

ASCENT

BY PETERCAM INSTITUTIONAL ASSET MANAGEMENT

N°2 SPRING 2013

CAN COUNTRIES BE SUSTAINABLE?

EQUITIES ARE STILL ATTRACTIVE

ARE QUALITY CORPORATE
BONDS IMMUNE TO
A RISE IN RATES?



Hugo Lasat,
Partner & Head of Institutional
Asset Management

Guy Lermينياux,
Partner & CIO Equity

Johnny Debuyscher,
Partner & CIO Fixed Income

Francis Heymans,
Partner & Head of Sales
and Marketing

EDITO

Dear reader,

Welcome to the spring edition of Ascent, Petercam Institutional Asset Management's newsletter on its research and management capabilities.

Once again, we present you a number of thought-provoking articles on our major expertises.

The first quarter of 2013 was characterised by mostly positive returns on financial markets. Equity markets across the board staged an impressive rally, and quality bond yields continued to decline.

As a matter of fact, Petercam's macro-economists see global growth rates picking up. The US economy seems to be on the mend, while Europe is still mired in a recession.

Against this backdrop, we have asked ourselves several questions. Firstly, what happens to the price of high-quality bonds when government bond yields rise? From our client feedback, we know this is an issue many institutional investors are faced with. In a dedicated article in the fixed income section, we aim to provide an answer.

Secondly, how are (European) equities currently valued? Guy Lermينياux, Partner and CIO Equity, tackles this issue drawing on 26 years of market experience and the successful track record of his equity management team.

Thirdly, in the SRI section of this newsletter, we ask ourselves whether a country can be sustainable. Not surprisingly, our answer is a resounding 'yes'. Countries with efficient and adequate institutions are better placed to provide their citizens with a sustainable future and create welfare for current and future generations. There is also a link between the quality of a country's institutions and its default risk.

In that respect, we are proud to present our recently launched third SRI fund, namely Petercam L Bonds Emerging Markets Sustainable. It invests in emerging market debt, but includes a normative and best-in-class SRI filter. We are convinced this overlay will generate additional financial and sustainable value in the long run. Please do not hesitate to contact your relationship manager, whose contact details are on the back page of this publication.

We do hope you will enjoy reading this second edition as much as we have writing it. Please do not hesitate to pass on your feedback to us.

Sincerely,

Hugo Lasat, *Partner & Head of Institutional Asset Management*
Francis Heymans, *Partner & Head of Sales and Marketing*
Guy Lermينياux, *Partner & CIO Equity*
Johnny Debuyscher, *Partner & CIO Fixed Income*

ASCENT

BY PETERCAM INSTITUTIONAL ASSET MANAGEMENT

TABLE OF CONTENTS

EDITO	2
EQUITIES, NOTHING BUT EQUITIES	4-5
HIGH QUALITY CORPORATE BONDS: HOW TO SURVIVE RISING GOVERNMENT BOND YIELDS?	6-8
CAN A COUNTRY BE SUSTAINABLE?	9-11
CONTACT DETAILS INSTITUTIONAL SALES & MARKETING TEAM	12

The information contained in this document is provided for pure information purposes only. Present document does not constitute an investment advice or an investment recommendation and independent investigations, assessments or analysis regarding any investment should be undertaken by the potential investors and recipients as deemed appropriate by them. This document doesn't form part of an offer or solicitation for shares, bonds or mutual funds, or an invitation to buy or sell the products or instruments referred to herein. Applications to invest in any fund referred to in this document can only validly be made on the basis of the current prospectus or simplified prospectus, together with the latest available annual report and accounts. All opinions and financial estimates herein reflect a situation on the date of issuance of the document and are subject to change without notice. Indeed, past performances are not necessarily a guide to future performances and may not be repeated. Petercam S.A. has made its best efforts in the preparation of this document. The information is based on sources which Petercam S.A. believes to be reliable. However, it does not represent that the information is accurate and complete. Petercam S.A. is acting in the best interests of its clients, without carrying any obligation to achieve any result or performance whatsoever. Petercam S.A., its connected persons, officers and employees do not accept any liability for any direct, indirect or consequential loss, cost or expense arising from any use of the information and its content. The financial instruments described herein may not be eligible for sale in all jurisdictions or to all types of investors due to legal or suitability restrictions. Present document is intended for institutional investors only and may not be duplicated, in whole or in part, or distributed to other persons without prior written consent of Petercam S.A.

