THE DRIVE YOU DEMAND

LIQUID ALTERNATIVES TO COMPLEMENT A TRADITIONAL FIXED INCOME ALLOCATION

UBP Asset Management | April 2017

UNION BANCAIRE PRIVÉE

Key points

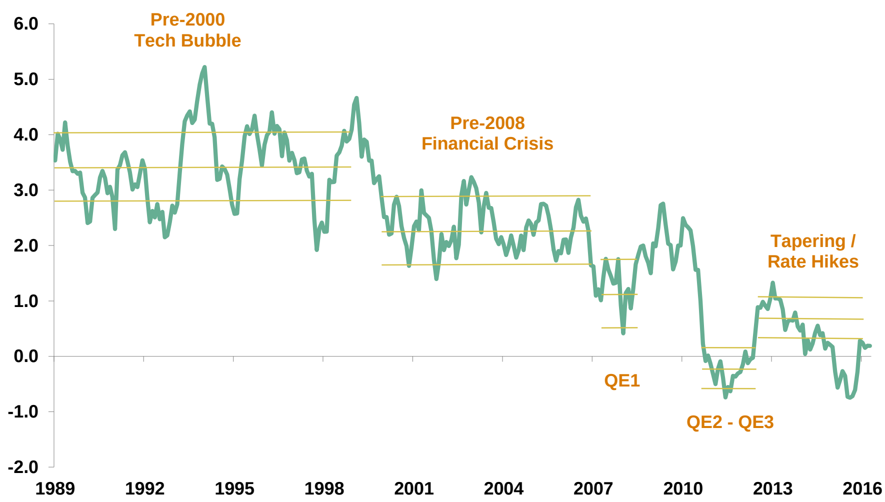
- *In light of policy shifts in the U.S. progressing and beginning to take shape in Europe, the transformation of investors' fixed income exposures across alternative strategies has now become a reality.*
- *Recognizing the need of investors for income, this paper highlights solutions that could help a portfolio position against a rise in interest rate volatility:*
  - *A liquid Discretionary Global Macro strategy capitalising on fundamental upward and downward trends in interest rates, credit and currencies;*
  - *A Senior Secured Loans solution acting as a pure positive carry strategy and bringing protection in a rising rate environment;*
  - *Insurance-Linked Securities solutions characterised by attractive yields and a true diversification power to all assets.*
- *These solutions are to be considered as "diversifiers" within a global portfolio, finding uncorrelated return drivers in specific markets with a moderate risk budget.*

A regime change in progress

The end of 2016 represented a period of transition for global markets and it seems that we are currently in a new paradigm, particularly in the U.S. This regime change is from a slow growth environment, dominated by low inflation and accommodative monetary policy, to one where we expect growth rates should be faster fuelled by fiscal easing, tighter monetary policy and a transition from deflationary to inflationary expectations. Outside the U.S., the ECB should begin tapering its quantitative easing (QE) program in a near future, and the Bank of Japan has already admitted the limits to QE by shifting to a yield curve targeting policy.

