will favor green and transition-aligned companies.

All of these initiatives aim to support transitioning companies through regulation, fiscal support and ensuring capital is available to companies seeking to decarbonise, while limiting access to finance for insistent polluters.

The result is likely to increase the dispersion in credit spreads between decarbonising companies and environmental laggards.

Within the credit market, the shift to a net-zero economy offers attractive alpha opportunities for investors who can navigate the new policy and market landscape.

LOIM's TargetNetZero credit offering incorporates consistent emissions-reducing credit strategies aligned with the goals of the Paris Agreement. Our flagship fund, LO Funds – TargetNetZero Global IG Corporate, targets a higher return than the index through a low-turnover, high-conviction approach.

A high-conviction approach

TargetNetZero Global IG Corporate has an average IG rating although it can hold up to 20% in sub-investment grade (almost exclusively in the BB range of ratings).

Through in-depth credit analysis coupled with alignment to targeting net-zero emissions, we aim to build a diversified portfolio of higher yielding positions than the corporate bond market index.

Fundamental credit analysis is at the heart our process. LOIM's implied temperature rise (ITR) tool gives our analysts higher confidence in the long-term viability of an issuer. This confidence is reflected in a willingness to take more concentrated positions; and an inclination, where conviction is high, to move down the capital structure in preferred IG issuers or invest directly in BB issuers in order to enhance potential returns.

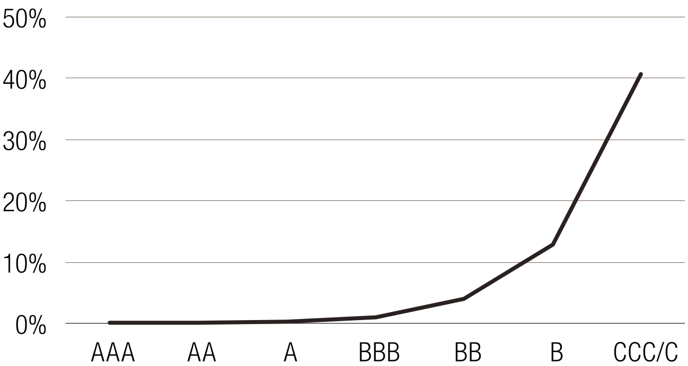
Where the analyst has a high level of confidence in the long-term viability of the issuer, we will generally invest further down the capital structure to benefit from the additional spread.

This positioning further down the capital structure is underpinned by an extremely low probability of default for IG issuers, coupled with higher return offered by subordinated debt. Figure 1 shows the historically low probability of default for IG issuers, regardless of the seniority of their debt.

[2] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

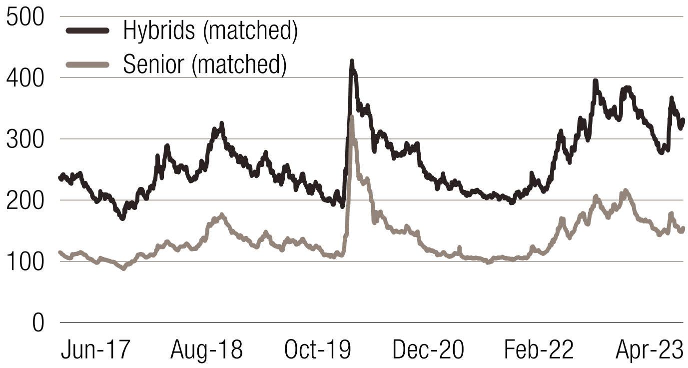
FIG 1. PROBABILITY OF DEFAULT FOR IG ISSUERS IS CLOSE TO ZERO

AVERAGE 3-YEAR DEFAULT RATES FROM 1981-2021



Source: LOIM calculations, Moody's, Bloomberg as at September 2022. For illustration purpose only. Ratings are subject to change. Past performance is not a guarantee of future results.

FIG 2. CREDIT SPREAD OF GLOBAL SUBORDINATED HYBRID DEBT VERSUS SENIOR DEBT



Source: LOIM, Bloomberg. As at May 2023. Senior debt maturity selected to match the hybrid call. Past performance is not a reliable indicator of future returns. For illustrative purposes only.

Investment in subordinated debt offers additional yield-pick-up compared to senior debt with the same risk rating, as shown in figure 2.