Writing finished on April 19, 2013

Editor: Jurgen Vlujijmans | Publisher: Hugo Lasat | Photography: iStock | Layout: Marc Vermeersch/Shake

EQUITIES, NOTHING BUT EQUITIES



Guy Lermينياux,
Partner & CIO Equity

The title of this article is closely related to my professional career. Since I first entered the labour force 26 years ago, my job has been to make decisions in the field of equities. Firstly, I was involved in Belgian, listed equities as an analyst, later on as a broker. After having spent more than ten years in brokerage, I moved on to the institutional asset management business.

LOOKING BACK

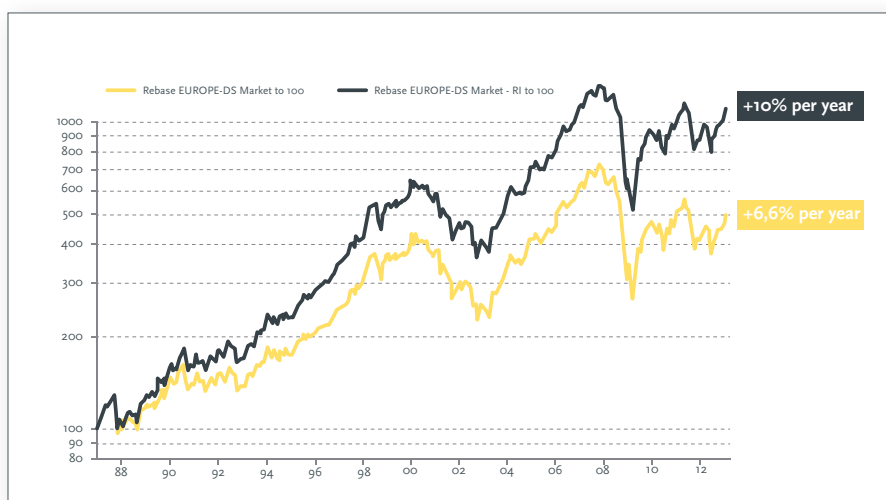
Looking back twenty-six years into the past, I am happy to share some insights with you.

Every stock market crisis has a number of common features. At first, there is disbelief, followed by the radio and TV reporters, resulting in headlines. Finally, investors throw in the towel and sell both their equities and equity funds. I have lived through each of these phases. Time and time again, it feels like, “this time will be different”. In reality, of course, it is not and things go back to normal. Business as usual.

Such corrections are not very pleasant and a strong stomach is needed to stay the course. With the benefit of hindsight,

each crisis turned out to be an outstanding buying opportunity.

The graph below is worth more than a thousand words. Despite around six severe corrections, it shows the average performance of the European equity index since I started my career. Investors who bought a basket of European equities on 1 January 1987, and have held onto them ever since, have seen their principal increase fivefold. Moreover, when taking into account yearly paid dividends, their capital has increased more than tenfold, i.e. an average annual return of +10%. I hardly dare to make the calculation, but if they had accumulated during each of these six crises, their return would have been even higher.



Source: Thomson Reuters Datastream - PETERCAM

LISTENING TO WARREN

I would like to add the following statement by the legendary investor Warren Buffett, one of the wealthiest people on this planet: “In the 20th century, the Dow Jones rose from 66 to 11,497 points, an impressive rise of 17,320%, in spite of four expensive wars, a Great Depression and numerous recessions. And don’t forget that shareholders during the same timeframe pocketed substantial dividends.” Buffett continues: “Since the underlying trend has been to increase wealth by means of corporate value creation, it has been a tremendous mistake to get in and out of the market based on advice or economic cycles. The risk of not being in the game at the wrong time is far greater than staying in the game.” Hence, the conclusion based on personal experience is the following:

- 1 **Equities always have a place in a portfolio**, provided that the investment horizon is long enough, namely at least ten years. Long-term studies in various countries show that equities as an asset class have a systematically higher return. This risk premium may be considered as “danger money”.
- 2 **Keep some cash on the side** in case a serious correction does happen in order to accumulate equities at lower prices.
- 3 **Do not think it is the end of the world** and do not indulge in the desire to sell during a crisis. It may be an emotional rollercoaster, but the facts are the facts and they speak for themselves.



