A FLEXIBLE AND OPPORTUNISTIC APPROACH TO INVESTING IN EMERGING COUNTRY DEBT

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Jean-Jacques Durand

FUND MANAGER,
EMERGING COUNTRY DEBT
AND CURRENCIES

Long considered an asset class reserved to specialists, emerging country debt has seen strong growth in assets under management in recent years. And yet portfolios are still underweight.

Jean-Jacques Durand, fund manager Emerging Country Debt and Currencies, discusses the attraction of the investment universe and his high-conviction approach.

WHAT ROLE CAN EMERGING COUNTRY DEBT PLAY IN ASSET ALLOCATION CHOICES?

For a number of months, European investors have had to contend with low, and even negative, sovereign debt yields but one bond segment, emerging country debt, has performed particularly well.

Emerging country debt is an asset class in its own right. It offers potentially attractive yields, both in relative and absolute terms, and is also a good way to diversify a portfolio.
Even if the segment only represents 12% of the global debt market, it has depth and is highly diversified. Emerging country debt can be denominated in hard or local currencies and fall under sovereign, quasi-sovereign or corporate debt, but in all cases it can offer varied investment opportunities for long term investors.

Growth in the number of issuers and investors has led the market to become more diversified in recent years. But although 2016 has seen a significant recovery in inflows, the bond portfolios of large international investors are still underweight emerging country debt. The asset class is underpinned by long term trends.
Emerging country fundamentals are now much healthier than in the past: for example, foreign currency reserves are robust and debt-to-GDP ratios generally under control.

Demographic growth, the rise of a middle class and healthy and steadily increasing foreign exchange reserves are also key support factors for the future. There are, of course, strong disparities between zones and countries and a certain number of risk factors that need to be managed so a selective approach is absolutely essential.

As well as the attractions of the asset class *per se*, we also believe that our investment approach creates value.

WHAT IS YOUR INVESTMENT PHILOSOPHY?

We take a flexible, opportunistic approach. The fund has a broad investment universe and can diversify its sources of performance by investing in hard or local currency debt, in currencies alone and in sovereign, quasi-sovereign and corporate bonds. However, the fund is structured to invest primarily in hard currency sovereign or quasi-sovereign debt as this segment offers a very wide variety of investment vehicles.

> **International investors** are still **largely underweight emerging country debt**

One of the strong points of Edmond de Rothschild Fund Emerging Bonds is its capacity to move significantly away from major emerging country debt indices and take strong bets based on sometimes contrarian investment cases.
Benchmarked investing does not suit emerging country bonds due to index bias.

We feel that it is important to assert strong long-term convictions. Each year, performance on this market depends on identifying specific investment cases.

That is why our portfolio is concentrated. For example, our biggest holding, Venezuela, represents close to 21% of the fund although its index weighting is nearer 5%[1].
We seek to create value over a 3-year horizon.
To achieve this target, we also realise that the portfolio's structure and its strong allocation choices may entail periods when the fund may underperform the market.

And one of the criteria that sets us apart from the competition is that we do not restrict our analysis to country fundamentals but also factor in technical factors like investment flows or investor risk appetites.

WHAT ARE YOU TOP BOND PICKS TODAY?

Our biggest position is **Venezuela**. At times, it has been a choppy ride but we have stuck with it as we truly believed in the investment case. In our view, these bonds still have upside and continue to enjoy a highly asymmetrical risk/return profile.

And at the political level, the country has already started its transition after more than 15 years of Chavism.
The opposition won the recent parliamentary elections and took control of congress. And the army seems to be taking a pragmatic attitude by supporting the will of the people.

Venezuela has the world's biggest oil reserves.
Our investment conviction is based on the fact that the Venezuelan government has always been keen to maintain debt service payments and avoid any conflicts with its international creditors so as to safeguard its oil industry.
More than 95% of its domestic economy relies on the oil business. The country has only moderate debt levels and has the means to service its debt over the long term.
Its bonds are currently trading below potential default recovery rates.
We are maintaining our positive stance on this position.

Ukraine is also one of our strong convictions. The country enjoys strong support from the West as well as from the IMF.
A new government has been in place for several months.
The resulting political stability and a gradual recovery in the economy augur well for the coming months.

In South America, **Brazil** is also one of our strong convictions even though, as with Argentina, we have trimmed our exposure.

