CANDRIAM
INVESTORS GROUP
A NEW YORK LIFE COMPANY

THE END OF CHEAP MONEY?

Fixed Income investing as monetary policy tightens: optimizing risk/return potential in credit markets.

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The financial crises of the past seven years created significant shifts in the financial markets. Long gone are the days of low risk sovereign bonds. The US and European governments have been downgraded. Bank-bailouts rewrote the traditional order and how investors and regulators treat the financial sector. New regulations, on-going volatility and continued deleveraging trends have forced both borrowers and institutional investors to reconsider their options.

As interest rates have been consistently pushed down since 2008 to keep the global economy going, investors' hunger for yield has grown stronger than ever and turned bond markets upside down with huge flows into corporate bonds, pushing down spreads.

But with Janet Yellen tapering the Fed's Quantitative Easing programme and UK's Mark Carney pondering whether interest rates should rise, much of the world is now shifting from unconventional policies that softened the effects of the crisis, towards the end of cheap money.

With rates bottoming out and corporate spreads having normalised, the great bull-run in bonds seems over. Investors need to become more discriminating and more daring in their fixed income investment decisions.

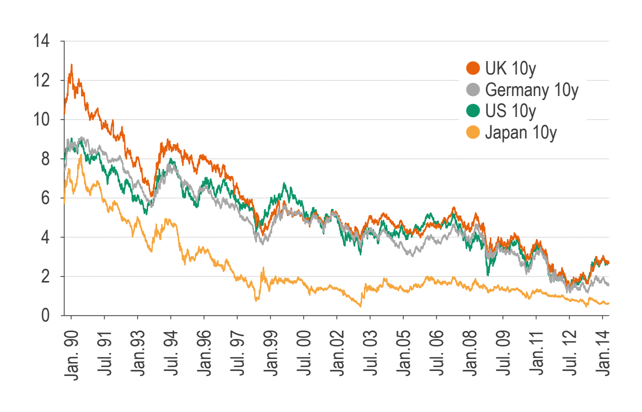
This paper addresses how investors can best navigate through the new fixed income era by focusing on High Yield corporate credit. It also details which strategies and tools are best adapted to benefit from credit opportunities and manage risk.

THE END OF THE LOW INTEREST RATE ERA

SEVEN YEARS OF CHEAP MONEY ARE COMING TO AN END. INVESTORS MUST PREPARE

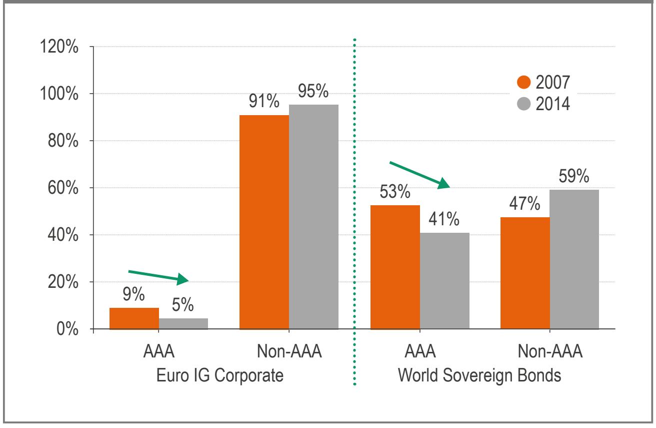
Interest rates have been falling consistently since the early 1990s, with major troughs highlighting the various economical and financial crises over the past two decades. Rates are now reaching historically low levels (*see Graph 1*). While investors benefited from capital appreciation as rates declined, they now face the prospect of falling bond prices as rates go up again.

GRAPH 1: Rates have fallen to historic lows



Source : Bloomberg

GRAPH 2: Risk-free issuers are harder to find



Source : BOAML (ER00 Index, WSOV Index)

Current market	Effective Yield	Effective Duration
Euro Gov	1.60%	6.60
Euro IG	1.76%	4.52
Euro HY	3.66%	2.92

One of the lasting consequences of the financial crisis has also been the reshaping of the Fixed Income universe. The financial sector, a large component of corporate issuance, took a hit from 2007. Country downgrades and events such as the Eurozone crisis mean that sovereigns are no longer risk-free. The number of AAA-rated issuers in both the sovereign and the investment grade world has dropped, affecting yields and portfolio diversification. (*Graph 2*).

With the end of cheap money approaching, investors now face two major concerns that need to be addressed: the impact of rising interest rate on investment portfolios, and how to find attractively priced yield.