Q1 investment policy in action

Moving to a net-zero economy, we see our high-conviction holdings enhancing the potential return of the portfolio, as the market reprices for net zero in 2050. In that context, we took advantage of the primary market at the beginning of the year and opportunistically added green bonds. Elsewhere, as concerns about the banking sector increased, we reduced exposure to issuers that are most exposed to the turmoil.

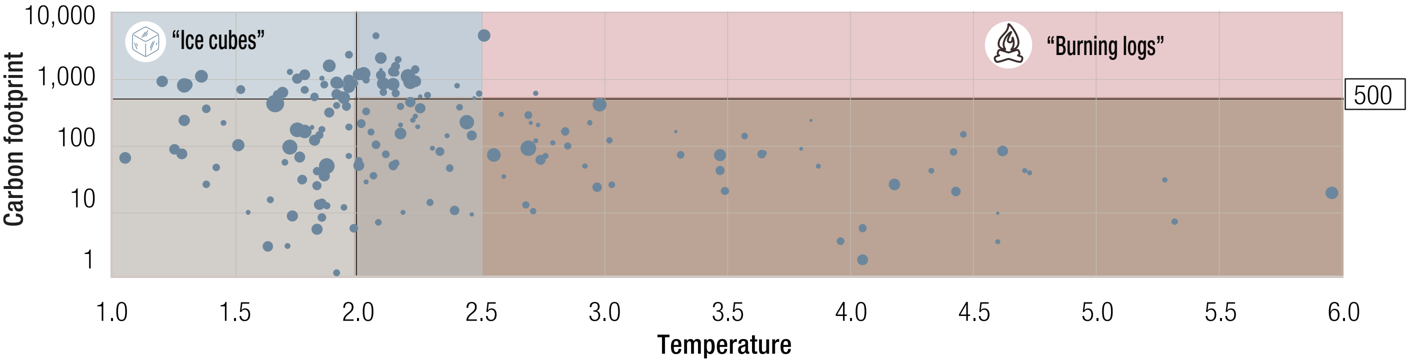
To mitigate the overall risk exposure of the portfolio, we actively managed our credit risk by taking advantage of credit derivatives naming Itraxx indices and Credit Default Swap Options (CDSO). Figure 3 lays out the portfolio's key metrics and performance.

FIG 3. LOF TARGETNETZERO GLOBAL CORPORATE IG FUND VERSUS BENCHMARK

Characteristics	TNZ fund	Benchmark
Issuers	187	2,375
Yield to worst (% H USD)	6.97%	5.43%
Yield to worst (% H CHF)	3.82%	2.28%
Yield to worst (% H EUR)	5.38%	3.84%
Option-adjusted spread (bps)	248	153
Duration (years)	6.1	6.14
Average rating[1]	BBB+	A
Temperature[2]	1.9	2.5
Carbon investment ratio[3]	522	598
ESG Materiality rating	B+	B

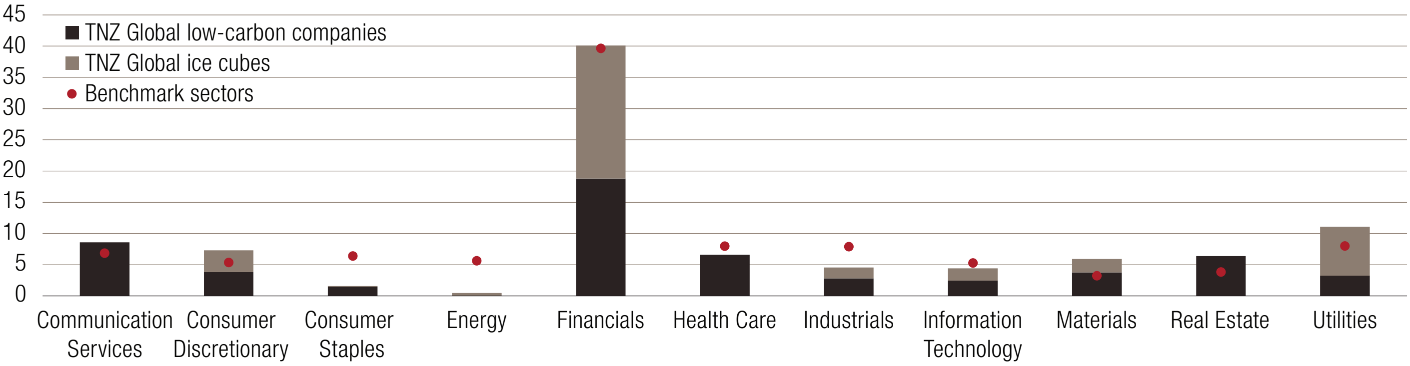
Source: LOIM calculations, Bloomberg PORT. All figures as at 31 March 2023. Benchmark refers to the Bloomberg Barclays Global Aggregate Corporate. [1] A linear metholodogy based on the issuer's best credit rating is used to calculate average rating.[2] Temperature refers to Lombard Odier Portfolio Temperature Alignment, our science-based proprietary framework that analyses portfolios' temperature pathways and alignment to the 2015 Paris Agreement. [3] Carbon footprint (Carbon Investment Ratio) is TeqCO2 per MUSD invested. Holdings, metrics and/or allocations subject to change. Yields may vary over time.