Risk

Many investors consider volatility (sharp fluctuations in security prices) as a yardstick for risk. Regulators, risk committees and even classical portfolio theory adhere to this reasoning. The higher the volatility of a share, the higher the risk associated with it; hence the lower its appeal. For these reasons, an equity investment is considered as very risky, unsuitable for “prudent” investors.

I tend to disagree with this.

Provided one’s investment horizon is long enough (at least ten years, preferably even twice as long), the part of one’s assets that are not immediately needed to finance some kind of expenditure can be invested in equities. The (market) price of these equities fluctuates over time, possibly quite strongly, around the company’s underlying value. When selecting the equities of the companies that create value over time, a decent return (combining price appreciation and annual dividend payments) over the same time period is guaranteed. In that sense, risk is not volatility, but permanent loss of capital. If there is no permanent loss of capital, the price of the equity fluctuates around its intrinsic value. If, at a certain point in time, the price differs substantially from this value, there is always a reversal to the mean, causing prices to move back to value again. A systematic reversal to the mean is one of the most reliable strate-

Equities always have a place in a portfolio.

gies investors have been able to apply throughout time.

Nowadays, we have reached low levels of inflation, with the dividends that companies pay to their shareholders surpassing what they would pay their bond holders. With the exception of a short period during the 1950s, this has been an unprecedented situation... until a couple of years ago.

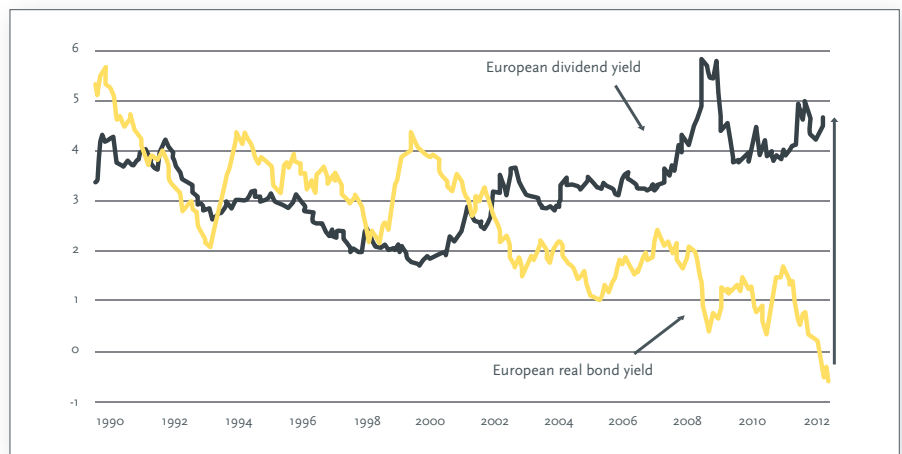
This has led to a major discrepancy (gap) between the real return of the European equity markets (= dividend) and real return (= coupon

after inflation) of bonds.

The graph below shows this gap over time, which currently stands at about 4%, a remarkably high difference from a historical perspective.

WHICH EQUITIES?

Since equity valuations are relatively low on average, we continue to prefer companies with a global foothold, offering products or services with limited competition, which can take part in globalisation (by means of investments or acquisitions financed by free cash flow) and which are managed by an experienced team with proven communication skills and, if possible, a track record of rising dividend payments. This is the kind of companies we tend to invest in for our core European funds, namely Petercam Equities Europe and Petercam Equities Euroland. Those wanting to add a sustainability overlay, may want to take a look at Petercam Equities Europe Sustainable. These funds combine an excellent long-term performance track record with limited volatility. ■



Source: UBS Investment Bank

HIGH QUALITY CORPORATE BONDS: HOW TO SURVIVE RISING GOVERNMENT BOND YIELDS?