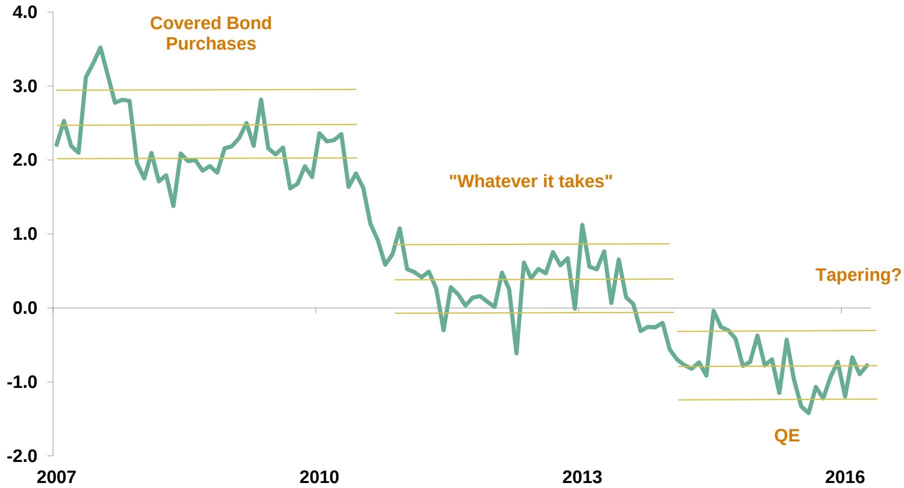
While the falling interest rate/rising bond prices have historically provided a 'cushion' for portfolios in the face of equity volatility, rising interest rate volatility is expected looking ahead. As a result, this 'cushion' or diversification effect may at best be less pronounced or potentially not be available in the months and years ahead. If this transpires, by default, volatility of portfolios would necessarily rise, exposing investors to higher levels of risk without compensating return prospect. Should bond yields continue to rise as they have done in recent months, the harmful impact of this new environment on portfolios may be more apparent.

Fig. 1 – Evolution of US 10Y Treasury yields (in real terms)



Sources: UBP, Federal Reserve Bank of St. Louis. Data as of March 2017.

Fig. 2 – Evolution of German 10Y yields (in real terms)



Sources: UBP, Bloomberg Finance L.P. Data as of March 2017.

In light of this development, most investors have already been exploring options to begin the process of transforming their traditional fixed income exposure in order to be better positioned to respond to this new regime change.

Liquid alternatives defined as 'diversifiers' definitely belong to the proposed options. Either by taking advantage of their investment flexibility or by simply capitalising on a relatively nichy market or sector, these 'diversifiers' have the potential to find uncorrelated return drivers in specific uncrowded markets. Targeting a moderate risk budget and exhibiting a reasonable liquidity profile, they act as risk reducers within a global portfolio by lowering volatility, drawdowns and correlation to traditional assets.

In this paper, we propose three liquid alternative investment solutions, which are particularly well suited to complement a traditional non-risky allocation under the current market conditions. They are:

- a Discretionary Global Macro solution
- an European Senior Secured Loans solution
- an Insurance-Linked Securities (ILS) solution

Their rationale and competitive edge are detailed hereunder.

Global Macro strategy

Access to a liquid Global Macro manager capitalising on fundamental trends in interest rates, credit and currencies worldwide

Our 1st liquid alternative solution is a pure Discretionary Global Macro strategy, which can trade both sides of the market (long and short) mainly in rates, currencies and credit. Hence it can combine risk-on and risk-off books across those asset classes, scouring the world for growth and transformation themes on one hand (risk-on), or simply using shorts and portfolio hedges on the other hand (risk off). The portfolio only trades highly liquid instruments.

The strategy has three main competitive edges: (i) a strong **fundamental research** where the street views are not taken as granted; (ii) a portfolio approach that relies on the ability to efficiently **expand the investment opportunity set** to specific markets and regions (e.g. emerging markets); and (iii) a medium size allowing a certain level of investment flexibility and an **accountable expression of trades** compared to larger macro funds which appear to be over capitalized today.

What to expect from our Global Macro strategy in a rising rate environment

Because of its investment flexibility to go long and short markets, the Global Macro strategy is **agnostic** about where we stand in the rate cycle. For instance, the portfolio's current rates exposure has a balance between developed markets where rising yields are expected and a few select emerging markets with the potential for significant rate cuts. The potential to express views on plenty of countries that are **disconnected** with the U.S., European or Japanese interest rate cycles can add many dimensions in terms of portfolio construction. And historical P&L has shown that performance could be generated from both rising and declining rate opportunities.

Investment results of our proposed solution

The Global Macro strategy has performed well in both bull and bear markets for both bonds and equities, annualising 6% of return net of fees with a 5% volatility and a limited correlation to traditional assets.