FIG 4. ICE CUBE BIAS: TEMPERATURE PATHWAY DISTRIBUTION FOR TNZ GLOBAL IG CORPORATE PORTFOLIO



Source: LOIM. As at 31 March 2023. For illustrative purposes only.

FIG 5. SECTOR EXPOSURE SPLIT BY LOW-CARBON AND ICE-CUBE COMPANIES



Source: LOIM. As at 31 March 2023. For illustrative purposes only. Benchmark refers to Bloomberg Barclays Global Aggregate Corporate.

A diversified portfolio of transition leaders

How do we discern between those debt issuers pursuing credible decarbonisation trajectories and climate laggards?

We bias our TNZ Global IG portfolio towards so-called ice cubes, or companies that are taking concrete and verifiable steps towards the net-zero transition, and whose progress, as monitored by our implied temperature rise (ITR) metrics, is aligned with a Paris Agreement. Ice cubes stand in contrast to burning logs, or high-emitting companies that are not currently on a credible path to decarbonisation, meaning that they are potentially contributing significantly to global warming.

Figure 4 shows the temperature pathway distribution of the portfolio, with a focus on ice cubes at the expense of burning logs.

Such a selection bias means that the average temperature score for the TNZ Global IG portfolio is aligned with the Paris Agreement at 1.9^0 C and lower than the benchmark's average temperature of 2.5^0.

The focus on transitioning firms in future, as opposed to today's low-carbon companies, also leads to more diversification in our holdings and across sectors as shown in figure 5.

Here, we take into account the proportion of ice cubes as well as low-carbon companies. We define low-carbon companies as those with a carbon footprint measured as the carbon investment ratio (Tonne Co2 per million USD invested) lower than 500 across scope 1, 2 and 3 emissions.

Performance drivers

Over the quarter, the TNZ Global IG fund achieved a net performance of 2.74% compared to 3.14% for the benchmark.[3] In absolute terms, the fund benefitted from its duration exposure of about six years, which helped mitigate the negative impact of wider spreads during the month of March due to the renewed (and more standard) decorrelation between rates and credit.

The year started strongly as narrowing credit spreads drove outperformance during the first two months. In March, however, due to the volatility resulting from Silicon Valley Bank's demise, the fund's structural overweight to corporate hybrids detracted from performance, leaving the fund's performance behind that of the benchmark year to date.

[3] Past performance is not an indicator of future returns.

FIG 6. PERFORMANCE OF TARGETNETZERO GLOBAL IG CORPORATE FUND

	Year to date	Inception to date
LOF TargetNetZero Global IG Corporate (H USD) NA	2.74%	-6.94%
Bloomberg Barclays Global-Aggregate: corporate (H USD)	3.14%	-5.35%
Relative performance	-0.40%	-1.59%

Source: LOIM, Bloomberg as at 31 March 2023. Inception date of the fund was 26 April 2021. Past performance is not a guarantee of future results. Metrics are subject to change. Performance is net of fees.

The allocation to real estate negatively impacted performance as did security selection within the financial and real-estate sectors.

The underperformance of subordinated holdings and hybrids was driven by negative sentiment resulting from the idiosyncratic writedown of Credit Suisse's AT1 debt as part of its takeover by UBS. As such, underperformance was sentiment-driven by a one-off hit, and not quality-driven. After the takeover, the EU reaffirmed its commitment to honouring AT1 terms and we see the worst of the negative sentiment now having passed. We believe adverse headwinds to subordinated debt should abate, and maintain our convictions as we think issuers will be able to repay their bonds.

