

## CARMIGNAC PORTFOLIO UNCONSTRAINED GLOBAL BOND

30.03.2016

### Fixed Income

**We remain convinced that the structural challenges faced by bond markets can be met with our conviction-driven, non-benchmarked approach that is combined with active management.**

### Key Takeaways

- In 2015, Bond markets witnessed heightened risk levels from the structural challenges presented by potentially lower central bank liquidity and scarce trading liquidity.
- The Fund combined its conviction driven approach with active risk management to navigate turbulent markets and deliver positive performance thanks to diverse performance drivers.
- Long term track record is consistently strong, as the Fund has beaten its reference indicator and Morningstar peer group average over the 5 year period, and has an overall 4 star rating
- Going forward, the fund aims to exploit opportunities in the fixed income universe, especially in the credit markets, where it focuses on segments such as European banks, Eur. CLOs, and selective holdings in the commodity space.
- The Fund favors peripheral and US sovereigns, where the comparative yield compression potential is attractive.
- Currency strategies and active duration management are used as portfolio construction tools and to mitigate risks in the fund.

## I - Demystifying past performance

### Survey of the Situation

Over the course of 2015, bond markets witnessed heightening risk levels. The increase in overall risk levels in the market had much to do with the lower central bank liquidity in the market (characterized by stabilization and shrinking of US and Chinese central bank balance sheets) and the shocks generated by debt negotiations in Greece and currency devaluation in China. For Fixed income markets, a more structural problem was brewing. Over the past 7 years, QE-flooded markets had encouraged investors to take on additional risk and

had led to extreme positioning across asset classes as market participants piled their money into risky assets. However, re-regulation of banks in the US and Europe (post 2008 crisis) has led to lower secondary liquidity, as these financial institutions have been forced to de-risk their balance sheets and can no longer adequately fulfill their role of intermediaries in the bond market. This phenomenon, exacerbated by a generally less accommodative Fed, has led to shocks and bursts of increased volatility in rates and credit markets.

## **2015 in depth**

In this context, there was no dearth of sudden moves in bond yields. In April 2015, in spite of the implementation of the January announced ECB QE, the undoubtedly over-bought German Bund yields saw a brutal upward move from 0.07 to 1%! The deadlock in negotiations over Greek debt and the resulting rhetoric then led to a sharp risk aversion, bringing the Bund yields back down to 0.3%, which are violent moves indeed. Later in the year (around September), it was the US rates that experienced uneven movements as Chinese authorities embarked on a US treasuries selling binge in order to stabilize the Yuan in the wake of sharp capital outflows in China. Finally, one should not forget the spikes in credit markets (illustrated by CDS spreads dramatically rising) that were initiated by an oil-pressured US high yield market, but that subsequently spread like wild fire to the rest of the Credit markets.

## **2015: Impact on Carmignac Portfolio Unconstrained Global Bond**

Over the course of 2015, Carmignac Portfolio Unconstrained Global Bond delivered positive performance thanks of course to diverse performance drivers, but also to its conviction driven, non-benchmarked approach.

The noise generated by these events was detrimental to the overall performance of Carmignac Portfolio Unconstrained Global Bond. It is hardly surprising that a conviction-driven portfolio, which relies on views driven by fundamental market analysis, was impacted by sudden, short-term movements in the market, largely driven by short term political movements and market technicals.

In light of the ECB's Eur. 60 billion bond buying program, we stood by our belief that bond yields in European peripherals would decline. The temporary shocks witnessed during the Greek crisis did not deter our belief in the asset class. Hence, while the Fund did sustain periods of weakness, ultimately, the conviction did result in positive performance over 2015. Similarly, the allocation to financial credit was also maintained in the Fund, in spite of turbulence in the credit space.

Once again, sticking to our convictions helped us in 2015 and our allocation to European bank contingent convertibles in particular resulted in good performance as the asset class was the one of the strongest performing ones in the credit sector.

