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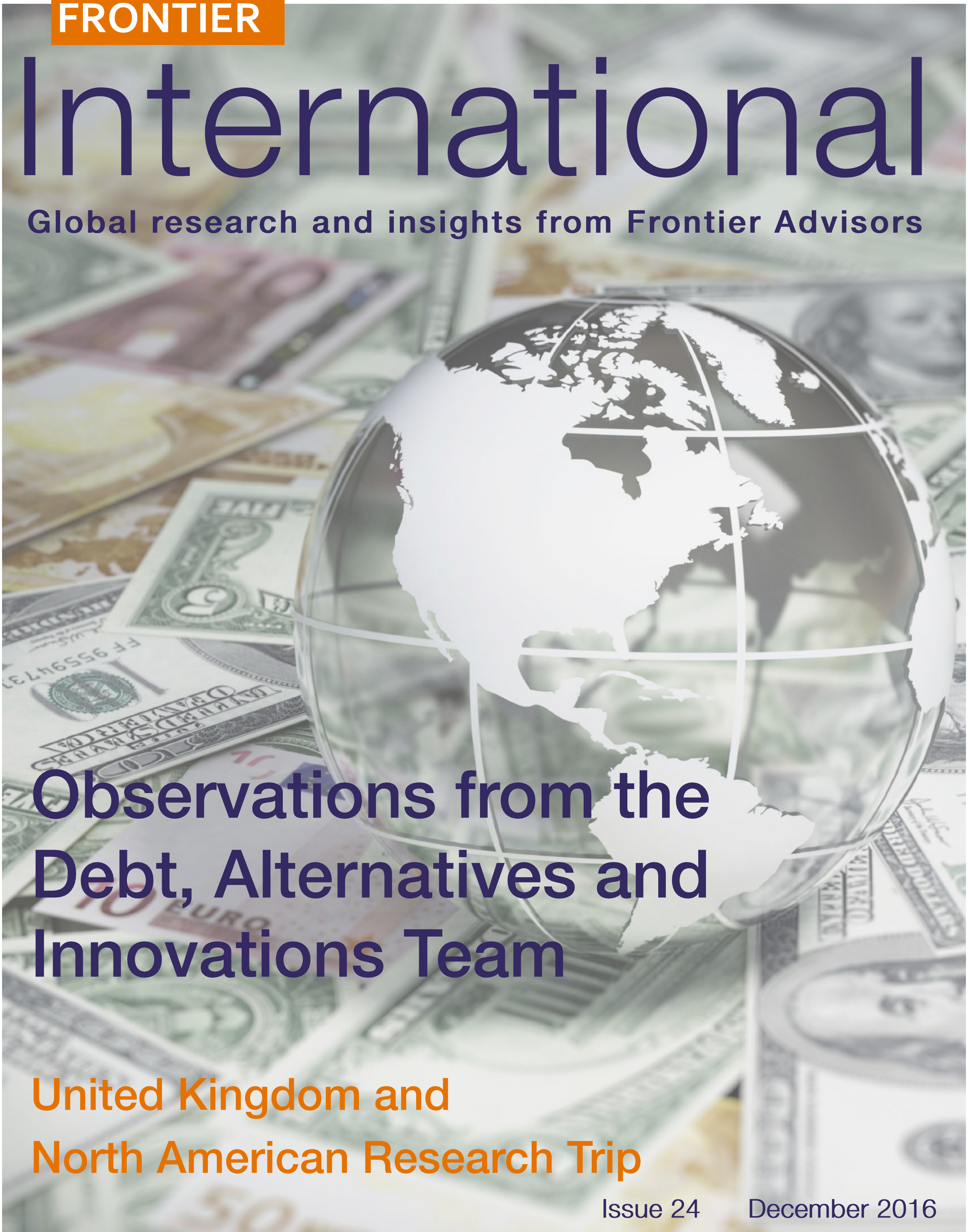

Observations from the Debt, Alternatives and Innovations Team

United Kingdom and North American Research Trip

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Members of the Debt Alternatives and Innovation (DAIT) team travelled to the United Kingdom and United States researching current and prospective managers across debt, currency, absolute return strategies and private equity. Within debt and currency, our team covered a range of strategies within total return, emerging markets and currency overlay. Within absolute return strategies, the team met with managers in multi-asset and liquid diversified strategies, trend following strategies, insurance linked securities and tail risk hedging. The trip spanned an interesting time in global financial markets leading into the US presidential election as well as after Trump's victory which saw markets adjust to a new regime.

