FIXED INCOME
EXPERTISE

Focus | November 2016

MAKE UP FOR LOW RATES WITH HIGH YIELD!

*EUR high yield corporate bond funds can enhance portfolio returns without taking on equity-like risk. They **can be a smart investment for institutions** at a time when low or negative government yields are jeopardizing long-term return objectives. In line with clients' distinct needs, DPAM's high yield fund suite offers access to defensive and more dynamic options with successful risk/return track-records.*

THE LOW RATE **CHALLENGE**

Most institutions are reeling from the side-effects of low interest rates. Their return shortcomings versus objectives require that they correct course and diversify fixed income investments, without taking excessive risk. This is all the more crucial that central banks' easing measures as well as soft global economic growth are expected to continue.

Pension funds, which typically invest in 'safe haven' government bonds, are increasingly facing deficits versus the amounts they are expected to pay to retiring employees.

Insurers' profitability, which partly derives from the income earned on customers' premiums, is declining markedly. According to Solvency II, insurers must 'freeze' equity proportionately to their portfolio's risk level (SCR: Solvency Capital Ratio). They must favor the asset classes with the lowest SCRs (see page 3).

Private banks & distributors must be able to offer quality high-yielding funds, as their customers, faced with dwindling income, are increasingly asking for investment options with higher yields.

THE LOW RATE **SOLUTION**

EUR high yield bonds offer **higher coupons** than government and investment grade corporate bonds. Thus, they can potentially help close institutions' return gap.

They are also **less sensitive to interest rate changes**, as their high coupons can help cushion potentially negative impacts.

EUR high yield bond funds are an **efficient diversifier** of conventional bond portfolios.

Funds that follow stringent risk guidelines and are highly selective when it comes to credit quality can reduce return fluctuations and thus significantly **limit risk**.

There is **no currency risk**.

Short-term high yield bonds imply **attractive SCR ratios** for insurers versus conventional bonds.

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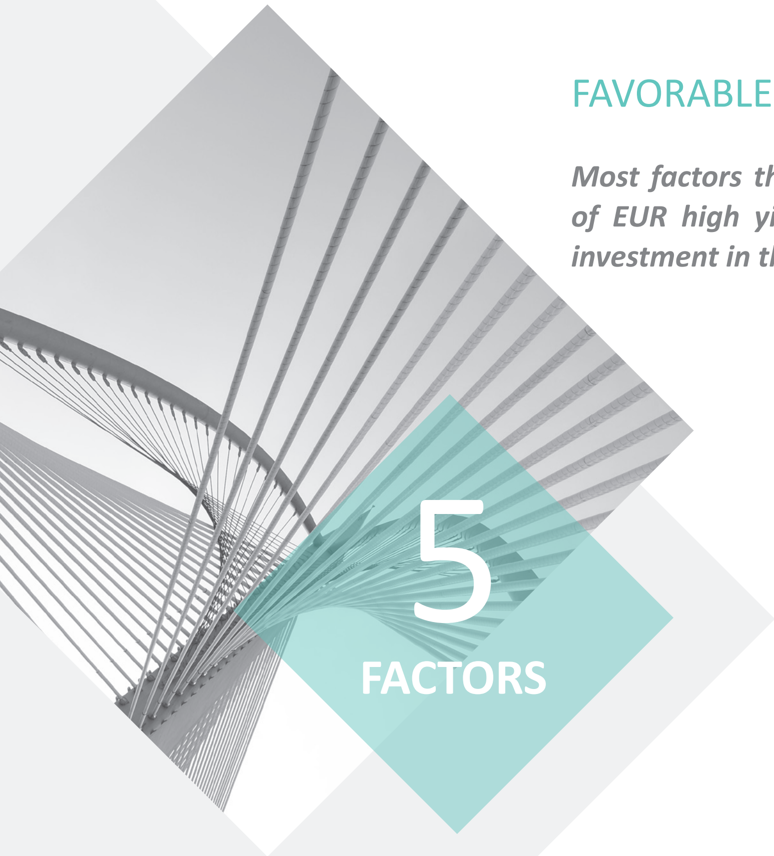
FAVORABLE **TRADEWINDS**

Most factors that impact the market dynamics of EUR high yield bonds currently support an investment in the asset class. They include:



SOLID FUNDAMENTALS

Corporations' **debt levels** are **sustainable**, especially in Europe. We are not witnessing any 'debt binging' due to a surge in leveraged buy-outs, etc. At the same time, **issuance**, while steady, is **not excessive** either, as, among other factors, corporations' near-term refinancing needs are mostly filled.

MONETARY POLICY

Within the Eurozone, the ECB's **accommodative stance** and corporate sector purchase program (CSPP) indirectly support high yield bonds. Rates remain low and the CSPP has led to a scarcity of investment grade bonds, pushing investors towards high yield bonds. This program is widely expected to be extended. Central banks in Japan and the UK have launched similar programs.

LOW DEFAULT RATE

Rating agencies forecast that **default rates** will **remain low** through 2017. For example, Moody's predicts a June 2017 default rate of 2.1%, close to the current level.