This relatively low correlation is further evidenced in Fig. 3 and 4, which plot all monthly returns of the Global Macro strategy (Y axis) versus bond and equity returns (X axis) since inception of the strategy in 2011.
The left-end part of Fig. 3, which exhibits the return behaviour of the Global Macro strategy during the down months of global bonds, shows that the strategy tends to behave relatively well during such periods, especially in terms of positive occurrence. In other words, when bonds are negative, circa 70% of the time the Global Macro strategy is able to print a positive figure. Looking at the right-end side of the chart, which exhibits the return behaviour of the Global Macro strategy during the up months of global bonds, it appears clear that the strategy is also able to capture some of the market upside. This pattern is similar when comparing the Global Macro strategy to world equities (Fig. 4).

Fig. 3 – Behaviour of the Global Macro strategy vs. global bonds since strategy inception in 2011

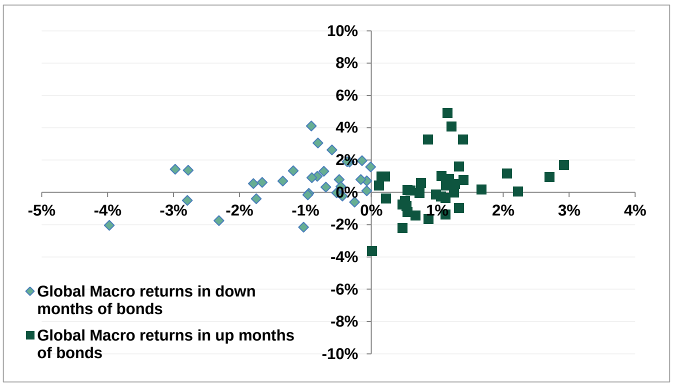
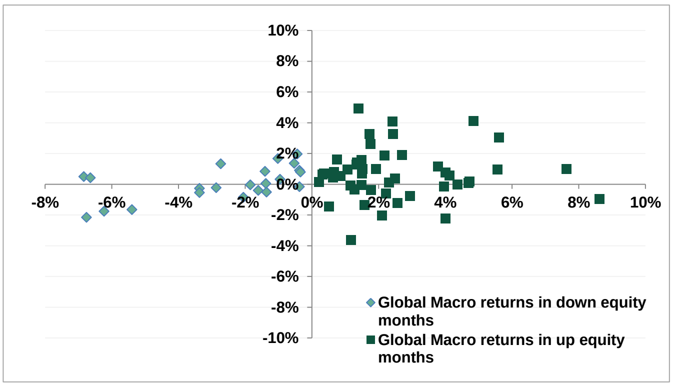


Fig. 4 – Behaviour of the Global Macro strategy vs. world equities since strategy inception in 2011



Sources: UBP, Bloomberg Finance L.P. Data as of March 2017. Indices used: Barclays Cap. Glob. Aggr. (global bonds) and MSCI AC World Net Ret Local (world equities).

As seen above, the Global Macro strategy is then particularly well suited to complement a traditional fixed income allocation. This represents nothing else but the outcome of the strategy's DNA, which consists of finding interaction with policy-makers and financial industry figures (i.e. bankers, central bank officials, pension funds and finance ministers) important to validate the manager's economic models and strengthen both qualitative and quantitative assessments in forming macro views that are different from what the market place prices.

The Global Macro strategy is offered through different vehicles, including a UCITS-compliant format, which brings comfort to investors through reinforced governance and risk control, enhanced transparency, a weekly liquidity and a low tracking error vs. the equivalent offshore program.