A focus of this trip was to examine in more detail the emerging market debt landscape (including currencies) and, considering strong 2016 performance, to better understand the managers' strategies. This trip note also examines how managers prepared in the lead up to, and post the US election, as well as reviewing fixed income ESG developments.

Kim Bowater

Kim is a Director at Frontier and has held a number of roles including managing Frontier's research program, leading research teams including alternatives, currency and infrastructure, and founding Frontier's retirement solutions group.

Kim is currently the lead consultant for a large industry superannuation fund client, a member of Frontier's Investment Committee and a senior contributor to the Debt, Alternatives and Innovation research team

Prior to Frontier, Kim was employed at Deloitte Touche Tohmatsu and Towers Perrin. Kim is a Chartered Financial Associate (CFA) and holds a Bachelor of Science degree with First Class Honours in Mathematical Statistics from Monash University in Melbourne. Kim is a member of the CFA Institute.

Andrew Kemp

Andrew joined Frontier in June 2016 as a Senior Consultant and is a member of the Debt, Alternatives and Innovation team leading Frontier's fixed income and currency research program.

Andrew has twenty years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK. Andrew was Head of Fixed Income at DBS Asset Management (Singapore) for three years and prior to that spent a decade as Fixed Income Portfolio Manager at Alliance Bernstein Australia. Andrew joins Frontier from Chimaera Capital, where he held roles in both Melbourne and Singapore. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.

Michael Sommers

Michael is a Senior Consultant providing risk management and consulting advice to clients, preparing client investment reports and undertaking manager and investment research with a particular focus on absolute return strategies.

Prior to Frontier, Michael worked in London for seven years in a number of trading floor based senior risk management roles at CIBC, Lloyds and HBOS. His roles involved advising on the risk and performance characteristics of diverse portfolios and investment strategies. Prior to this, Michael worked in credit risk modelling at ANZ in Melbourne. Michael holds a Bachelor of Commerce with majors in Actuarial Studies and Finance (including First Class Honours in Finance), a Bachelor of Science and a Master of Applied Finance degree from Macquarie University.

Manager responses to the US election

As discussed in a recent Market Insights paper by Frontier's Capital Markets and Asset Allocation team, the US election result sparked a large divergence across asset class returns and also between developed and emerging markets. The research trip timing was such that we could observe how managers across a variety of strategies and investment approaches considered their positioning ahead of the election, as well as under a new political regime.

Preparations ahead, and reactions after the election by managers were varied, despite a near universal acceptance of a Clinton victory in the lead up to Election Day. The DAIT team heard some optimistic outlooks for economic growth under a Trump government, coupled with heavy uncertainty around global trade and diplomacy, particularly from the US managers, to more cautious outlooks from those in the UK. Brexit was noted as somewhat of a "trial run" for the US election in terms of non-consensus outcomes, and we noted a heightened intensity around scenario testing and analysis as a result in the lead up to the election. In most cases, managers were generally incorrect on both these major events, yet performance implications were mixed and less severe than expected in many cases. Some managers discussed modest use of out of the money option strategies to help manage downside risks, yet seeing volatility was elevated around the event, prior planning was needed to execute such transactions profitably.

Below, we summarise the thoughts, investment approach and portfolio actions taken by a variety of managers across several sectors.

