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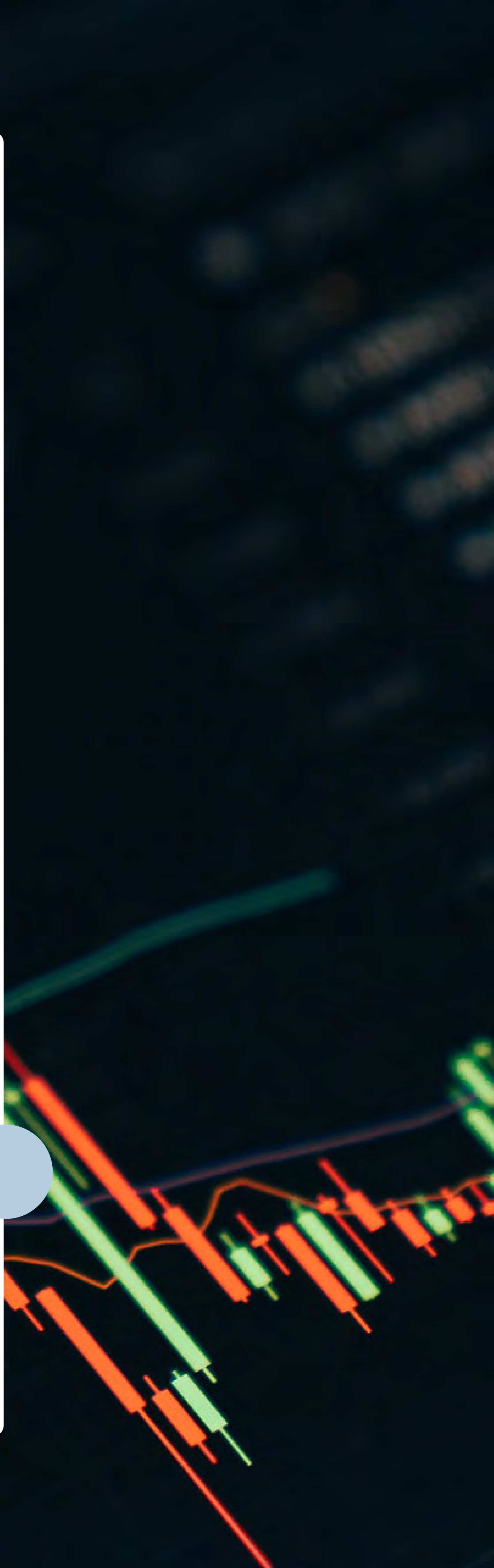
Falling bonds, falling equities: Need for uncorrelated returns?



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Marketing communication

About the authors.

Nicolas Jullien, CFA

Head of High Yield & Credit Arbitrage

Nicolas Jullien has been Head of High Yield & Credit Arbitrage and Deputy Global Head of Credit since 2019, and Deputy Head since 2017. Since joining Candriam in 2007, he has been a Fund Manager and a Senior Fund Manager.

Nicolas holds a Masters in Financial Sciences and Insurance from the University Claude Bernard Lyon I, in France. He has been a CFA Charterholder since 2012.

Charudatta Shende

Head of Client Portfolio Management – Fixed Income

Head of Fixed Income Client Portfolio management since 2018, Charu joined Candriam as a Senior Client Portfolio Manager in 2016. Charu is responsible for communicating Bond Market and Fund strategies across the entire range of fixed income strategies, with particular background in the Credit and Emerging Markets debt segments. Previously, he was a Product Specialist for Fixed Income at Carmignac Gestion. He began his career as a Product Research Analyst and RFP writer in the Fixed Income segment of Pioneer Investments.

Charu holds double majors in Finance and Economics from the American Business School of Paris.

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A strategy for a new time – or for any time.

A paradigm shift is underway, we believe. Since the beginning of 2021, a new stance has been clearly communicated and adopted by policymakers.

Today's higher rates and lower liquidity support from central banks follow a lengthy period of accommodation, easy conditions which persisted for more than twelve years. For credit issuers, this is a significant change, depriving them of a key source of support.

Further, companies are confronting structural shifts which are increasingly forcing issuers to alter their business models to face the new trends. In such a context, **credit markets are, and set to remain, increasingly volatile. Specific or idiosyncratic risk is moving to the fore.**

In the midst of difficulty … lies opportunity

Credit investors need to focus on the ability of issuers to meet their financial obligations, rather than to simply surf on central bank driven liquidity waves. Balance sheet and credit metric analysis are gaining importance while the strengths of business profiles will increasingly drive creditworthiness of issuers. In short, fundamental-bottom-up analysis will be essential going forward.