## Performance drivers in 2015 (in bps)

<b>Rates Strategies</b>	<b>233</b>
G4 Sovereigns	-27
Peripheral Sovereigns	244
Oceania Sovereigns	53
Emerging Sovereigns	0
Others	-37
<b>Credit Strategies</b>	<b>49</b>
Financials	86
Energy & Materials	-33
Consumer Discretionary	-4
Others	0
<b>Currency Effect</b>	<b>182</b>
US Dollar	304
Japanese Yen	-29
AUD, CAD & NZD	26
EM	9
GBP	-117
Others	-11
<b>Gross Performance</b>	<b>464</b>

Source: Carmignac, 31/12/2015

Past performance is not a reliable indicator of future performance.

Between Conviction and Active Management: Staying True to our Nature

Carmignac Portfolio Unconstrained Global Bond is first and foremost a conviction driven fund, geared towards generating long term performance. When convictions are deployed, they can be challenged by short term actions in the market. However, our convictions are regularly reviewed and should there be no change in our views, we will stick to our beliefs.

Of course, active risk management is also part of the Fund's core philosophy, and it can be witnessed over the course of 2015.

The dollar exposure was reduced when the EUR/USD cross reached 1.05 (close to multi-year lows). We locked in profits on some of our peripheral sovereigns where yields were likely to experience temporary widening on the back of political uncertainty and stretched valuations. However, the core conviction remained unchanged (in light of the potential ECB QE extension and expansion) and our allocation was gradually reinforced again as valuations appeared more attractive (following the spread widening).

Hence, even though certain positions were yielding negative temporary performance, since our views did not change (namely on peripherals and bank credit), we kept the positions that ultimately delivered positive long term performance.

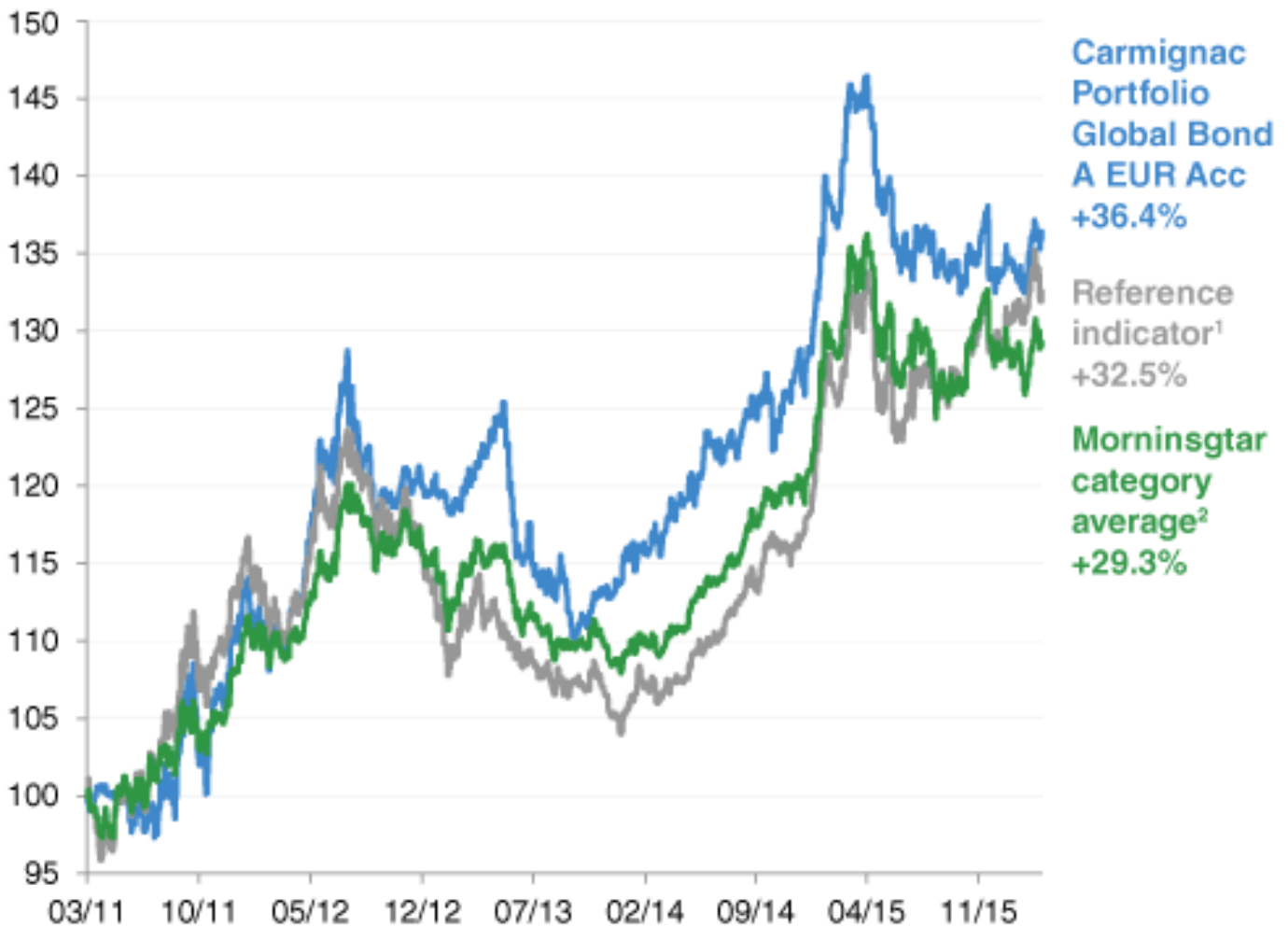
### **Laudable, Lasting Long Term Performance**