Benchmark aware and total return bond managers

- Chances of Federal Reserve rate hike expectations were initially revised down yet this was quickly reversed and more hikes were priced in, despite a sense that the Federal Reserve would remain "behind the curve" for some time. Expectations remain for a continuation of curve steepening led by higher long rates.
- Our impressions of market positioning during the event were mixed. Some risks had been reduced during October when yields initially began rising. Overall portfolio durations were short. Managers with a specific focus on limiting short term downside losses reduced exposed positions such as the Mexican peso (MXN).
- A few managers successfully sold bonds below 2% in US 10 year treasuries while others simply observed the selloff from the sidelines.
- Post-election discussions revolved around the Trump administration repealing parts of the Dodd Frank regulations potentially reducing "red tape" which was viewed as generally bullish for the business outlook and particularly for the financial sector, as well as the benefits from an increase in fiscal spending.

Emerging market (EM) debt managers

- Faced heavy losses in major EM currency exposures including MXN, Columbia, Argentina and South Africa. Overweight positions in Mexico were a common theme during meetings, which were mostly held through the election.
- In the minority were managers who reduced currency risks ahead of the event and were able to avoid significant drawdowns.
- Most felt that currency market had over-reacted on the downside to potential Trump trade and protectionist policies.

Credit managers

- Appeared to alter positions the least of all managers prior to the election - low liquidity and transaction costs were often cited.
- Meetings on the credit side focussed on broader sector themes and the forward outlook.
- Negative sentiment around healthcare. `
- Positive sentiment for infrastructure, energy and financials.

Liquid diversified strategies, tail risk strategies and trend followers:

- Positioning driven by models led to some short EM currency positions, especially in MXN, which have worked. Short MXN vs the Canadian dollar was discussed to avoid US dollar uncertainty.
- Bond positioning was more mixed as models were just starting to get short following the October spike in yields.
- Option strategies utilising single-sector options in the US as a relatively cheaper approach to protecting against a fall in the S&P500. Currency options for the MXN were also used.

Private equity/distressed

- An increase level of realisations occurred in 2016 in mature portfolios as direct managers sought to realise gains and reduce portfolio risk ahead of the election.
- Discussions around the political landscape and need for jobs were noted as being a message from Trump voters, but few managers felt this should alter private equity strategies. Venture capital was noted as being a provider of new jobs.
- Managers were assessing sector exposures that were likely to gain or lose under a Trump scenario with support expected for infrastructure, energy and pharmaceutical sectors, with risks to the hospital and affordable healthcare sectors.

Emerging market debt

Common themes from 2016

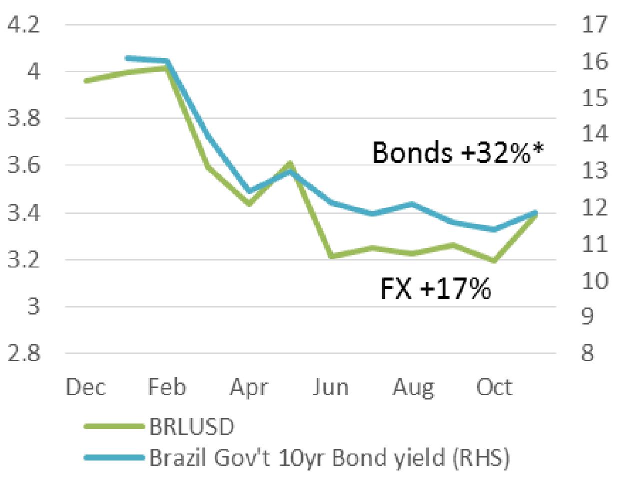
With relatively modest returns across many tradeable asset classes in 2016, the emerging market debt segment has had a standout year despite some post-election volatility.

Managers spoke of two key themes which had significant performance implications, the first being Brazil, a standout from both a currency appreciation and bond market outperformance. Manager outperformance versus benchmark in 2016 was largely influenced by portfolio positioning around the transition from still weak economic fundamentals in Brazil, to assessment of market valuations and positioning which had become extreme.
Igniting the
fuse on Brazil was speculation around the impeachment and detention of former President Rousseff, who was viewed as stifling economic reform and progress, amid personal corruption investigations.