Euro Senior Secured Loans

Access to recurrent income streams characterised by positive carry, low interest rate risk and appealing dynamics

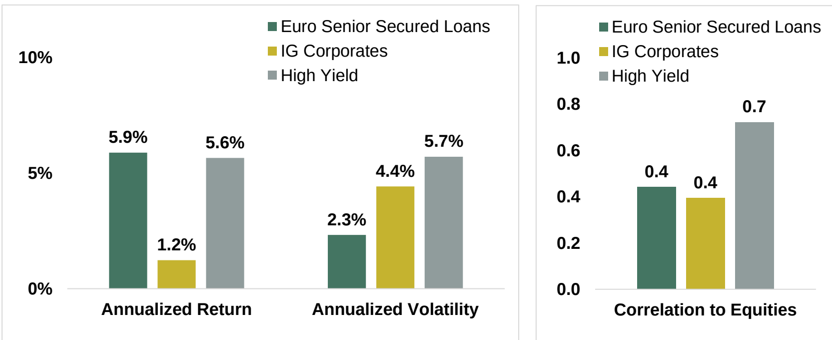
A natural way to look at alternatives to traditional fixed income is to move along the credit spectrum. Senior Secured Loans (or Leveraged Loans) are **privately arranged loans** issued to a consortium of banks and institutional creditors, which provide companies with access to debt capital. Generally, the **borrowers are corporates below IG credit ratings,** and the contracted loans are usually dedicated for corporate purposes such as capital expenditure, M&A-related transactions or refinancing programs.

Senior Secured Loans offer many benefits to investors. The first one is **protection**, which takes the form of a high level of seniority in the company's capital structure (i.e. first lien on the company's assets in the event of a bankruptcy), coupled with superior credit protection through financial covenants setting credit limits and guarantees.

The second benefit is the unique investment profile related to such instruments. Indeed, Senior Secured Loans pay a **floating rate coupon** at a premium above a base rate, which translates into limited interest rate sensitivity. This premium simply reflects the issuer's credit quality as well as the characteristics of the loan.

As an asset class and considering the current market environment, Euro Senior Secured Loans have provided a **better risk/return profile** than IG corporate bonds and high yield in recent years, as shown below in Fig. 5. In this document we deliberately focus on the European Senior Secured Loans segment, which has the potential to offer a higher compensation vs. its U.S. counterpart because of the following characteristics: smaller market size, more institutional based than retail based, less liquid and less trading oriented, and reinforced protection through superior credit profile of borrowers and financial covenants.

Fig. 5 – Comparative returns and risk metrics since December 2012



Sources: UBP, Bloomberg Finance L.P. Data as of March 2017. Indices used: S&P European Lev. Loans Index hedged in USD (Euro Senior Secured Loans), Merrill Lynch Corporate Bonds (IG Corporates), Credit Suisse High Yield Index (High Yield), and MSCI AC World Net Return Local (equities).

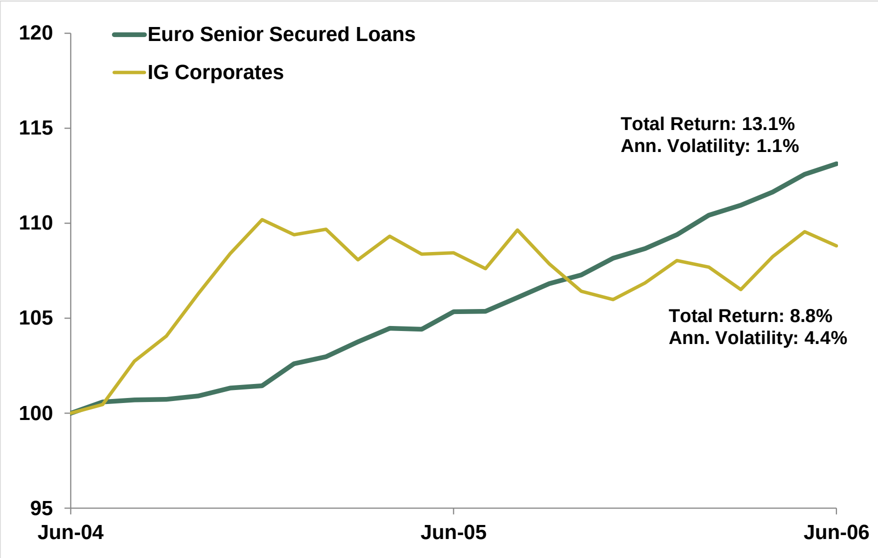
In light of bond indices' returns fading since the end of 2012, it becomes obvious that Euro Senior Secured Loans act as a viable alternative to traditional fixed income in terms of both return attractiveness and diversification power. Moreover, Senior Secured Loans have been historically characterised by higher recovery rates (75% on average) and lower default rates (2% in 2016) compared to high yield.

