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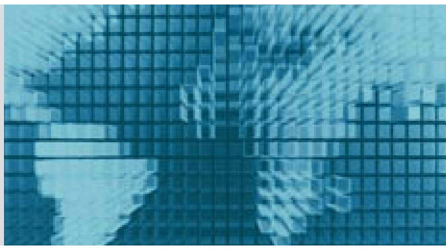

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Managing global sovereign bonds with a Smart lens

Scorecard for unique Enhanced Beta investment strategy

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Key Takeaways:

- The Ostrum AM's enhanced beta strategy, which combines systematic portfolio construction and active views to a customized index, has exhibited strong results since its launch two and a half years ago[1].
- The customized index offers an alternative to standard benchmarks and better reflects the global economy by being based on GDP data and by a stronger representation of emerging markets.
- The strategy fits either as a core investment for global treasuries investors or as a global sovereign bucket in a global aggregate core exposure.
- Success of strategy should lead to its application to other asset classes, starting with the global corporate universe and a sustainable carbon footprint bond solution, by looking at the carbon footprint of issuers.

Back in 2015, THE HUB showcased a unique investment proposition for sovereign bond investors. The proposed strategy was aimed at investors chasing for more yield, while staying in the global sovereign bond spectrum.

The strategy, which has now been live for 2.5 years, combines a smart beta benchmark, with systematic portfolio construction and active insights. This two-step approach is designed to outperform standard issue size-weighted bond benchmarks. But has it? And can it evolve further to further improve its risk-return characteristics?

A strategy in two parts

Let's start with a recap on the strategy and how it works.

First, the strategy invests in global sovereign bonds, and is benchmarked against a customized smart reference index. Based on Gross Domestic Product (GDP), this "smart index" uses a blend of indices in local currency in order to develop a GDP by PPP (purchasing power parity) - weighted global government index more representative of the global economy. The weights are yearly reviewed based on October IMF data.

This smart index has a higher exposure to emerging markets than a traditional index and inversely decreases the exposure to countries that exhibit less growth.

The smart index is therefore believed to be more yielded, diversified, counter-cyclical, forward-looking, and efficient. As of end of November 2017, it was composed as follows:

- 30% Bloomberg Barclays US Treasury Index (USD)

1 Source: Ostrum AM – Data as of 29.12.2017. Figures mentioned refer to previous years. Past performance does not guarantee future results.

- 20% Bloomberg Barclays Euro Treasury (EUR)
- 5% Bloomberg Barclays Asia Pacific JP TSY (USD unhedged)
- 5% Bloomberg Barclays Sterling Gilt (GBP)
- 40% Bloomberg Barclays EM Local Currency Government / 10% country-capped (local currencies).

Moreover, using a local currency only universe provides by construction less risk than a traditional index. Indeed, currency exposures improve diversification to the fixed income only universe and by consequence leads to lower volatility.

Second, the strategy involves a proprietary optimisation approach. It seeks to optimize performance, using carry as the main driver, within both an absolute and relative risk considerations and investment team's views limit. The investment management team assumes that carry is the main performance driver for long term fixed income index returns. The yield to maturity is a relevant estimate of the future carry (income return). Portfolio construction using systematic selection aims at maximizing expected return and minimising absolute and relative risk in the portfolio while respecting Ostrum AM's investment professionals' views in terms of market changes.

It is also during this stage that the active views in terms of interest rates and country fundamentals are incorporated in the process. These seek to anticipate changes or liquidity bottlenecks in the marketplace and thereby reduce drawdown risk.

The outcome of this two-steps process is a strategy best described as "enhanced beta" (as compared to smart beta). In other words, the managers are not content with building a better index, they want to beat it too.

Drivers of performance

So, 2.5 years into the strategy, how has it fared?

Total net performance as of December 2017 since inception in July 2015 is 10.57% and the strategy outperformed the Bloomberg Barclays Global Treasury index by more than 3%, in line with expectations. The strategy also outperformed the customised smart beta index by more than 0.40%, again meeting expectations. Moreover and for the same period, the realized yearly volatility was about 6.2% for the strategy compared to 5.9% for our smart benchmark and 7% for the Bloomberg Barclays Global Treasury1.

The outperformance compared with traditional bond benchmarks has been driven by Ostrum AM's smart index construction and its hybrid and systematic investment process which includes the active views. By overlaying the systematic portfolio construction with a human tilt, the investment team has been able to reduce the high turnover that is often associated with systematic investing. This reduction in turnover has resulted in lower transaction costs without too much impact on performances. The active views also enable the managers to anticipate trends; It can be extremely valuable in bull markets. In bear markets, the active views can improve relative performance by adapting duration and currency views to mitigate downside risk.

In absolute terms, the strategy faced important market challenges in the past two and a half years ,for instance USD and Oil shocks mid-2015, Brexit and the Trump election. Despite these market events, the performance has been strong since inception.

The strategy made also the most of its exposure to emerging markets, in terms of return potential.

While this may look like fortuitous timing for the strategy, in fact there is a lot of support over the long term for emerging market debt. While projected emerging market growth is not as strong as in the past, it is still considerably higher than in developed markets. In addition, there are few signs of inflation, which is usually damaging to bond performance.

From that extent, one decisive element is an important exposure to local currency denominated debt. Liquidity in local currency debt is improving and this means the asset class is considerably less risky than many believe.

Next steps

The strategy has matched the expectations of the investment team since its launch 2.5 years ago. The managers believe the strategy meets the needs of clients looking for an alternative to a pure beta global treasury exposure. They are currently thinking to adapt it to other asset classes, the global corporate universe being a possibility. A different alternative is to create a sustainable carbon footprint bond solution, by looking at minimizing the carbon footprint of a portfolio and using an hybrid process.

Written on 26 April 2018

Source: Ostrum AM – Data as of 29.12.2017. Figures mentioned refer to previous years. Past performance does not guarantee future results.

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Share capital €27 772 359
Regulated by the Autorité des Marchés Financiers
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