Turkey is another big position. It benefits from a number of favourable macroeconomic factors, notably 3% growth[1]. It has a highly diversified economy, its debt to GDP is low and its budget is under tight control. Its sovereign debt is generally trading at attractive levels. There are admittedly geopolitical concerns but we consider that the geopolitical premium is currently excessive.

Venezuela, Ukraine and Turkey are among our top-conviction picks

We are however, fully aware of risks on this market and have in recent weeks increased our cash position and bought hedges while maintaining exposure to our strong-conviction holdings. That helped us limit drawdown after Donald Trump's election. We will be maintaining this defensive stance in coming weeks but our upbeat view on emerging debt over the medium to long term is still intact. We are currently well placed to seize opportunities should markets fall again. This sort of phase is often the best time to make particularly interesting investments.

WHAT IS YOUR VIEW ON CHINA?

Since 2014, we have been particularly attentive to Chinese risk as we thought it was being underestimated by markets. The portfolio has since been hedged against credit bubble risk. China still represents a major macroeconomic risk. In spite of recent encouraging news on the economy, the country is beset with a large number of imbalances.
Its debt is running at around 250% of GDP, its official non performing loan ratio is a far cry from reality and its property market is overheating. These are all in our view genuinely worrying factors.
Given these risks, we have maintained our hedges. Their asymmetrical profile (significant upside with limited downside potential overall) is a strong advantage.

HOW HAS YOUR INVESTMENT APPROACH PERFORMED?

For 2016, the fund has so far returned 19.2%. This is a particularly convincing performance compared to developed country sovereign bond returns and disappointing, volatile performance from equities. Over 5 years, the fund has returned an annualised 12.5% compared to 4.6% for its benchmark the JPM EMBI Global Hedged index, or more than 55%[2] in cumulative outperformance.
The fund is rated 5 stars by Morningstar[3] and has also recently won several international awards, a token of the added value our investment approach has created over the long term.

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1. Data at 31/10/2016. Source: Bloomberg.

2. **Past performance is not a reliable indication of future returns and is not constant over time.** Data at 24/11/2016. Cumulative 5-year returns for the fund's A share (€): +80.58% vs. +25.48% for the JPM EMBI Global Hedged index.

3. Morningstar ratings at 31/10/2016 in the category Emerging country bonds EUR Hedge. Morningstar ratings are not market ratings and cannot be interpreted as recommendations to buy, sell or hold units or shares in mutual funds managed by Edmond de Rothschild Asset Management (France). **Any reference herein to a ranking or award given to this fund is not an indication of future performance by these funds or the fund manager**. © Morningstar TM.

EDR EMERGING BONDS : KEY POINTS

- A booming asset class with a more attractive risk/return profile than some developed country sovereign bonds
- A diversification tool offering overall exposure to emerging country debt
- An opportunistic investment style which blends several sources of performance
- Emerging markets might prove more volatile and less liquid than developed country markets

SUBFUND INFORMATION*

Inception date: 29/04/1998 as a French-regulated fund which was then transformed into a Luxembourg-regulated SICAV in February 2016

ISIN Codes:
A share: LU1160351208 / I share: LU1160352354

Maximum management charges
A share: 1% net/I share: 0.45% net

Variable management charges: 10% of annual performance in excess of the benchmark

Minimum initial subscription:
A share: 1 share/I Share: 500 000 €

Front load charge: Maximum 3 %

Redemption charges: None

Benchmark: JPM EMBI Global Index EUR hedged

Recommended investment horizon > 3 years

* Shares described herein are the main euro-denominated shares. The subfund also has shares in USD, GBP and CHF. Please ask your sales contact for any further information.

Edmond de Rothschild Fund Emerging Bonds is a sub fund of the Luxembourg regulated SICAV which is approved by the CSSF and approved for marketing in France, Luxembourg, Spain, Austria, Switzerland, Germany, Finland, United-Kingdom, Italy, Netherland and Taïwan.

MAIN POTENTIAL INVESTMENT RISKS

The subfund is classified in category 5 (A EUR & I EUR shares) in line with the nature of securities and geographical zones in the "objectives and investment policy" section of the key investor information document (KIID).