NEW FIXED INCOME STRATEGIES REQUIRED

MAINTAINING INCOME STREAMS WHILST PROTECTING CAPITAL REMAINS A DELICATE BALANCING ACT

With rising rates on the horizon, alternative credit strategies may be required to complement traditional long-only Fixed Income investments in order to generate income and manage risk. Regulatory, structural, technical and fundamental drivers of change in the Fixed Income market will also need to be carefully considered. How can investors assess the major factors affecting their investment strategies?

The key for many investors is to focus on alternative credit investment opportunities, such as High Yield corporate credits which have a low correlation to interest rates movements, and offer more attractive yields, along with a flexible and dynamic management to mitigate key risks.

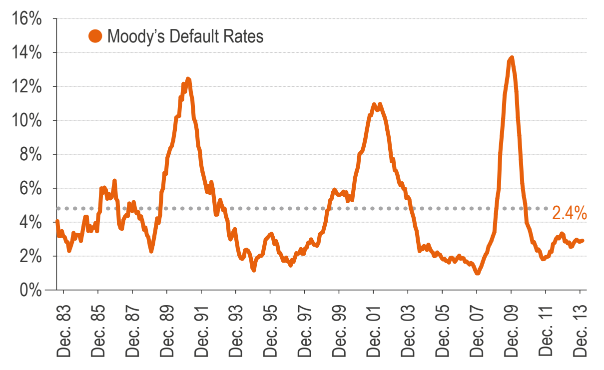
Contained default rates: a positive stance for High Yield strategies

High Yield strategies present an interesting profile. As graph 3 shows, the default rate for global High Yield over the past 12 months is well below the long-term average of 4.5%. It stands at a low level of 2.4%. A sharp rise in default rates seems unlikely as the US economy and refinancing conditions in Europe improve.

Corporate issuers are healthy. They have trimmed their debts and re-financed, meaning outstanding loan obligations will be easier to meet. Growth in the US and even low growth in Europe should increase their revenues, meaning there will be more profit to pay back debts.

Yet, the expansion of the High Yield universe has not been without its pitfalls. ‘Fallen Angels’ can drop from the upper rating echelons to the more speculative grades, thus sharply impacting their bonds’ valuations. However, while default rates spiked in 2001 in the dotcom bust and again in the wake of the financial crisis, they have dropped back considerably since then, boosting investor confidence.

GRAPH 3: It’s all about the default rate

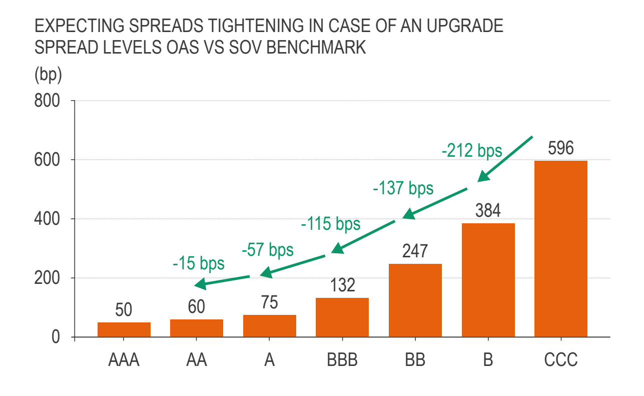


Source : Data from Moody’s Investor Service as of 28/02/2014.

Time for an upgrade

If corporates are in better shape, so are the 'Fallen Angels'. The additional cost of servicing their loans when risk premia rose was a strong motivation to get themselves back into shape. Automakers and basic material producers for instance have cut their overall debt levels and refinanced on better terms, making their corporate bond programmes more sustainable. Banks have done the same, with an extremely big regulatory push from governments who do not want taxpayers to shoulder the cost of any future bailouts.

GRAPH 4: Rising Stars



Sources : BOAML, Bloomberg (data as of March 2014)

Thus, many 'Fallen Angels' are now the new 'Rising Stars'. They are seeking rating upgrades with a shift back up from High Yield to Investment Grade territory. This upgrade reflects a strong indication that investors believe a business will be profitable in the long-run and its bond issues will rise in value as more investors feel confident enough to invest.

A move from a CCC rating to a B rating is worth a lot. It could mean spreads tightening by as much as 212 basis points. For holders of the bonds, that could equal an uplift of 8% or 9% in the value of their particular holding.

The key is to buy the right 'Rising Stars' at a good price, based on thorough research and fund manager conviction that an upgrade is in the pipeline.

Mergers and acquisitions

Mergers & Acquisitions (M&A) is also a fast developing theme. It is one we believe will be a key performance driver for 2014 and beyond.

Globally, the top 1,000 non-financial corporates have stockpiled US$2.8 trillion in cash, according to Deloitte. They have done so partly in response to the crisis. But, just like sovereign bond investors, those companies are making little or no money on their investments. With the crisis largely over, it is time to reinvest.