Frederiek Van Holle,
Quantitative Specialist

With interest rates at historical lows and abundant liquidity provisions by central banks, fixed income investors have become increasingly concerned about rising interest rates. It is well known that rising interest rates have a negative impact on a bond prices. However, the total impact on a fixed income portfolio is not necessarily negative.

A corporate bond yield can be roughly considered as the sum of three main building blocks. First, the government bond yield. This is considered the 'risk free' component. Second, the swap spread. This is the extra yield banks have to pay above the government bond yield because they have a higher default risk. Third, the credit spread, which is the spread a corporate has to pay above the swap yield in order to finance its business. Each of these components can change independently or in tandem with another component. For example, a rating change on a corporate bond will typically impact the corporate bond spread. Or, a sudden rise in market risk aversion might reduce the government bond yield and at the same time increase the corporate bond spread. In fact, the credit spread and the government bond yield tend to be negatively correlated. In other words, a rise in government bond yields

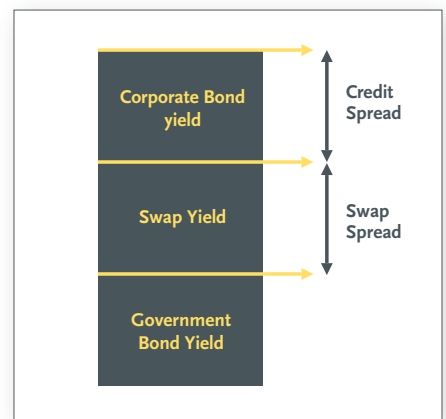
Credit spread and government bond yield tend to be negatively correlated.

seems to go hand in hand with a contraction of the credit spread. To illustrate this point, the graph below shows the one-year moving window correlation between the daily returns of the euro corporate spread performance and the performance on an index of German 3-5 year government bonds. The correlation tends to vary over

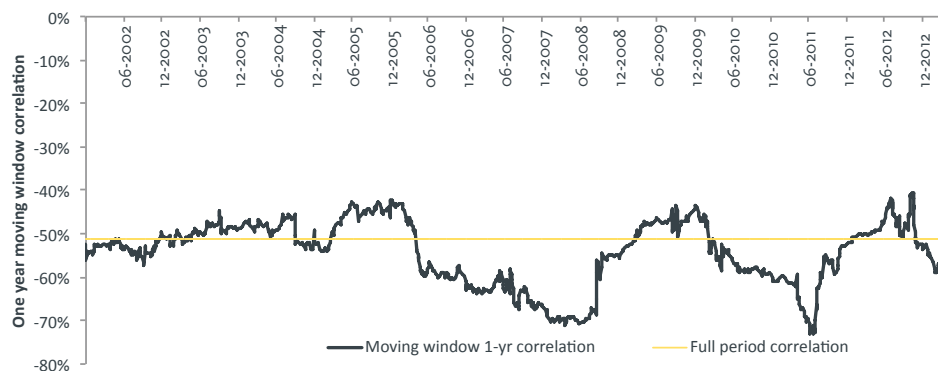
time but is about -51% on average. In 2011, the correlation dropped as low as -73%. This relationship between government bond yields and corporate bond spreads is an indication of the implicit

hedge present in a corporate bond. When government bond yields rise, the modified duration will indicate how much the portfolio is expected to lose. However, a corporate bond portfolio also has an exposure to spread duration. Typically, the spread will contract and this will generate a positive return contribution in the portfolio. The net portfolio impact depends

on the correlation between the credit spread and the government bond yields. To further illustrate this point, we will apply a 100 basis points upward shock on the German government yield curve and study the impact on a typical investment grade corporate bond portfolio.



One-year correlation between Euro Corporate Spread Returns and German government bonds (3-5 years).