Risk of capital loss: The subfund is not guaranteed, nor does it offer capital protection. There is some risk that the capital initially invested in the subfund will not be fully recovered. Shareholders are hereby notified that the investment objective is provided for information purposes only. Under no circumstances can it be considered as a performance obligation for the asset management company.

Discretionary management risk: Discretionary portfolio management is based on the anticipation of trends in different markets. There is some risk that the subfund may not be invested at all times in the most lucrative markets or financial instruments.

Interest rate risk: Interest rate risk is the risk linked to a rise in yields on the bond markets, which causes bond prices to fall and thus leads to a decrease in the subfund's net asset value. A rise in yields can adversely impact performance over an undefined period; similarly, in the event of negative interest rate sensitivity, a decrease in yields can adversely impact performance over an undefined period, causing the subfund's net asset value to decline as a result.The subfund's interest rate sensitivity may fluctuate within a range of 0 to 15.Interest rate risk may cause the subfund's net asset value to decline.

Credit risk: In the event of a credit event (e.g. significant widening of the spread between a given issuer and a government bond with the same maturity), or the default or downgrading of a bond issuer (e.g. downgraded credit rating), the value of the debt securities in which the subfund is invested may decrease and, in turn, cause the subfund's net asset value to decline. The use of High Yield bonds, within the limit of 100% of the subfund's net assets, may increase the risk of a decrease in NAV, as these securities generate increased default risk. This fund should be considered as speculative and is specifically designed for investors aware of the inherent risks of investing in securities issued by companies with low or non-existent ratings.

Equity risk: The fund will not invest either directly or indirectly in equities. However, through its exposure to convertible bonds (maximum 10% of assets), and in exceptional cases resulting from the restructuring of debts already held in the portfolio, the subfund will be indirectly exposed to the equity markets. For hedging purposes, the subfund may take positions in equity index futures.

Foreign exchange risk: The subfund may invest directly in currencies either for exposure or hedging purposes. Foreign exchange risk can impact up to 100% of the subfund's net assets.

Risks linked to investing in emerging markets: The subfund may be exposed to some securities incurring a higher degree of risk than that usually associated with investments on the main financial markets, due in large part to local political and/or regulatory factors. The legal framework of some countries in which the underlying UCITS and investment subfunds might invest may not offer investors the same guarantees in terms of protection or information as those usually offered by the main financial markets. The securities issued on some emerging markets may be significantly less liquid and more volatile than those issued on more mature markets. In this respect, the liquidity of emerging country securities is more restricted than developed country securities; as a result, holding such securities may increase the portfolio's level of risk. Market declines can be more sudden and more pronounced than in developed countries, potentially causing the subfund's NAV to fall faster and more significantly.

Risk associated with financial contract commitments and counterparty risk: The subfund is exposed to risks inherent to derivative products. Risks inherent to the use of futures, options and swaps include, but are not limited to: downward and upward fluctuations in the prices of options, warrants, swaps and futures, due to changes in the prices of their underlying instruments; gaps between the prices of derivatives and the value of their underlying instruments; the occasionally limited liquidity of such instruments on the secondary market.
Entering into derivative contracts on the OTC market exposes the subfund to potential counterparty risk. In the event the counterparty to a derivative defaults, the subfund is liable to incur a financial loss. Use of derivative products may therefore generate risks of specific losses for the subfund, which it would not have been exposed to if such strategies were not implemented.

Risk linked to hybrid products (convertible bonds): As convertible bonds can be converted into shares, they introduce equity risk into bond portfolios. They also expose the portfolio to equity market volatility, which is stronger than bond market volatility. Holding such instruments therefore increases the portfolio's level of risk, which can be mitigated – depending on the market scenario – by the convertible's bond component. The subfund's total exposure to convertible bonds will be limited to 10% of assets.

GLOBAL DISTRIBUTOR
EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)
47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08
Société anonyme governed by an executive board
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AMF Registration No. GP 04000015 - 332.652.536 R.C.S. Paris

MANAGEMENT COMPANY
EDMOND DE ROTHSCHILD ASSET MANAGEMENT (LUXEMBOURG)
16, Boulevard Emmanuel Servais, L – 2535 Luxembourg

SUB INVESTMENT MANAGER
EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)
47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE) SUCURSAL EN ESPAÑA
Paseo de la Castellana 55 – 28046 Madrid – Spain
T + 34 91 789 32 21
info@lcfr.es

www.edmond-de-rothschild.com