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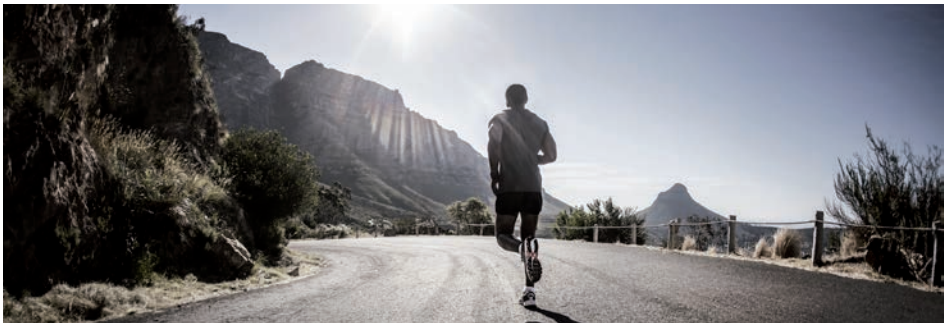
LYXOR ALTERNATIVE UCITS

EXTRACTING THE BETA AND ALPHA OF EMERGING MARKETS DEBT



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With emerging markets (EM) debt flourishing on the back of transformed economic fundamentals and greater diversity, Marathon Asset Management has designed a distinctive approach to portfolio management within the asset class.

EM debt demonstrates in 2019 its attractiveness for investors, exhibiting compelling yield in a global low rate environment and attracting strong inflows.

It comes after a testing year in 2018 for the asset class. Against a background of US interest rates hikes, a rising US dollar and tightening financial liquidity, the asset class came under pressure. The Argentinian peso and the Turkish lira plunged, leading to an IMF rescue in the former and an emergency economic program in the latter. But unlike previous EM economic crises, contagion was limited.

Contrast this with the crises of the 1990s or even 2013's "taper tantrum", only six years ago, when the mere suggestion that the Fed might slow its program of asset purchases led to a broad-based sell-off in EM. Far from 2018 being a troublesome year for EM debt, in fact it showed how mature the asset class has become. Prudent financial management and sustained economic growth have made these economies more robust, and their financial markets more diverse.

For the EM debt team at Marathon Asset Management, L.P. (Marathon), the global credit manager, this represents the perfect paradigm shift – the macroeconomic improvements are reflected in a multi-year re-rating of bond markets, while the greater number of bond issues creates scope for delivering Alpha.

Marathon takes a distinctive approach to investing in hard currency sovereign, quasi-sovereign and corporate bonds that, it believes, is perfectly suited to these markets. It aims to both replicate the Beta of the J.P. Morgan EMBI Global Diversified Index*, and to deploy an opportunistic credit selection strategy to mine Alpha.

SPEED READ

- EM debt demonstrates in 2019 its attractiveness for investors.
- EM debt has been transformed by years of improving financial management.
- Growth in the size and diversity of EM debt offers a rich environment for harvesting Alpha.
- Marathon has developed a distinctive approach to investing in these markets, both tracking the Beta of its benchmark index and seeking to add Alpha.
- While periods of global market volatility come and go, the secular themes underlying Marathon's portfolios remain the same.

*Marathon's Emerging Markets Debt strategy is benchmarked against the J.P. Morgan EMBI Global Diversified Index and is used with permission; Copyright 2019, J.P. Morgan Chase & Co. All rights reserved.

LYXOR Asset Management
SOCIETE GENERALE GROUP

This stands in stark contrast to some of the ETFs specializing in the asset class. After quickly expanding, certain ETFs are so large that even tracking the index has become difficult for them, as some of the 73 countries in the J.P. Morgan EMBI Global Diversified Index simply do not offer the liquidity they need.

"A few notable considerations make us different from our peers," explains Gaby Szpigiel, Partner & Head of EM. "When it comes to portfolio construction, we begin with the index and from there we employ a comprehensive investment process across the market. We seek to deliver the Beta of the asset class in addition to utilizing our credit expertise to achieve excess returns.

Jean Baptiste Berthon
Senior Cross-Asset Strategist

Discriminating EM backdrop. Any US-China trade truce would be vulnerable from key unresolved issues. Pressure from existing tariffs and uncertainty would still take toll on global growth, partially mitigated by Chinese stimulus. Countries most sensitive to exports and capex would underperform. In the longer run, EM economies will need to adapt a possible peak in globalization and weaker Chinese growth. The EM vs. DM economic convergence is set to continue. Yet, the ability to reform, move up in the product range, join regional integration and foster domestic demand might be key differentiator.