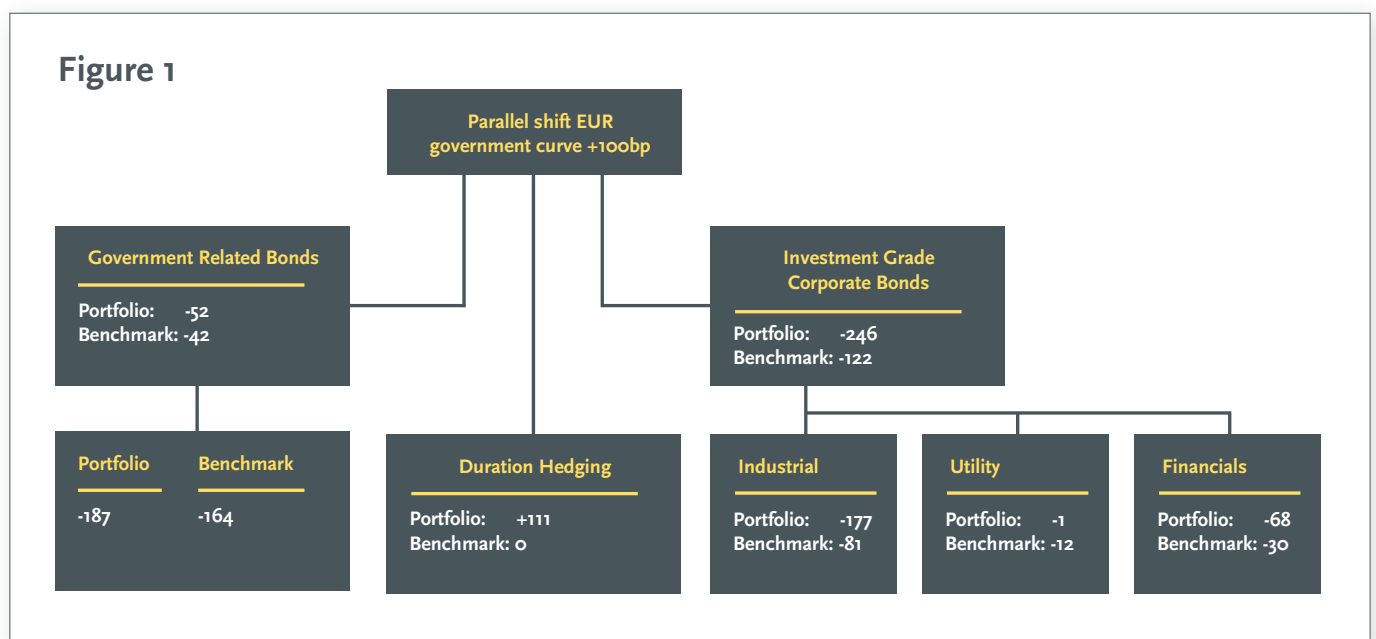
CASE STUDY: IMPACT OF A 100 BASIS POINTS PARALLEL SHIFT ON THE GERMAN GOVERNMENT BOND YIELD CURVE ON THE PETERCAM L BONDS EUR QUALITY

The portfolio has a duration of 4.6 years and the benchmark has a duration of 4.5. As a result, without taking into account the correlations with other risk factors in the portfolio, the portfolio is expected to lose -4.6% because of the 100 basis points yield increase. The benchmark has a slightly lower duration, hence the return impact is expected to be lower. However,

the portfolio seems to lose only -1.9%. This is because of the previously reported negative correlation between government bond yields and corporate bond spreads. More specifically, when the government bond yield increases, corporate bond spreads tend to compress. Given the positive spread duration in the portfolio, this spread compression generates a positive return contribution which, partially, offsets the pure modified duration impact.

The table on the right shows the decomposition of the shock on the portfolio and the benchmark. The computations are performed on the Barclays Point® platform.