The 5 year (long term) track record of Carmignac Portfolio Unconstrained Global Bond is very competitive, above peer group average and well above benchmark. The Fund caters to bond investors long term requirements. It fully embraces short term volatility in its quest to deliver returns over the longer period. The proof of that is illustrated in the chart.

Moderate short term drawdowns do occur, but ultimately, the overall performance since the Fund has implemented its investment philosophy is very strong indeed. The 1st quartile ranking over the 5 year period is a testament to the Funds ability to outperform its peer group average.

We choose to focus on active risk management in the Fund, instead of controlling the short term volatility. That being said, the overall volatility of the Fund is very much in line with its peer group average. If we look at the Sortino ratio (down-side volatility), it is even more clear that the Fund does better than peers. Indeed the Fund's overall 4 star rating awarded by Morningstar illustrates the strong risk-adjusted returns that have been delivered over the long term.

## 5-year Performance of Carmignac Portfolio Global Bond vs reference indicator<sup>1</sup> vs peer category average<sup>2</sup>



1. Reference Indicator: JP Morgan GBI Global (Euro); 2. Morningstar category: Global Bond. Source: Carmignac, Morningstar, 14/03/2016. Past performance is not a reliable indicator of future performance. Performances are net of fees (excluding applicable entrance fee acquired to the distributor)

## II – Current convictions and flavor of future

The challenges faced by Fixed income markets ([detailed in our “past performance” note](#)) are fairly structural in nature. Over the past 7 years, QE flooded markets had encouraged investors to take on additional risk and had led to extreme positioning across asset classes as market participants piled their money into risky assets.

However, re-regulation of banks in US and Europe (post 2008 crisis) has led to lower secondary liquidity, as these financial institutions have been forced to de-risk their balance sheets and can no longer adequately fulfill their role as intermediaries in the bond market.

This combination, exacerbated by a generally less accommodative Fed, has led to shocks and bursts of increased volatility in Rates and credit markets. This phenomenon is a result of tighter regulation imposed on banks and is not likely to change any time soon. As a result, we expect volatility spikes to continue to occur in the markets and while this presents challenges, it also yields opportunities.