Conducive EM HC Debt conditions, which would still benefit from supportive liquidity conditions. Recent surge in bond supply remains met by end-demand. A maturing cycle, the trade war and Chinese growth deceleration are key risks. However, moderate inflation would allow most EM central banks to cut rates. Spreads remained broadly stable without sign of exuberance. Our models, based on economic and market differentials, call for modest EM spread tightening. The fundamental improvements for a majority of issuers, many of which now compares favorably to mid-size developed economies, would result in low default rates. The asset class offers about 5% in carry, compared to 3.4% for US corporate. Meanwhile, the weakest links open deep-value and market-timing opportunities.

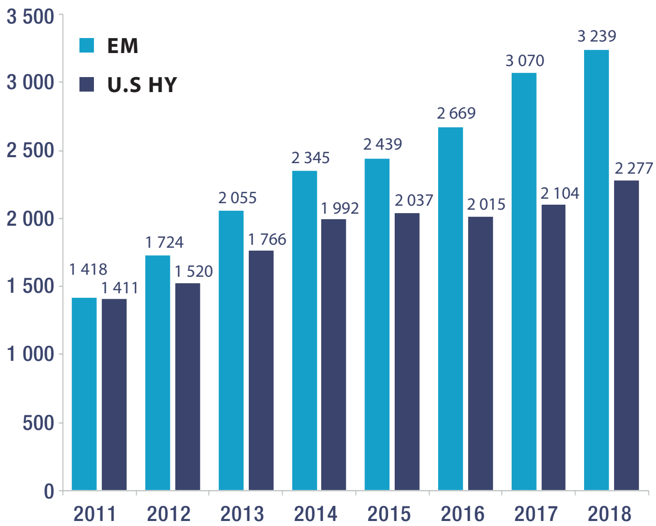
Improving alpha for EM debt managers. A more discriminating economic backdrop and idiosyncratic developments provide relative-value opportunities. In Asia, differentiation would reflect uneven monetary leeway and sensitivity to the trade war and Chinese stimulus. Economic reforms and regional trade negotiation are central in Latin America. Sanctions against Russia and the European macro pulse are key catalysts for CEE. Some frontier markets also offer more country specific returns. These disparities are showing in declining correlations and soaring dispersion across EM HC countries, ratings, and to some extent durations.

We have been managing assets in emerging markets for more than two decades and have developed a very strategic franchise as far as it pertains to the relationship with the investment community, company officials, rating agencies and sovereign debt management offices, among others. This depth of franchise greatly assists our portfolio management team in mapping out our market and credit views."

AN ESTABLISHED ASSET CLASS

Marathon has been involved in EM debt for the two decades since the New York-based credit specialist was founded in 1998, during which time EM debt has grown from under 5% to more than a quarter of the global fixed income market. Reaching USD 3.2 trillion in size at the end of 2018, the EM external debt market (Emerging Markets Debt in Hard Currency) is now bigger than the USD 2.3 trillion US high yield bond market, as shown in Figure 1. Consequently, Marathon's global team has a deep understanding of the asset class and the dynamics of the J.P. Morgan EMBI Global Diversified Index, as well as expertise in sourcing and executing across the breadth of external EM debt.

Figure 1: Growth of EM bonds in Hard Currency inventory versus U.S. High Yield ($ billion)