As indicated before, given the duration of the portfolio of 4.6 years, a 100bp shift in the government bond yield curve is expected to generate a negative portfolio return of -460 basis points. However, the portfolio contains some implicit/natural hedges due to the corporate bond exposure. The duration impact is correctly represented by the 'upward parallel government shift' component. However, this is largely compensated by the swap- and corporate spread tightening. ➔



Returns are in basis points

Source: Petercam



Corporate bond spread as an implicit hedge against a yield curve shift

	Portfolio	Benchmark
Other volatility, emerging spread, curve slope	-9	+27
Corporate Bond Spread Compression	+214	+190
Swap Spread Compression	+65	+71
Upward Parallel Shift Government Curve	-460	-450
	-187	-164

This entails that a typical investment grade corporate bond portfolio has a natural (partial) hedge against rising government bond yields. In the current environment of extremely low government bond yields, this feature could prove valuable when government bond yields would revert to more normal levels. Of course, the asset manager can further protect the portfolio against government bond yield rises by adding an explicit hedge in the portfolio. In fact, this is valid in our case study. The modified duration of 4.6 years is the result of an initial corporate bond portfolio with

a modified (and spread) duration of 5.7 years and an overlay hedging strategy (a short bond futures position and short call options on the Bobl bond futures contract) with a modified duration of -1.11 years. This hedging is a pure alpha strategy that will generate a profit when yields rise. This strategy is a clever way to protect the portfolio against rising government bond yields. First, there is the natural hedge of the corporate bonds and, second, the portfolio has a higher exposure to spread duration (5.7 years) and the government bond yield exposure has been reduced by 1.11 years to only 4.6 years.

Finally, the carry on a corporate bond should not be ignored. A corporate bond earns a higher yield than a government bond because of the higher implied credit risk. This higher yield generates a carry when holding the bond. Currently, the euro corporate bond portfolio in our case study has a yield of 2.24% p.a. and has a credit spread of 1.55% against a comparable government bond portfolio. Roughly speaking, if the scenario described above is realized over a three-month period, the total return of the portfolio will be the -1.87% impact due to the yield rise + $2.24\% \times 3/12$, the carry earned on the portfolio, which makes a final total return of -1.31% on the portfolio.

CONCLUSION

In an extremely low interest rate environment, many investors are concerned about the impact on the value of their fixed income portfolio. It is true that rising yields have a negative impact on bond prices. However, other factors are also at play. In this article we demonstrated that a well-constructed corporate bond portfolio is by nature capable of reducing the impact of a government bond yield rise. The typical negative correlation between a corporate bond credit spread and government bond yields provides a hedge against the adverse impact of a government yield rise. In addition, active management can introduce further protection. First, by selecting solid names in the portfolio to reduce credit risk and by adding, for example, an overlay short futures/options position to further reduce the adverse impact of a government bond yield rise. Finally, due to the higher credit risk in a corporate bond portfolio, the yield (pickup) relative to a government bond portfolio provides further protection in the form of a return 'buffer'. ■

¹ The Euro corporate bond spread return is computed based on the iBoxx Euro Corporate bond index where the government bond component in the total yield has been hedged away with a duration matched German government bond index. In this way, the pure corporate bond spread performance is obtained (the corporate bond spread being the sum of the swap spread and the credit spread).

² We used the JPMorgan Germany 3-5 years government bond index

³ Spread duration is the sensitivity of the bond to a change in the credit spread. A bond with a positive spread duration will gain when the credit spread contracts.

CAN A COUNTRY BE SUSTAINABLE?

Extra-financial research on corporations has been around for several years, and company rankings based on a 'best in class approach' are common nowadays.

Nonetheless, it looks as if the Eurozone sovereign crisis has been a necessary evil to question the status of Eurozone government bonds as risk-free assets. This has led to the emergence of rankings based on extra-financial criteria for governments as well. Most of the models are quite recent. However, some investors, such as Petercam, have been acknowledging the usefulness of assessing the sustainability of countries, even before the crisis of late 2008.



Ophélie Mortier,
SRI Coordinator

IN-HOUSE SUSTAINABILITY ANALYSIS MODEL

The number of country sustainability models remains fairly limited today, especially given the lack of a universal definition, which has proven hard to establish. Nonetheless, the first lessons of the sovereign crisis in the Eurozone seem to shed some light on the notion of the financial sustainability of a country. It is clear that public debt cannot be analysed as such. It must be analysed in relation to the level of private, corporate and household debt levels. The current account balance is a crucial sustainability parameter.