An M&A operation can be an efficient way to kick start this process. We already see activity in Europe as Vodafone and other telecoms operators seek deals to acquire competitors or cable TV operations to boost their fixed line, mobile, internet and television bundled product offers.

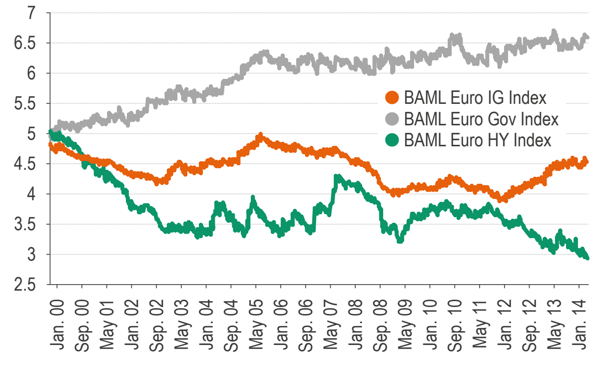
In Q1 2014, the value of merger deals announced globally was 54% higher than in the same quarter the previous year, according to Thomson Reuters. Total deals worth $710 billion were announced as chief executives, boards and shareholders felt more confident they could grow their businesses by acquiring other firms.

M&A is also positive for equity holders as they usually receive a premium for agreeing a deal. A similiar situation can happen in the bond world as debt holders are bought out on preferential terms or get their rating upgraded.

Shorter duration papers: offering a yield cushion

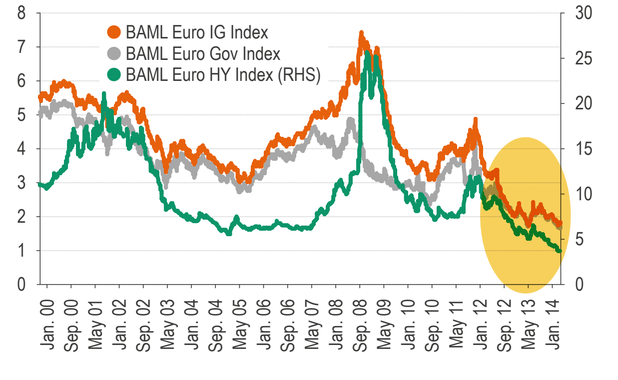
Short duration bonds offer some protection to investors' capital as they are less sensitive to rising rates than longer duration bonds. Interestingly enough, the average duration of the corporate and High Yield segments is much lower than that of the overall government bond segment (*see Graph 5*).

GRAPH 5: It's all about duration



Source : BOAML (EG00 Index, HEC0 Index, ER00 Index)

GRAPH 6: It's all about yield



Source : BOAML (EG00 Index, HEC0 Index, ER00 Index)

As graph 6 shows, yields are down due to investor demand and the low rate environment. Both drivers will change in time. High Yield remains an attractive income producing class, particularly as default levels are low. High yield markets offer a more attractive yield and a higher level of protection when rates rise. Active investment strategies can also enhance returns over the benchmarked yields illustrated here.

The end of beta-driven performance

Rates are low and even an increase will leave them historically low. Spreads have also normalised. Both elements signal the end of recent beta-driven performance. Portfolio performance will now come from alpha.

Dispersion among securities is rising as normal macro and market environments return and central banks diminish their interventions. Now more than ever, alternative credit strategies that profit from this rising dispersion need to be considered in a global asset allocation portfolio.

HIGH YIELD – MANY OPPORTUNITIES FOR 2014

DEEPENING AND EXPANSION OF THE HIGH YIELD MARKET: OFFERING GREATER PORTFOLIO DIVERSIFICATION

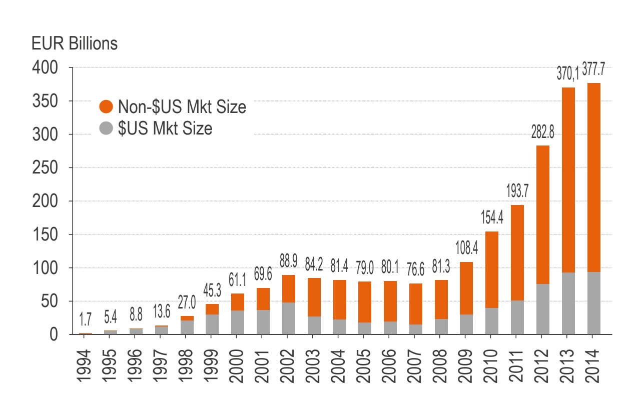
Despite the many uncertainties that investors face, there are solid economic trends that support our belief that alternative credit strategies, especially based on High Yield investing, can provide returns. JP Morgan estimates for the first quarter 2014 show that inflows from high yield funds in Europe were around €3,3 billion.