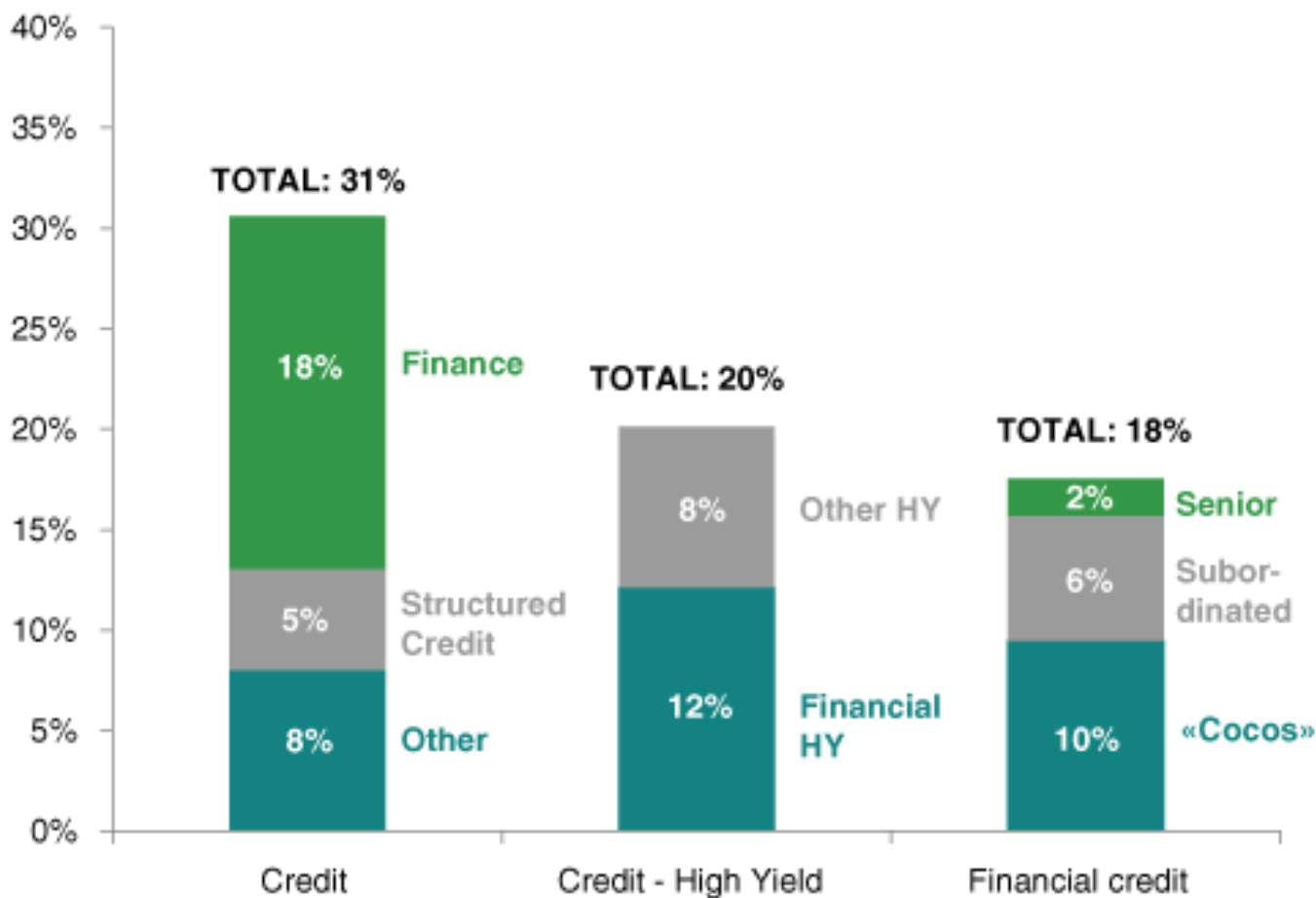
## **Seizing Opportunities**

A prime example of the above mentioned concept of exploiting volatility is our choice of investing in interesting stories in the credit market. An on-going turbulence on US high yield markets (driven by low oil prices and exacerbated by lower trading liquidity) has spread to the rest of credit space. This has resulted in severe losses and sharp rises in spreads.

In our opinion, this has produced very good opportunities in the sector, provided they are chosen appropriately. We rely on our reinforced credit team, which is constantly monitoring markets to spot anomalies. Once the opportunity is spotted, it is important to understand the fundamental case behind each opportunity, both on a sector and single name level. Clearly understanding key elements such as default risk and ability to deleverage is important. The team places a strong premium on understanding the risk-reward profile of each segment that is analyzed and it is extremely important to gauge if we are getting paid for the risk taken or if we are being paid to wait.