But what about sustainability criteria that are beyond the financial scope? What are the other sustainability parameters of a country, and is there a link between those two dimensions?

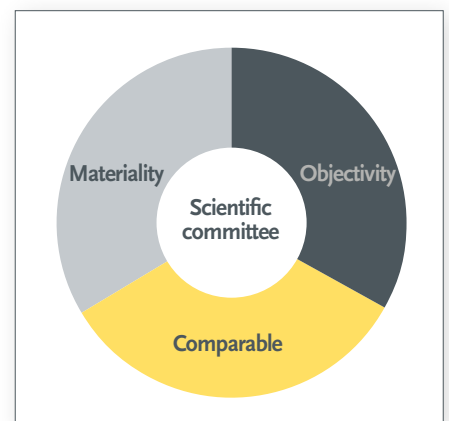
Given the lack of a universal definition for sustainability, Petercam, as an investor in government bonds, started developing an in-house sustainability analysis model in 2007. Its sustainability approach draws on various dimensions:

1. **The political and democratic dimension:** a sustainable country respects its commitments vis-à-vis other countries and its citizens. Sound governance of a country ensures the implementation of development institutions and adequate controls in order to guarantee the optimal working of a country. Institutions are founded democratically, corruption is legally forbidden and citizens are free to express themselves;
2. **The environmental dimension:** a sustainable country that cares about its natural resources and acts to the benefit of the environment. It considers the planet as a public good which everyone needs to respect and preserve;
3. **The social dimension:** a sustainable country looks after the wellbeing of its population. To this end, government authorities ensure a quality of life that is acceptable for the entire population. They guarantee safety and access to quality healthcare;
4. **The future dimension:** a sustainable country invests in future generations; not only by ensuring the best conditions for the arrival of future generations, but also by offering them sufficient education in order to safeguard the development and the governance of the country in the future;
5. **The economic dimension:** finally, a sustainable country should have the means to ensure its economic viability by avoiding excessive debt, by assuring price stability for its population and by managing income and expenditure in a sensible way.

In selecting the relevant criteria enabling the assessment of the five dimensions mentioned above, a differentiation clearly emerges between the countries of a relatively similar universe such as for example the OECD. With regard to these five dimensions, several countries position themselves at the top of the ranking, such as Scandinavia or Switzerland. Conversely, countries such as Greece, Turkey or Mexico exhibit sustainability flaws, which are pervasive throughout the five dimensions.

In assessing the sustainability of countries, Petercam has opted for a pragmatic and objective approach based on four key principles:

- Quantifiable data
- Similar for all studied countries
- Coming from reliable sources
- The relevance and weighting must be validated by the scientific committee, consisting of two external experts.





A PIONEER IN SUSTAINABILITY ANALYSIS FOR EMERGING COUNTRIES

Although most emerging countries are not exactly examples in terms of sustainability or democratic processes, they do show signs of progress. Integrating these criteria into the management of a portfolio investing in these countries, can be of real added value.

Thanks to the experience that Petercam has accumulated in the sustainability analysis of OECD member states, it has enabled our investment professionals to construct a sustainability model specifically designed for emerging markets. It also takes into account the particularities of these countries.

The world population currently has 7 billion people, and according to United Nations statistics, this number is projected to grow to 9.5 billion by 2050. This increase will be prevalent in emerging countries, which are currently confronted with overpopulation and a lack of natural resources. The demographic challenge is related to energy and ecology challenges. In other words, it also entails a challenge for the entire economy.

This is why the analysis on the attractiveness of an emerging country should also be based on an analysis of the sustainability of this country in terms of transparency and democratic value, the environment, demographics, health care, wealth distribution, education and economy.

The model that is applied to emerging countries, takes into consideration the same underlying principles as the model for developed countries: quantifiable criteria that can be applied to all countries, coming from acknowledged and reliable sources. The relevance of these criteria and the weighting allocated to them are discussed and validated by a scientific committee consisting of two external and two internal professionals.