Decorrelated investments is beneficial to fixed income allocations in any market, and are a particularly welcome addition in the current context. This may offer not only the potential for positive returns, but also the potential to control risk in the portfolio, though it requires an extremely flexible and active approach.

Our solution: Candriam Bonds Credit Alpha.

The Candriam Bonds Credit Alpha Fund[1] is a pure long/short credit process with no bias. The investment process employs a high-conviction, selective approach with flexible and active management with the aim to deliver uncorrelated performance across all market conditions.

Candriam Bonds Credit Alpha uses active and discretionary management to generate an **absolute performance superior to the €STR (capitalized) index with an ex-ante volatility target of less than 10%** under normal market conditions. Volatility could nevertheless be higher, especially under abnormal market conditions.

The strategy, launched in February 2021, invests mainly in corporate bond securities[2] in developed countries with ratings greater than or equal to CCC / Caa2.[3]

The strategy relies on the disciplined portfolio construction that **combines two main sources of alpha a fundamental long/short and a quantitative long/short, with a tactical overlay. The Fundamental long/short bucket relies on bottom-up issue and issuer selection based on rigorous in-house research. The Quantitative Long/Short Bucket relies on proprietary tools as well as qualitative analysis to benefit from dislocations between bonds and credit default swaps, bonds in denominated in different currencies and across credit curves. The Tactical overlay enables the team** to calibrate the overall credit exposure, mitigate volatility and manage correlations with credit markets.

Investment approach.

As an actively-managed and high-conviction investment process, Credit Alpha focuses on the fundamentals of issuers, dislocations amidst instruments and uses tactical overlays to manage market exposure, duration, and other factors. Portfolio managers follow the credit quality of issuers over time to identify changes and new investment ideas, to gauge the impact of new information, and to determine optimal entry points.

The 20-strong credit analyst team, which supports the fund, boasts of significant industry experience. The portfolio team incorporates quantitative tools to constantly monitor credit market valuations across sectors, ratings, regions, and instruments. The long/short credit investment managers filter these fundamental results, resulting in 30 to 50[4] high-conviction positions.

A four-step thorough investment process

The investment teams establish a macro-economic scenario, identify opportunities as well as macro risks, top-down preferences in terms of sector, region, and rating through detailed assessments of economic, sector, and industry conditions. They leverage on their market expertise as well as the interaction with other teams within Candriam such as our economists, fixed income strategists, ESG analysts and long/short equity teams.

A preliminary filter excludes credits for exposure to controversial activities, with additional issues excluded for insufficient liquidity.

Portfolio construction is a function of valuation, technical factors and market timing. Positions are monitored in real time. As with purchases, the strict sell discipline is also conviction-based.

The fund includes of two buckets, fundamental long/short and quantitative long/short. The Fundamental bucket reflects the team's highest convictions on individual credits, expressed through long and short positions. This bucket can exhibit long, short or market neutral bias, adjusted with overlays. The Quantitative bucket is purely market neutral relative value trades such as cross-currencies, credit basis and curve trades. These utilize proprietary quant tools to monitor markets and identify dislocations. The allocation to each bucket depends on market conditions and our convictions.

Portfolio positions are meticulously calibrated to reflect the level of our convictions as well as internal limits.[5] While portfolio construction is not determined by quantitative models, we closely monitor overall ex ante volatility to cap it below 10% (ex-ante). We use Credit Default Swaps (CDS) and Total Return index Swaps to manage volatility, calibrate the overall credit exposure, and manage correlations with credit markets. The tactical overlay enables us to manage risk in the fund while emphasizing our fundamental convictions on individual issuers and issues.

Figure 1:
Portfolio construction – long/short credit

Fundamental Long Short

Strategies:
High conviction, special situation and relative value trades

Instruments:
Bonds, CDS and Treasuries

Strict Internal limits:
Net credit exposure [-50%, +50%]
Credit duration (-2, +2
Max net issuer: 5%

+

Quantitative Long Short

Strategies:
Credit basis, cross-currency basis and curve trades

Instruments:
Bonds, CDS and Treasuries

Strict Internal limits:
Net credit exposure [-50%, +50%]
Credit duration (-2, +2]
Max net issuer: 5%

Objective: Managed credit exposure to mitigate volatility and correlation with credit markets
Instruments: CDS and TRS indices
Strict Internal limits: Net Credit exposure [-100%, +100%] ; Duration [-5, +5]

TACTICAL OVERLAY

Candriam Bonds Credit Alpha

Strategy: 30-50 high conviction positions
Strict internal limits:
Net credit exposure [-100%; +100%]
Max exposure to CCC: 20%

Note: these internal limits are indicative and may change over time. They are not regulatory, but are part of our internal process, intended to help us remain within regulatory and prospectus limits.
Source: Candriam

Performance.