VALUATION

The asset class has rallied in recent months. Nevertheless, valuations are not overly stretched, unlike in 2007 ahead of the financial crisis, and **risk is still relatively well rewarded**. Further, investors that participated in the recent rally did not buy indiscriminately.

VOLATILITY

Bouts of volatility are likely given sources of uncertainty, for example the US interest rate outlook, Italy's constitutional referendum, Brexit's impact, etc. While this is typical of the asset class, it is worth remembering that this can be mitigated via strict risk controls within a fund and that overall, the **volatility** of high yield bonds is **lower than equities**' and their returns are comparable over the long term.

EUR high yield bond valuations remain attractive*

Source: DPAM, 1/1/2005-30/9/2016.
* Barclays EUR High Yield, 3%-Capped, Ex-Financials, Index.

5- year risk/return of EUR high yield bonds vs. equities

Source: DPAM, 30/9/2016.
*Barclays EUR High Yield, 3%-Capped, Ex-Financials, Index.

HAPPY ANNIVERSARY!

Petercam L Bonds EUR Corporate High Yield just joined the exclusive club of five-star rated funds in Morningstar's EUR high yield debt category. This top rating rewards a fund's consistent performance, taking inherent risks into account, over a minimum of three years.

DPAM HIGH YIELD FUND SUITE

DPAM's high yield experts, who currently manage close to EUR 1.5 billion in assets, steer two EUR high yield funds with distinct risk profiles:

Petercam L Bonds EUR High Yield Short Term is more **defensive** in nature and has returned an annualized 5.68% with a maximum drawdown of only 2.25% since launch*.

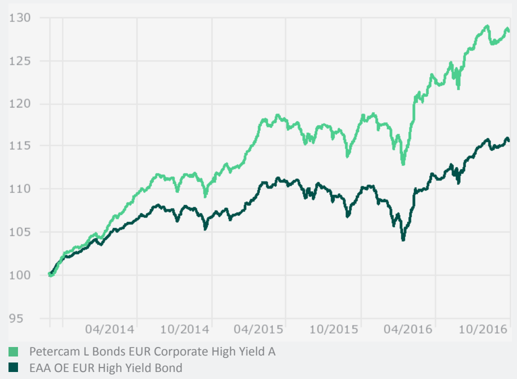
Of note, short-term high yield bonds can be particularly **attractive to insurers given their SCR ratio** versus conventional bonds (see chart).

Petercam L Bonds EUR Corporate High Yield, which is **actively managed against a benchmark**, has outperformed its index by 2.04% per year since launch** (see chart).

Both DPAM funds have consistently **met their stated objectives** (see table next page) since launch. The fact that risk avoidance is the bedrock of the managers' disciplined investment process has been highly instrumental to this result. **Neither fund has had to face a default since launch.**

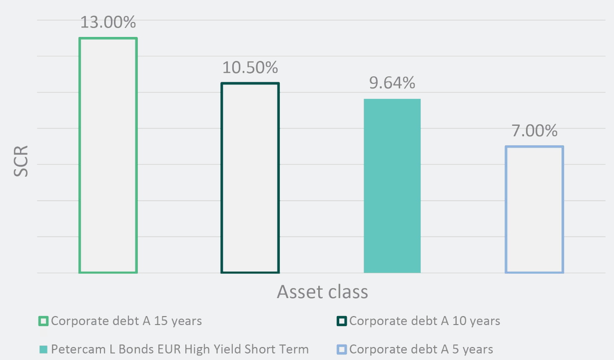
*Data as of 30/9/2016, F share class.
**Data as of 30/9/2016, A share class.

Petercam L Bonds EUR Corporate High Yield strongly outperforms its Morningstar category average



Source: MorningstarDirect, 9/2016.

Short-term high yield bonds have attractive SCR ratios versus many corporate and government bonds



Source: Vlerick and DPAM, 30/6/2016.

FUND **SUMMARY** TABLE

Petercam L Bonds EUR High Yield Short Term

DEFENSIVE

Launch date	30/6/2010
Investment universe	EUR corporate bonds Max. 4-year residual maturity Worldwide issuers, especially Europe
Average holdings	40-70
Benchmark	Benchmark-agnostic
Objective	Yearly 250 bp above EONIA on 3-year rolling basis Contain volatility & avoid downside risk
Style / Focus	Active management style Conviction portfolio Focus on risk avoidance & credit quality throughout cycles

Petercam L Bonds EUR Corporate High Yield

DYNAMIC

Launch date	23/9/2013
Investment universe	EUR corporate bonds All maturities Worldwide issuers, especially Europe Financials are excluded Distressed-rated bonds are excluded Max. 10% out of benchmark
Average holdings	60-90
Benchmark	Barclays Euro High Yield 3%-Capped, Ex-Financials, Index
Objective	Outperform the benchmark by 75 bp on 3-year rolling basis Ex-ante tracking-error of 2.5% 1st quartile ranking vs. peers on 3-year basis
Style / Focus	Active management style Conviction portfolio Focus on value & credit quality throughout cycles

Funds.degroofpetercam.com