EM External Debt has surpassed the stock of U.S. High Yield

Source: JP Morgan, Bank of America, as of December 2018

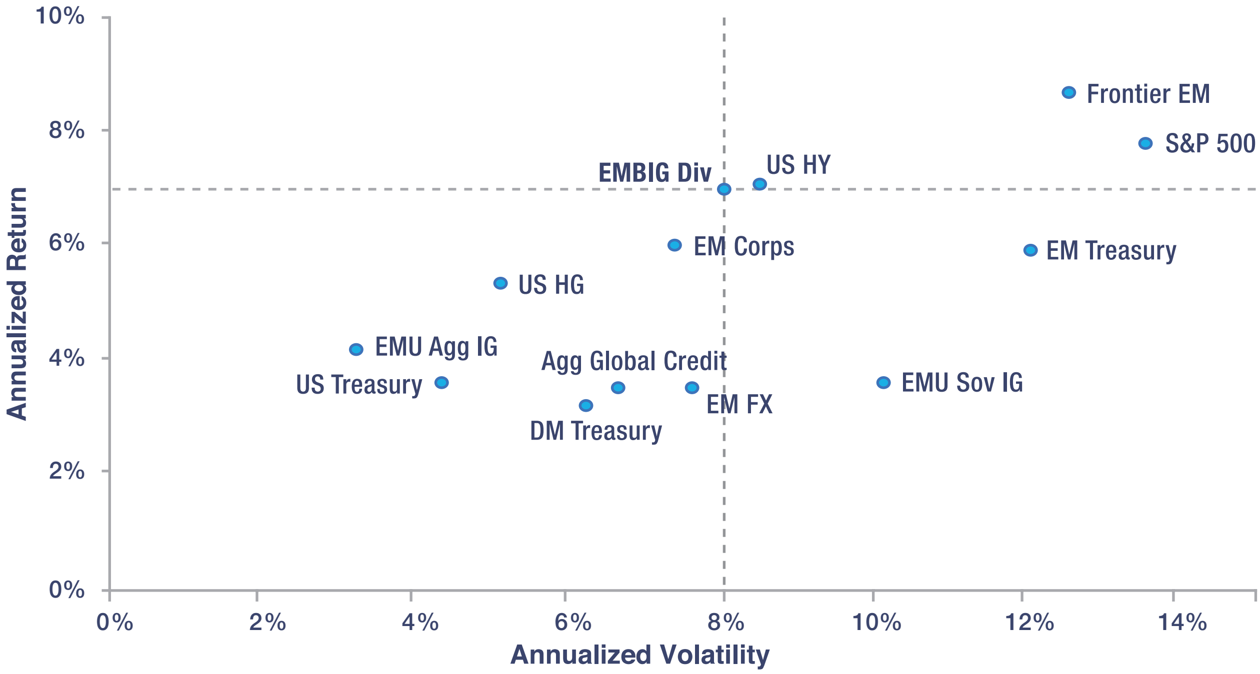
Additionally, during this time, EM governments have transformed the stability of their finances. They have introduced flexible exchange rates, built up foreign exchange reserves and, with the notable exception of China, significantly reduced the ratio of government debt to GDP. Relative to advanced economies, EM economies have been growing faster and are expected to continue doing so, according to economic specialists such as the IMF**.

Not only has this record been rewarded by EMs' strong risk-adjusted returns – the J.P. Morgan EMBI Global Diversified Index had an annualized return of 7.0% with an annualized volatility of 8.0% over the five years from 2013 to the end of 2018, as shown

**World Economic Outlook, April 2019, by the IMF in Figure 2 – but also, the asset class boasted a low correlation to other asset classes, offering investors the opportunity to spread their risks.

For example, the correlation with US Treasury bonds was just 0.28 over the same period, and 0.73 relative to the J.P. Morgan High Yield index.

Figure 2: 2006-2018 historical returns and volatility of fixed income asset types and S&P 500



Source: JP Morgan, data from January 2006 to December 2018.

Even so, Marathon believes that the improved fundamentals of the asset class are yet to be fully recognized. To illustrate the point, Marathon's Szpigiel points out that despite over 50% of the J.P. Morgan EMBI Global Diversified Index's bonds being rated as investment grade, the asset class remains under represented in investors' portfolios.

CAPTURING BETA, GENERATING ALPHA

With a team that includes members who previously developed J.P. Morgan's indices, Marathon seeks primarily to replicate the performance, or Beta, of its benchmark, the J.P. Morgan EMBI Global Diversified Index*. By using an intensive relative-value sampling methodology, Marathon aims to have a Beta of approximately one, while minimizing tracking error against the index, and opportunistically taking active positions to outperform the index.

Primarily establishing core positions aligns the broader portfolio to the index in terms of key characteristic and Beta metrics, while allowing for measured deviations through active credit management to add Alpha.

Just as the number of EM bond issues in the J.P. Morgan universe*** has grown to more than 670 with more than 150 issuers, so too has the diversity of the universe and the potential for Alpha generation. Marathon uses four different ways to generate Alpha – credit selection, relative value, index arbitrage and buying securities in the primary market.

Dialing the different sources of Alpha up or down depending on market conditions means that Marathon always has opportunities. "In dynamic markets we seek to take advantage of a dynamic set of opportunities," notes Andrew Szmulewicz, a Managing Director in Marathon's EM team. "Under all market conditions we find that we can generate excess returns from these factors. When geopolitics are at the fore, we might come up with more relative value and credit selection ideas. In more constructive market environments, index arbitrage and primary markets may offer opportunities to capture Alpha."

A SPECIFIC STYLE, WELL ADAPTED TO THE EMERGING MARKETS DEBT EVOLUTION

Marathon's distinct blend of Beta and Alpha was first introduced in January 2015, over a four-and-a-half-year period including both volatile and favorable markets. Despite the ongoing transformation in EM economies, and the high number of EM bonds that are rated investment grade, the asset class continues to trade at a sizeable discount to US high yield, which does not have such high average credit ratings.

For Marathon's distinct style, this is the ideal evolution. Through the combination of an optimal Beta replication and targeted Alpha generation, it aims to harness the overlooked opportunities in this rich array of flourishing, EM bond markets, to produce risk-adjusted returns that match the best of any asset class.

***Defined by the JPM EMBI Global Diversified Index

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