Since its inception on 5 February 2021, the fund has delivered an absolute performance of +3.11% (I-Share Eur ND), comfortably outperforming the €STER (capitalized) index return of-0.32% (both through 30 September 2022). It is noteworthy that while this history has been short, the performance was achieved during highly-stressed credit markets. During this period, credit markets posted a decline of -16.64% on investment grade (BofA Global IG) and a decline of -15.74% on high yield (BofA Global HY). Of course, past returns are not an indication of future performance.

The fund has also posted low levels of volatility since inception. Actual volatility of 2% since inception has been well below the 10% ex ante constraint.

> **"The fund leverages upon the expertise of the high yield team at Candriam, while also relying on our flexible absolute return bond strategies. It aims to provide diversification and uncorrelated returns in volatile markets.**
>
> **– Nicolas Jullien**
> **Head of High Yield & Credit Arbitrage**

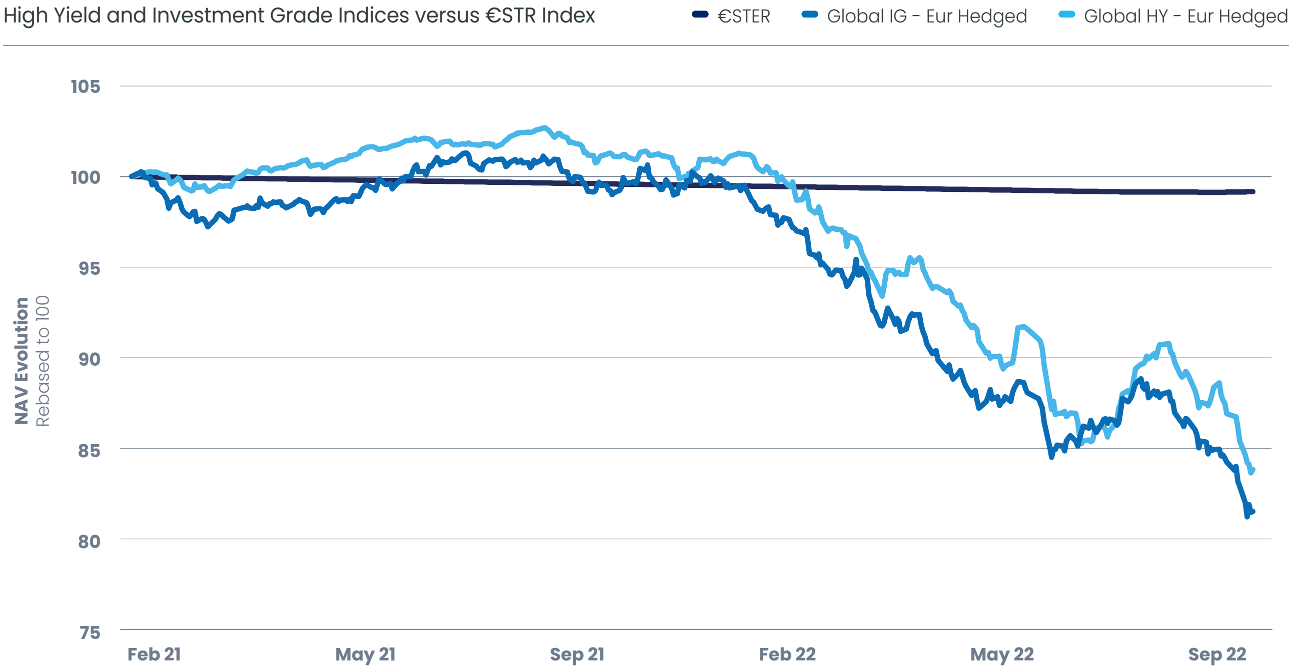
Figure 2:

Candriam Bonds Credit Alpha versus €STR Index

Source: Candriam, Bloomberg. Rebased to 5 Feb 2021 = 100.

Figure 3:

High Yield and Investment Grade Indices versus €STR Index



Source: Candriam, Bloomberg. High Yield represented by BofA Global HY, and Investment Grade represented by BofA global IG. Rebased to 5 Feb 2021 = 100.