With current assets representing over € 1300 billion globally, of which €280 billion in Europe, the corporate High Yield segment still only represents approximately 25% of the US market. However, as the number of issuances increases, the depth of the market is significantly expanding by geography and sector. We expect to see record levels of issuances in 2014 at around €110 billion.

The deepening of the market stems from a structural change in the way asset managers work and the fact that diversity is also on the rise. US corporate issuers still dominate the market, but new opportunities can be found in Europe and Emerging Markets. High Yield is now bigger and broader than ever, encompassing new sectors, issuers and opportunities. Investors are increasingly looking at companies from Southern Europe, most of which are making their first steps into the bonds markets.

The number of High Yield bond issuers from Italy, Spain and non-core European countries such as Portugal, Greece and Ireland is growing. According to Moody's, High Yield corporate issuances from the Europe's periphery countries doubled to $24 billion in 2013, thereby increasing to 27% of total issuances from the European Union, up from 18% in 2012. This is a surprising yet positive sign for the asset class, proving its value and investment attributes.

GRAPH 7: A growing and more diversified High Yield market



Source : Credit Suisse

One of the main reasons market participants are confident the peripheral High Yield market will remain strong is the greater availability for refinancing. With banks under pressure to shrink their lending schemes, more companies are likely to tap into the High Yield market for funding rather than to turn to banks.

Another attribute of this asset class, which helps explain its popularity, is its ability to inject diversification in a portfolio. Not only does it offer an attractive carry but is also allows investors to be less impacted by moving interest rates.

At Candriam for instance, our **High Spread strategy** offers a positive risk /return profile, with expected performance between 4% and 6% with a 4% to 6% volatility.

This strategy can optimise investment portfolios as it combines **two complementary engines of performance**:

- **a short duration bucket** with issuers having a strong liquidity profile,
- coupled with **an opportunistic bucket** focusing on alpha generation: high convictions (Potential upgrade, deleveraging…), special situations (M&A, refinancing…) and specific capital structure positioning (Senior secured, hybrids…). This bucket benefits from a dynamic Tail Risk hedging.

THE RIGHT TOOLS FOR THE RIGHT JOB

LONG ON OPPORTUNITIES, SHORT ON POOR VALUE

An attractive strategy despite the threat of rising interest rates

Asset managers must be prepared for the challenge whenever interest rates are set to rise. Many have already thought of ways to minimise impacts on portfolio values, putting in place contingency plans and appropriate downside risk protection. This includes a range of investment vehicles including futures & options on interest rates. While these can be costly protections measures, they are largely compensated by the expected performance.

Key drivers for successful investing in credit markets

Credit markets are technical markets offering many opportunities. They require experts to identify, capture and benefit from these opportunities, as well as manage the risks involved with delivering outperformance on the long-term. Understanding key drivers of performance and risk management is therefore crucial in more uncertain times. Investors should rely on the ability to deliver performance and hedge risk, in all market environments.

A thorough investment process is founded on robust research and selection looking at each issuer's business and financial profiles, and specific situations. This key step is supported by quantitative research followed by implementation. The portfolio is constructed based on two strong pillars: a short duration one along with an opportunistic one. Together these offer investors a varied yet performing strategy with robust downside risk protection.

The main pillars for successful investment management of alternative credit strategies include:

- High-conviction and active fund management
- Fundamental analysis, legal expertise and quantitative research
- Tail risk management capturing asymmetry in the market
- Careful use of derivatives including futures & options but also CDS & indexes
- Healthy liquidity levels

ABOUT CANDRIAM INVESTORS GROUP

Our alternative credit team

- Three senior fund managers working alongside supported by two analysts, fully dedicated to the 'High Yield and Credit Arbitrage' team.
- Proven ability to identify opportunities, capture profits and manage risks.

Philippe Noyard
Head of High Yield & Credit Arbitrage
26 years of experience

Patrick Zeenni, CFA
Deputy Head of HY&CA
Senior Fund Manager
18 years of experience

Nicolas Jullien, CFA
Senior Fund Manager
7 years of experience

Our High Yield heritage

1999	• Development of our high yield process and launch of our Euro High Yield strategy
2000	• Launch of Obli-Inter strategy with a flexible and unconstrained profile across the credit Spectrum
2002	• Based on the same approach, **High Spread strategy** launched with an absolute return approach
2003	• Our Global High Yield strategy extends our capabilities to the global high yield market
2009	• Launch of the Long Short Credit strategy, an alternative credit approach
2013	• Total AUM of the process **crosses the EUR 1bn threshold**
2014	• **CANDRIAM renames its range of alternative investment funds** • Total AUM of the process **currently sits at EUR 1.5bn**

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