What to expect from Senior Secured Loans in a rising rate environment

Because of their floating rate nature, Senior Secured Loans are **optimally positioned for an inflationary and increasing rate environment.** As their yields automatically adjust to market rates on a quarterly basis, Senior Secured Loans fully participate in rising rate markets, as soon as they move through the Libor/Euribor floors. At the same time, due to their short duration (with average interest rate reset periods of 45 to 60 days), the rate hikes should also cause no real threats to Senior Secured Loans prices.

Taking the example of the period from July 2004 to June 2006, which saw the Fed hike rates 17 times by a total of 425bps, we can see how Euro Senior Secured Loans acted as a natural hedge against increasing rates, outperforming IG corporates over that period with much less volatility.

Fig. 6 – Euro Senior Secured Loans vs. IG corporate bonds in a rising rate environment



Sources: UBP, Bloomberg Finance L.P. Indices used: S&P European Lev. Loans Index hedged in USD (Euro Senior Secured Loans) and Merrill Lynch Corporate Bonds (IG Corporates).

Our Euro Senior Secured Loans solution

The solution we propose is a well-diversified portfolio of 100+ continental Europe issuers spread across 16 sectors, focusing exclusively on **first lien performing loans,** and following a conservative buy and hold approach **(pure carry strategy relying on coupon value).** Because its investable universe is only comprised of loans (excluding for instance CLOs and high yield investments that are more liquid), this portfolio offers a weekly liquidity that is aligned with the nature of its underlying positions.

This solution has delivered the equivalent of Eonia +400bps since strategy inception in 2011, annualising 4.1% of return net of fees, with a 2% volatility and a low correlation to traditional assets.

The average margin of the portfolio stands at around 449bps at an average price of 100.35%.

Even though credit spreads in the European Senior Secured Loans market are expected to remain at an attractive 400bps over Euribor in the months to come, mainly supported by an active primary market activity and no significant degradation of financial structures with stable leverage, it is absolutely key for Senior Secured Loans investors to rely on a portfolio manager which (i) has **true and proven selection capabilities** enabling reward-to-risk benefits and downside protection in challenging periods like 2008 and (ii) has **access to the full spectrum of transactions** (including club deals and early bird deals that come prior to primary market's issuances) in a market characterised by high barriers to entry.

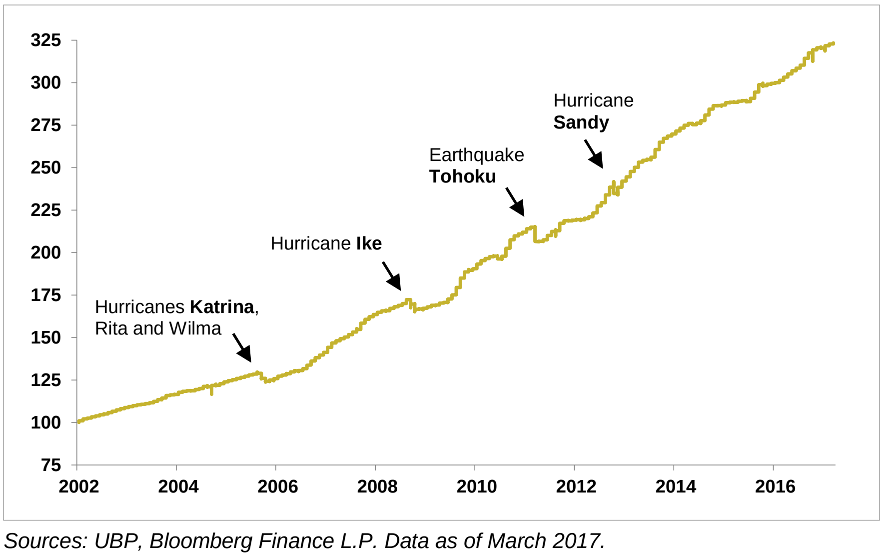
Insurance-Linked Securities (ILS)