Risks.

The risk level shown reflects the fund's historical volatility, completed where applicable by that of its reference framework. The volatility indicates the extent to which the value of the fund may fluctuate upwards or downwards. The historical data may not be a reliable indication for the future. The indicated category may vary over time.

The lowest category does not mean "risk-free". There is no guarantee or mechanism to protect the capital.

In order to fully understand the fund's risk, investors are recommended to carefully read the official prospectus which describes the fund and its risks in more detail.

1	2	3	4	5	**6**	7

Lower risk — **Higher risk**

Potentially lower return — Potentially higher return

The main Risks associated with the investment in the Candriam Bonds Credit Alpha fund are :

- **Risk of capital loss**
- **Interest rate risk**
- **Derivative risk**
- **Arbitrage risk**
- **Credit risk**
- **Liquidity risk**
- **Counterparty risk**
- **Currency risk**
- **Risk on Contingent Convertibles**
- **Volatility risk**
- **Emerging market risk**
- **External factors risk**

All or some of the fund share classes are authorized in the following countries:

AT CH DE ES

FR IT LU

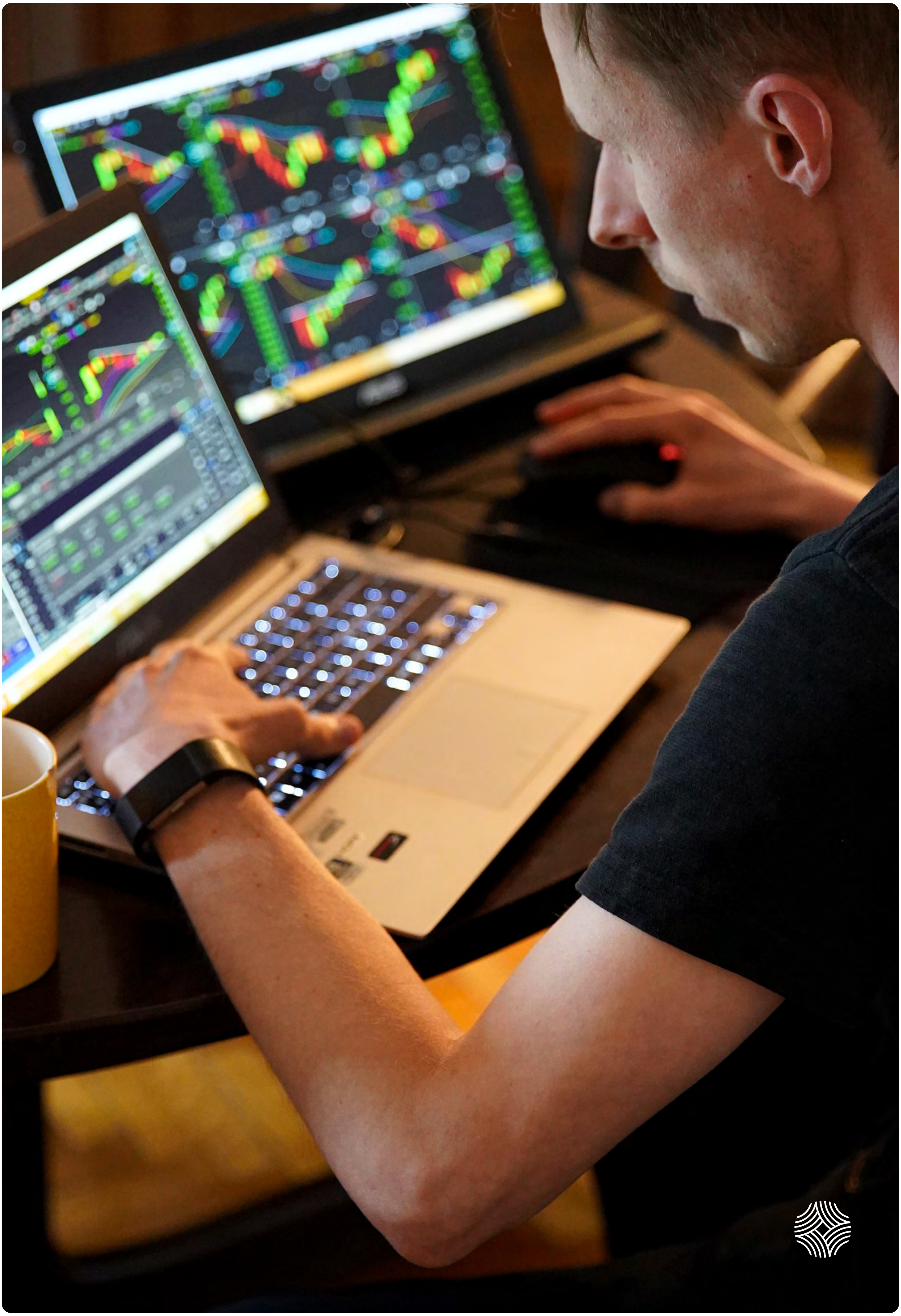
Fund Characteristics

Candriam Bonds Credit Alpha - October 2022

Launch date: February 1, 2021	**Frequency of valuation:** Daily
Management fee (max.)*: 0.70%	**ISIN Code (I - Cap):** LU2098772523
Subscription fees (max.)*: 0%	**Domicile:** Luxembourg
Redemption fees (max.)*: 0%	**Management company:** Candriam
Performance fees (max.)*: 20%	**Legal form:** UCITS - SICAV
Fund AUM: 108 million	**Depositary bank:** CACEIS Bank, Luxembourg Branch
Fund currency: EUR	**Benchmark:** Capitalised €STR (Euro Short Term Rate)
SFDR classification: Article 6	**Recommended investment horizon:** 5 years

* Real fees indicated in the KIID or annual report

The fund is actively managed, and the investment process implies referring to a benchmark index, the Capitalised €STR (Euro Short Term Rate)



A strategy for any future?

Paradigm shift? Central banks have adopted a clear change in stance since the beginning of 2021. Persistently elevated levels of inflation have been recognized as such by policy makers, and fighting inflation through tighter monetary policy has become a priority for most central banks across the globe.

Not just tighter – markets have become comfortable during the long period of accommodation. The fact that this tightening follows more 12 years of lower liquidity support and rising rates are a context which bond investors have not faced for a very long time. Ultra-hawkish monetary stance now openly seeks to combat inflation through demand destruction for "as long as it takes" – potentially leading to sharp economic slowdown -- has already generated to significant volatility spikes, which show no signs of abating.