Markets unwound short positions causing a Q1 rally in Brazilian Real (BRL) of more than 10% whilst Brazilian 10 year local currency bonds rallied as yields fell from 16.5% to 11.5% p.a.

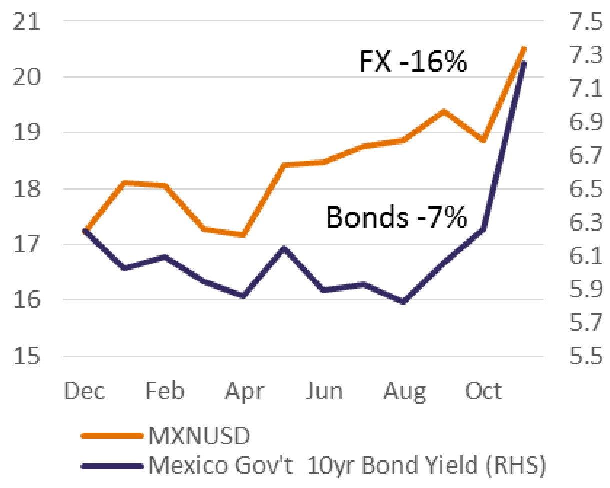
Conversely, overweight Mexican exposure appeared to be a consensus holding across most managers in 2016, a position which has caused much underperformance. Despite this, most managers remained invested in Mexico across the US election, some noting stop loss selling on the day of the election as the market weakened, others considering it to be a high conviction position given its superior EM fundamentals.

Chart 1: 2016 Brazilian Real and 10yr yields



Source: Bloomberg, Frontier
*From 31 Jan 2016

Chart 2: 2016 Mexican Peso and 10yr yields



Source: Bloomberg, Frontier

Benchmarks fail to evolve

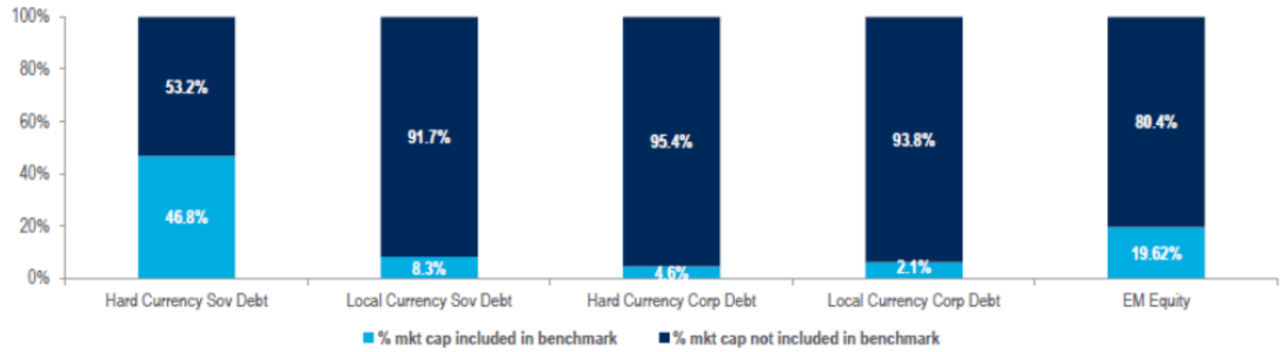
A long standing feature of emerging market debt has been the poor representation of hard and local fixed income securities in the most widely used benchmarks.

The most common benchmarks for fixed income managers have been built by investment banks who rely on the manufacturing of downstream products such as futures, swaps and options in order to make money off liquid and tradeable products. With variable levels of liquidity in some parts of the market, large portions of the market are deemed not investible for the purpose of benchmark construction.

Skilled managers are able to navigate changing liquidity conditions yet most managers we spoke with noted a gap in the market around benchmarks but felt conflicted around their ability to provide an alternative solution.