Access to attractive yields and diversification power in a quest for straight bond yield replacement

Our last liquid alternative solution refers to Insurance-Linked Securities. ILS consists of the transfer of insurance risk that results from **large natural catastrophes** (e.g. hurricanes, earthquakes, flooding, etc.) to the capital markets. This mechanism provides (re)insurance protection to the sponsor of the transaction, typically an insurance or reinsurance company, and the insurance risk is then redistributed across a broader investor base, **the investor receiving a premium** as being the end risk taker.

Fig. 7 shows the historical performance of the ILS industry (represented by cat-bonds) over the last 15 years. One can easily see the **linear return profile** of the asset class over time, annualizing 8% since index inception, and more importantly the relatively quick recovery following drawdowns resulting from the occurrence of severe events.

Fig. 7 – Historical performance of the ILS industry (Swiss Re CatBond Index)



Sources: UBP, Bloomberg Finance L.P. Data as of March 2017.

Another benefit of ILS is its ability to **reduce the overall risk of a portfolio** at all times. The comparative risk metrics provided in Fig. 8 are quite unique, proving that ILS significantly reduces both the standard risk (volatility and correlation to other asset classes) and the extreme risk (largest drawdown) of a common portfolio. Statistics are being shown since inception of the Swiss Re Cat Bond Index at the end of 2001.

Fig. 8 – Key risk metrics of ILS vs. a traditional passive portfolio

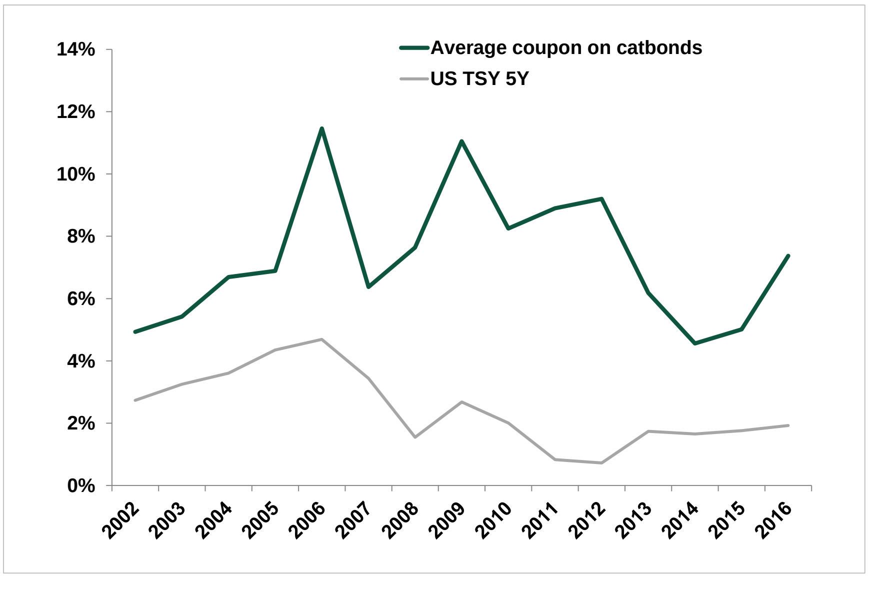
	Swiss Re Cat Bond Index	Passive Portfolio	Reduction (%)
Correlation to Equities	0.17	0.93	**-82%**
Correlation Bonds	0.12	0.35	**-66%**
Max Drawdown	-3.92%	-28.98%	**-86%**
Annualized Volatility	2.71%	7.71%	**-65%**

Passive portfolio refers to a traditional portfolio evenly split between bonds (Merrill Lynch Global Broad Market Index) and equities (MSCI AC World TR Net Index).
Sources: UBP, Bloomberg Finance L.P. Data as of March 2017.