Structural trends – geopolitics, populism, and deglobalization. Certain structural trends both add to the complexity, and are likely to have a considerable impact on rates. Geopolitical risk can be expected to be a strong driver of current and future volatility. With the conflict in Russia is still showing no signs of resolution, the impact on inflation, especially through energy prices, is likely to last for some time. The rise in populism and deglobalization are also likely to cause spikes in inflation and turbulent markets.

Rethinking of corporate business models alters issuer fundamentals. The decarbonization trend accelerated during Covid, as regulation and environmental guidelines were reinforced. Digitalization, automatization, artificial intelligence, and deglobalization are strong influence on business activities. These trends are pushing companies and issuers to rethink their business models and structurally alter their day-to-day activities. This not only concerns issuers but also loops back to create a material impact on inflation and growth, once again being a source of disruption in markets.

Changing risk profiles, in an asset class with an asymmetric return distribution. These trends are not only sources of disruption, but also a lead to dislocations and investment opportunities as idiosyncratic risk rises. This, combined with dearth of central bank support, will continue to lead to increase in volatility. We believe this creates a strong argument for active investment management, and rewards research and conviction. It also creates nearer-term opportunities through pricing and valuation inefficiencies amongst issues and instruments. Indeed, shorter term trades that exploit dislocations between currencies or maturities of same issuers, or even differentials between cash bonds and CDS can be potential sources of alpha and contribute to de-corelated return across market conditions.

We believe the Candriam Bonds Credit Alpha strategy can offer both decorrelation and absolute return potential across all markets, and is particularly well-suited to the tough current context. The strategy operates across a **wide investment universe** of both investment grade and high yield, offering **diversification** and potentially avoiding specific biases. The long/short buckets enhance the potential to deliver returns that are **uncorrelated** with the credit market, while the tactical overlay enables the managers to **limit volatility and manage drawdowns flexibly.**

Notes & References.

1 The fund is managed actively and the investment approach implies a reference to a benchmark (€STR Capitalized).

2 Including up to 40% of net assets in corporate subordinated debt.

3 Ratings by one of the recognized rating agencies greater than or equal to CCC / Caa2 (or equivalent), or analysed to be of equivalent quality by the management company.

4 Indicative data, may change over time.

5 We set internal limits, which may change over time, in order to remain within regulatory and/or prospectus limits.

€143 B

AUM as of
30 June 2022

600

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committed professionals

25 years

Leading the way in
sustainable investing

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