Within real estate, high-beta corporate hybrids underperformed on concerns that increased financial volatility would lead to more conservative lending standards and challenging refinancing conditions for the sector.

Delving into real estate

Following the move higher in rates last year, we conducted a thorough review of our real-estate exposure in June 2022. We continuously monitor the fund's exposure to the sector and credit quality. Despite volatility, **we believe market concerns for the real-estate sector are manageable as:**

- Refinancing needs were not high in 2022 or 2023 as companies extended debt maturities in 2020 and 2021
- The vast majority of companies that issue in the bond market are well-run; well-managed; comply with the necessary accounting, reporting and other regulatory requirements; and ultimately have a measurable, valuable and saleable asset base
- Grand City Properties (GCP)[1] decided not to exercise its option to voluntarily call its short-dated corporate hybrid in 2022, a decision that effectively curtailed the company's access to the capital markets. In our view, the decision backfired on the company as it caused spread widening of its senior and hybrid bonds, increased its potential refinancing rate, and effectively ended its ability to borrow from the bond market. In our view, the market reaction to GCP's move makes it unlikely that other companies with outstanding corporate hybrids will refrain from calling their bonds
- Following this negative development for GCP, we have since seen several real-estate companies take actions to support their ratings and commit to calling their corporate hybrids

Overall, we see our holdings in the real-estate sector managing their maturity profiles and expect the price of the bonds to recover as financial conditions stabilise.

Why it's the right time to invest in TargetNetZero Global IG

- **Addressing transition risks.** Increasing environmental regulation and policy support for the green transition intensifies the transition risks in investor portfolios. Central banks have already begun 'greening' their monetary policy – such as the ECB's climate tilt - and the next round of quantitative easing reinvestments could see this greening intensify. Addressing such transition risks and positioning portfolios on the right side of climate-friendly policy changes is at the heart of our strategy
- **Higher yields and balanced exposure.** After the repricing of rates in 2022, fixed income offers higher yields than during the low-rates era.[4] In the beginning of 2023, the traditional negative correlation between rates and credit returned, contributing to balanced risk exposure in credit portfolios with duration such as ours
- **High-quality exposure.** IG names offer high-quality credit exposure in the more challenging economic environment characterised by investors de-risking their exposure. With an average rating of BBB+, our high-conviction selection focuses on companies engaged in decarbonising, and thus aligned with the transition to a net-zero future

[4] Yields are subject to change and can vary over time. Past performance is not a guarantee of future returns.

LO Funds – TargetNetZero Global IG Corporate

Risk profile

LO Funds – TargetNetZero Global IG Corporate

Synthetic risk indicator (SRRI)

1 2 3 **4** 5 6 7

Lower risk
Potentially lower rewards

Lower risk
Potentially higher rewards

This indicator (SRRI) represents the annualized historical volatility of the Sub-Fund over a 5-year period. Where there are less than 5 years worth of data, missing returns are simulated using an appropriate benchmark.

The following risks may be materially relevant but may not always be adequately captured by the Synthetic Risk Indicator and may cause additional loss:

Credit risk: A significant level of investment in debt securities or risky securities implies that the risk of, or actual, default may have a material impact on performance. The likelihood of this depends on the creditworthiness of the issuers.

Operational risk and risks related to asset safekeeping: In specific circumstances, there may be a material risk of loss resulting from human error, inadequate or failed internal systems, processes or controls, or from external events.

Model risk: Models may be misspecified, badly implemented or may become inoperative when significant changes take place in the financial markets or in the organization. Such a model could unduly influence portfolio management and expose to losses.

Liquidity risk: Where a significant level of investment is made in financial instruments that may under certain circumstances have a relatively low level of liquidity, there is a material risk that the fund will not be able to transact at advantageous times or prices. This could reduce the fund's returns.

Currencies: If the Sub-Fund is denominated in a currency other than that in which the majority of the investors assets are held, the investor should be aware that changes in rates of exchange may affect the value of the funds underlying assets.

The portfolio risk management process includes an effort to monitor and manage risks, but this does **NOT** imply that investing in this Sub-Fund is risk-free.

There can be no assurance that a return will be achieved or that a substantial loss of capital will not be incurred.

Before taking any investment decision, please read the latest version of the prospectus, the articles of incorporation, the Key Investor Information Documents (KIIDs) and the latest annual report and semi-annual report. Please pay attention to the Appendix B "Risk Factors Annex" of the prospectus.

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