What to expect from ILS in a rising rate environment

ILS yields are **technically not linked** to the interest rate cycle as they are driven by their own dynamics, namely (i) the occurrence (or not) of major natural catastrophes, (ii) the yields offered within the overall traditional reinsurance market, and (iii) the number of market participants. However, the below chart indicates that **a certain correlation can be observed** between catbond yields and U.S. Treasuries over time (i.e. 2002-06 peak, 2006-08 trough, 2009 recovery, overall decrease between 2010 and 2012). It also shows that catbond yields have always been higher than U.S. Treasury 5Y yields over that period.

Fig. 9 – ILS yields vs. U.S. Treasuries since 2002



Sources: UBP, Artemis. Data as of December 2016.

Our ILS solutions

At UBP we propose two ILS solutions: (i) a pure catbond strategy and (ii) a diversified ILS strategy made of catbonds and less liquid OTC contracts, the latter expanding the opportunity set originally offered by catbonds. The catbond portfolio offers a weekly liquidity while the diversified ILS portfolio offers a monthly liquidity. Both portfolios contain 50+ positions.

Both solutions have delivered as expected since strategy inception in 2011, annualising respectively 6.5% and 5.5% of return net of fees, with a very low volatility (1 to 2%) and no correlation to traditional assets.

Against this, investors must be aware of the following two important risk aspects when considering investing into ILS. ILS, by their very construction around the occurrence and expected losses of insurance events, present indeed a tail risk to investors. The greater the expected loss of a given insurance event is, the greater the **tail risk** will be for investors. Once the trigger of the underlying security has been breached, the investor could typically have an absolute loss on this underlying position, usually 50 to 100% of the face value. As a result, it is absolutely key for investors to (i) access the asset class through a **well-diversified portfolio of numerous lines** like the ones we propose at UBP and (ii) require the full transparency on portfolio holdings in order to assess the potential, aggregate tail risk or **expected modelled loss** of such portfolio should the occurrence of very extreme and costly events happen.
Liquidity may also be limited after the occurrence of a catastrophic event as investors must await resolution amounts or disputes. This can take up to a few months, holdings being usually put aside in an illiquid bucket prior to final payment to investors.

Conclusion

This paper outlines several liquid alternatives which can be contemplated when transforming a conventional fixed income portfolio.

While each solution relies on the unique characteristics of its related asset class (i.e. Global Macro, Senior Secured Loans or ILS), one should not forget that the managers' skillsets are at least of equal importance in an environment that requires increasing active management and investment flexibility.

Our Global Macro strategy relies on the investment team's research and **trading skills**, scouring the world for transformation themes and implementing macro views that are ideally different from the street.

Whereas Euro Senior Secured Loans consist by definition of a pure **carry, floating rate** strategy, the manager's access to the market and ability to properly assess deals and structures represent the real value.

And finally, while Insurance-Linked Securities by essence offer **sustainable and uncorrelated yields,** here again the manager's size and selection capabilities represent the extra mile to ensure success.

Olivier Marion
Senior Investment Specialist – Alternatives

Union Bancaire Privée, UBP SA
Rue du Rhône 96-98 | CP | CH-1211 Geneva 1
T. +41 58 819 27 42 | E. olivier.marion@ubp.ch
www.ubp.com | LinkedIn | Twitter | Vimeo

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