At the same time, the assessment criteria must be adapted to the specific context. The level of development strongly varies from one country to another. That is why it is of key importance to focus on a limited number of criteria which are crucial to sustainability. For instance, the literacy rate is not relevant in developed countries in Europe, but quite relevant in countries such as Brazil, Ghana or Malaysia.

The essential conditions to a population's wellbeing and its sustainable development must be guaranteed. Indeed, political rights and civil liberties, including the freedom of press, are of key importance to lay the foundations of economic and social development. It is also of paramount importance to abolish corruption. If it is impossible to do business without corruption, this corruption will have an influence on the assessment of investments in the involved country. The lack of transparency and the risks ensuing from an additional risk premium should be taken into account.



The core of the model is the democratic values. Upholding them is a moral obligation to Petercam which is intrinsically linked to the stance of a sustainable investor. As a matter of fact, academic research has demonstrated that there is a clear correlation between the quality of the institutional framework of a country and its default risk.

Petercam uses the research of the international NGO Freedom House to assess the democratic development of a country. Based on an annual survey containing 25 questions on political rights and civil liberties, a country is attributed the status of 'free', 'partially free' or 'not free'. This addition is complemented by the democracy index by The Economist, which is also based on twenty-odd questions to assess the democratic level of a country, and by the Human Rights Watch and the annual report of these organisations on human rights.

It appears that there is a clear link between the democratic level of a country and its sustainability. It should therefore not come as a surprise that majority of not-free countries are at the bottom of the sustainability ranking. The analysis provides important information on several domains about the sustainability level of the studied countries. It enables to compare several countries which have a similar level of economic development, but which have varying levels of social, ecological and

There is a link between the democratic level of a country and its sustainability.

corporate governance development. Making a clear and full analysis of the sustainability of a country is a real added value in constructing an investment portfolio, in addition to the ideological values that may be presented. In essence, it boils down to putting into context the opportunities and risks linked to a country.

The objective is not to exclude countries which still have low sustainability scorings, as several countries in the universe have just started their democratization process. Many years of dictatorship weigh on a country's sustainable development. The transition to a full respect of civil liberties and political rights, freedom of press and gender equality does not happen overnight if these rights have been violated for many years. It should be noted that this takes time and that the progress made should be closely monitored. In that sense, Ivory Coast is a good example of a country with a promising economic future, which has an abundance of natural resources and commodities. As the former president Laurent Gbagbo was toppled, the country was plagued by instability and social upheaval. Although the country seems to be on track for a better future, it is too early to say it is a full and real democracy.

Petercam's extra-financial research now covers the global average of countries investors may want to invest in. That is a strong argument for conviction manage-

ment, which is based on seeking risk-adjusted performance. Investors having a clear and full view of the risks and opportunities of a specific country, have an outstanding source of information to assess whether the companies active in that particular country may be successful. After all, the quality of a financial investment is judged, among other things, by the characteristics of the markets the company operates on, and of the specificities of those countries. ■

INSTITUTIONAL SALES & MARKETING TEAM

BELGIUM

Tomás Murillo
tomas.murillo@petercam.be / +32 2 229 62 56
Frederik Cosyns
frederik.cosyns@petercam.be / +32 2 229 62 59

FRANCE

Ives Hup
ives.hup@petercam.be / +32 2 229 62 65
Thierry Minet
thierry.minet@petercam.be / +32 2 229 62 54

GERMANY & AUSTRIA

Thomas Meyer
thomas.meyer@petercam.com / +49 69 27 40 15 295

ITALY & TICINO

Alessandro Fonzi, CFA
alessandro.fonzi@petercam.com / +39 02 86337 223

LUXEMBOURG

Bernard Jans
bernard.jans@petercam.be / +32 2 229 62 51

SPAIN & LATAM

Amparo Ruiz Campo
amparo.ruizcampo@petercam.com / +34 91 5720366

SWITZERLAND

Frederic Guibaud, CFA
frederic.guibaud@petercam.ch / +41 22 929 72 23

THE NETHERLANDS, SCANDINAVIA, UK

Marco van Diesen
marco.vandiesen@petercam.be / +32 2 229 62 72

www.petercam.com
funds.petercam.com