Today, the portfolio is essentially divided between convictions on the European financial sector, European CLOs and finally, bottom up bond picking in single name stories (primarily in the commodity sector) that appear attractive. Finally, we will continue to rely on CDS indices to tactically hedge the portfolio during periods of disturbance as done in early days of February this year.

## Carmignac Portfolio Global Bond: Credit allocation



Source: Carmignac, 10/03/2016

### III – Inside our investment strategy

## Credit

European banks are a long standing conviction, which has been reinforced over the past few weeks. Indeed, as we trudge along towards a European banking union, the inevitable on-going re-regulation is likely to last for several years. During this time, banks will continue to increase capital ratios and reserve requirements and shrink their balance sheets, which are supportive fundamentals for Bank credit.

We are invested in the subordinated tranches and bank contingent convertibles (CoCos). It is important to know that we rigorously analyze each position before investing, and we focus on large national champions, whose capital structures have already considerably improved. Hence, we remain confident that their trigger levels are very unlikely to be breached (both in terms of coupon payments and write-offs). Finally, the banks we own need to continue to maintain a minimum level of capital ratios and CoCos remain the favored instruments to do so. Furthermore the issues we own have access to cheap funding and a very strong incentive to not miss a payment due to the need to keep accessing capital markets.

To a lesser extent, European CLOs are also an interesting opportunity. The sector exhibits attractive levels of spread and an extremely low default history that dates back to pre-financial crisis. Furthermore the structures appear to be cleaner, more transparent and better regulated post 2008 financial crisis. Once again, a sharp analysis is necessary to see what segments we want to select in order to maximize risk adjusted returns. We carefully calibrate this position with clear limits in mind.

The strong fundamentals of our holdings will not entirely insulate us from the overall market volatility. Indeed, if a weak bank gets hurt, the contagion effect will generate some price volatility on our positions. However, it is worth pointing out that our holdings carry a very protective yield and will generate sturdy returns until they are called. It is also important to note that we have calibrated the positions in a very cautious manner.

## Government Bonds

The low inflation picture combined with the current weak macro-economic scenario should continue to put downward pressure on US rates. We continue to favor the long end of the curve (10&30-year) where yields still appear attractive on this safe haven asset. In Europe, we have slowly and tactically reduced our exposure to peripheral sovereigns, where our strong positioning dates back to mid-2013. While yields are at very low levels in Spain and Italy, Portuguese rates have seen an upward trend since the beginning of the year as political risk premium is getting priced in. While political uncertainty and negotiations with the European commission persist, we believe that with the backing of ECB (as lender of last resort) and the QE program that includes Portugal, yields will move lower. The current (increased) level of yields hence appears attractive even in terms of carry.

Once again, it will be extremely important to tactically manage the overall modified duration through derivative instruments to face potential shocks in the market. Should the Portuguese yields suffer from bad news in the region or the US rates experience technical shocks in the form of Chinese reserve sell offs, duration management through futures will be very useful. Similarly, our flexibility to adopt a negative modified duration will be vital to managing rates in the current environment.



## Currencies

Currency exposure continues to be managed actively in the Fund. In the face of the strong volatility described above, the currency segment offers a significant amount of diversification and is an invaluable portfolio construction tool. FX strategies are hence also used to mitigate risk and balance the bond performance drivers.

In the current context, we prefer to tactically manage our FX exposure. The divergence between US and European monetary policy is currently quite thin and most of it appears to have been played out (pending future central bank interventions). We continue to monitor the central bank policies as well as the overall exposure of our bonds to balance our Euro/dollar allocation.

Asian currencies on the other hand appear doomed to depreciate. The weakness of the Yuan is a distinct possibility in spite of actions taken by the Chinese and this could create additional pressure on neighboring export countries (Korea, Taiwan and Singapore) that are likely to depreciate their currencies in order to gain competitive advantage.

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