Poor benchmarking options have resulted in a large variety of emerging market products on offer to meet different investor needs and preferences. Managers visited during this research trip offer hard currency products, local currency products and blended benchmark aware products. More recently in response to poor currency market performance, total return products are offered which exhibit lower volatility yet retain some of the yield and desirable upside characteristics which investors desire from this sector.

Chart 3: EMD Benchmark coverage versus total market capitalisation



* EMD Universe assets as of December 2014 – 2015 data is not yet available.

Sources: BofA-ML Size and structure of Global Emerging Markets Debt, JP Morgan, BAML. Data as at 31-Dec-15.

Hard currency products

Australian investors concerned with currency volatility can consider sovereign and corporate debt assets denominated in USD (known as hard currency debt). This component of the market has seen heavy inflows by northern hemisphere investors in recent years yet managers have found it difficult to outperform. Managers report that underperformance has related to being short duration as US treasury yields have fallen, coupled with difficulties in assessing relative value opportunities across the various country exposures.

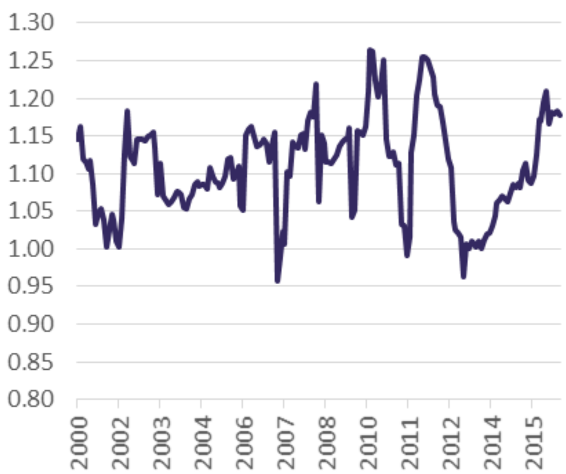
In response to the underperformance, it appears managers have cut risk levels (measured by tracking error as shown in chart 3) by a significant margin. Manager performance has also exhibited strong positive beta relative to benchmarks, and we have observed fees becoming more competitive for active benchmark aware products.

As a result this component of the market could become suitable for asset allocators looking to time entry points using macro inputs.

Chart 3: Tracking error rolling 2yr out/underperformance

Source: Evestment, Man Glg

Chart 4: Average beta relative to benchmark



Source: Evestment, Man Glg

Local currency and multi-asset products

Emerging markets have long been viewed as a complicated and risky proposition for debt investors whereas emerging market equity exposure is common across Australian portfolios.

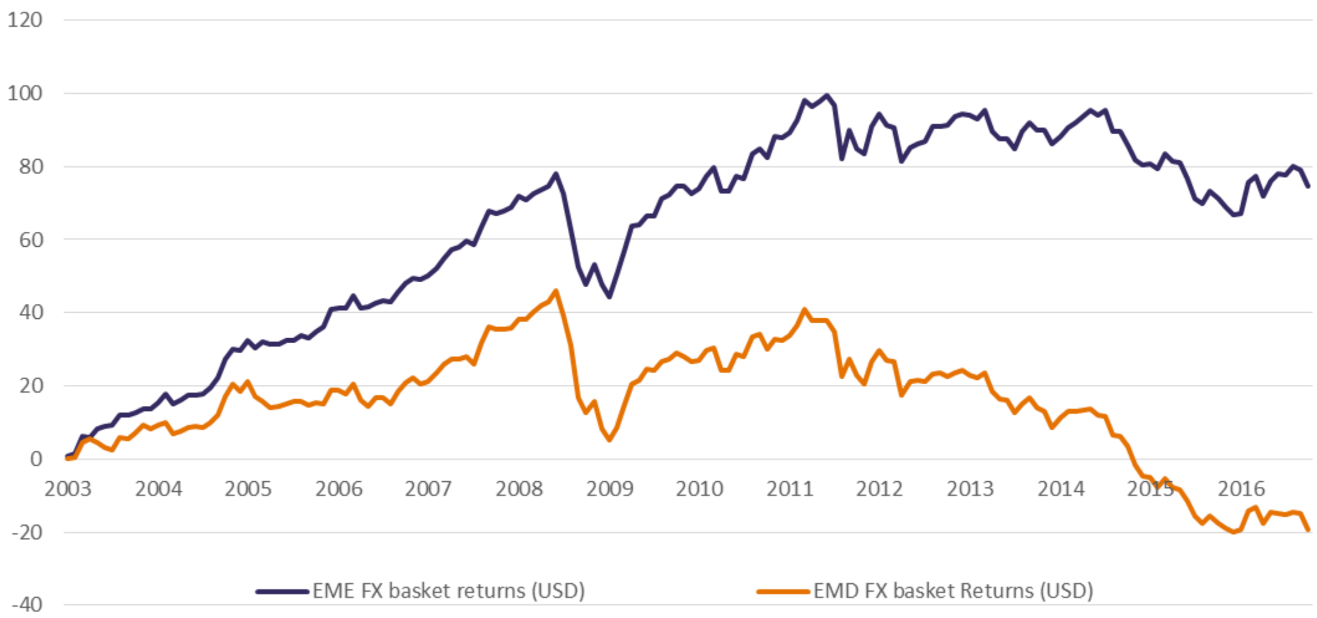
EMD total return solutions, which incorporate blended hard and local currency debt exposure, appear to have gained prominence. These products offer market beta and a combination of reasonable upside capture, dynamic currency allocation and generally more defensive positioning, which lowers volatility versus local currency benchmarks and aligns them better with broader fixed income sector objectives.

Some of the larger managers now also offer multi-asset portfolios that invest in a combination of emerging market equity and debt securities with flexible allocations governed by the manager, including off benchmark exposures. This approach offers an interesting and flexible alternative, especially from a currency standpoint given the stark compositional differences between currency exposures resulting from common equity benchmarks such as MSCI ACWI and JPM GBI for local currency debt.

Equity market currency exposure is comprised of over 70% allocation to Asian currencies which have performed well given a predominance of semi-floating or USD pegged currencies. Conversely within the local currency debt benchmarks, Asian exposure is around 25% with a much wider dispersion of currency exposure including a much higher allocation to Latin American currencies.

Managers note this divergence for two reasons. Firstly, the divergent performance of equity versus debt currency baskets in recent years highlights potential opportunities for investors, and secondly liberalisation of China's currency basket means it is less USD centric, which reduces the portfolio diversification through holding AUD/CNY positions, something that emerging market equity investors will need to understand in the future.

Chart 5 - MSCI FX basket returns versus JPM GBI local currency FX basket returns



Source: Bloomberg, Frontier

ESG

We observed some evolution in ESG considerations within the fixed income and alternative segment, off a historically low base. This evolution appears to be moving from purely screening out "sin" sectors in credit portfolios, to more investment analysis around the forward looking investment return divergence between businesses and countries which utilise ESG drivers and those who don't.

Whilst this discussion is becoming more prominent within fixed income, still some managers are unaware or not observant of ESG within their processes.

Some of the key trip findings are as follows:

- More managers reported becoming signatories to UN Principles of Responsible Investment
- Some evidence of ESG committees being formed within larger managers
- Roll out of ESG to corporate debt strategies in alignment with equity strategies
- Still limited focus on sovereign ESG considerations, particularly within emerging market managers
- Some managers willing to overlay screens by country and sector based on client requirements
- There continue to be managers who do not consider ESG at all, nor even understand the acronym!

The last word

- Emerging market debt is very different to emerging market equities in terms of currency exposure.
- USD denominated EM debt has embedded US Treasury duration risk, yet can be accessed cheaply.
- Much of the performance of the emerging market benchmarks in 2016 came from falling bond yields and higher carry rather than currency appreciation.
- Emerging market local currencies have fallen dramatically over recent years and have only just begun to find a base.
- Total return and blended investments between hard and local currencies can be useful in reducing potential emerging market volatility.
- ESG considerations are becoming more prevalent in broader fixed income investment processes

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