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WHY CAUTION SHOULD PAY OFF IN 2018

KEY POINTS

- 2017 was notable for the calmness of markets. This was beneficial for equity investors, but it led to underperformance in our Dynamic Global Bond strategy[1] because of the defensive stance we maintained throughout the year.
- This was disappointing, but we strongly believe that our positioning in 2017 was correct given the number of risks present in the market at the time.
- Geopolitical risks will continue to challenge the global economy in 2018, inflation could make a comeback and a number of developed market central banks are set to begin hiking rates. Concerns over these developments have already led to increased volatility.
- As such, we believe that positioning the portfolio for further volatility and rising yields will deliver the best results for our clients this year.

Last year was notable for the remarkable calmness of markets. Against a background of missile threats from North Korea, a potentially slowing Chinese economy, growing populism in Europe and concerns over the impact of central bank tightening, volatility was notable largely for its absence. This was good news for equity investors and more generally for risky assets, but led to underperformance in our Dynamic Global Bond (DGB) strategy because of the defensive stance we maintained throughout the year.

This was disappointing, but we strongly believe that our positioning in 2017 was correct given the number of risks present in the market at the time. We also continue to maintain high conviction in our investment approach, which is aimed at providing clients with a defensive anchor in their portfolios by generating positive returns with a focus on downside risk and diversification from equity markets. Policy tightening among developed market central banks is set to begin in earnest this year, inflation

[1]Effective June 30, 2017, the Global Unconstrained Bond Strategy was renamed the Dynamic Global Bond Strategy.

could make a comeback and a number of geopolitical risks will continue to challenge the global economy. Concerns over these developments have already led to a major spike in volatility. As such, we continue to believe that positioning the portfolio for a potentially volatile, rising rate environment is very much in the best interests of our clients.

LOW VOLATILITY DID NOT REWARD DEFENSIVE POSITIONING IN 2017

Risk events usually result in higher volatility, so last year's juxtaposition of a large number of risk events and sanguine markets was an unusual one. The amount of central bank monetary stimulus in the system undoubtedly contributed to the lack of volatility, but it is also possible that so many unusual geopolitical events have happened over the past few years that investors have begun to regard them as normal, and as a result have become complacent about them. Whatever the precise cause, the effect was that our decision to hedge some of our higher risk-seeking positions against event risk in the DGB strategy did not pay off, resulting in a negative return for the year.

Sector allocation had a notable negative impact on the DGB strategy's performance. This was driven primarily by losses from a particular stock-picking position within European high yield and the fact that our defensive hedging positions, implemented to help protect the portfolio in a risk-averse environment, detracted from performance as markets remained upbeat. The drag on performance from the hedging part of the portfolio not only suffered from the negative carry embedded in the position, but also from the slow grind lower in credit spreads that led ultimately to a capital loss. However, our exposures to U.S. dollar-denominated and sterling-denominated high yield added at the margin.

Active currency management also had a negative impact on performance, largely due to losses from a short position in the South Korean won, which we held from April as protection against growing tensions with North Korea. Other defensive positioning, such as short positions in the Taiwanese dollar and Russian ruble, also weighed on performance. A long position in the euro had a positive impact, however, particularly from March to July, when political concerns were abating, the eurozone economy was picking up and the European Central Bank (ECB) was becoming more hawkish. A tactical long position in the Swedish krona also had a positive impact on performance. Our currency management is sometimes used to protect against particular scenarios, as was the case in December when a short position in the Mexican peso clearly benefited from potential tensions ahead of the NAFTA negotiation between the U.S. and Mexico.

Country/duration management contributed positively to relative returns, led by our decision to use the full scope of duration range available during the period. A long U.S. duration position held between March and September had a positive impact, as did a meaningful flattening position which we implemented in the second half of the year. This benefited from short-dated Treasuries coming under pressure from tax reform legislation and the prospect of the Federal Reserve raising interest rates. Elsewhere, tactical allocation to Eurozone periphery countries also added gains, particularly long positions in Italy and Cyprus, where allocations were tactically managed around the French election and the Catalonia referendum.

While we were of course disappointed with the negative performance of the DGB strategy last year, it is important to note that our specific objective of diversification against equity markets makes it more difficult to outperform in periods of low volatility—in particular when a number of events occur that would ordinarily be expected to cause considerable volatility.

RISKS CONTINUE TO LOOM LARGE

The lack of volatility in 2017—and subsequent underperformance of defensive strategies—has led some market participants to suggest that a more relaxed approach can be taken to bond market risk. This is not our view. Although our defensive hedges did not pay off last year, we believe that we made the right calls given the risks present in the market at the time, and more importantly we believe that the combination of risks still present in the market continue to pose a significant threat. Given this, we feel that it is important to protect our clients' assets by maintaining a broadly cautious stance in the DGB strategy in the current environment.

Although we remain mindful that our cautious positioning did not pay off last year, we strongly believe that given the likelihood of further market volatility and rising yields in 2018, our portfolio positioning and overall approach will deliver the best results for our clients this year.

Developed market central bank tightening is set to begin in earnest in 2018, ending an almost-decade-long period of ultra-easy accommodative policies. The Federal Reserve will step up the unwinding of its balance sheet and potentially deliver more than three interest rate hikes. In addition, it is possible central banks in Canada, Sweden, and the UK raise rates, while the ECB is reducing the pace of its bond buying to EUR30 billion per month. This synchronized move tighter, together with stronger global growth, is likely to drive core bond yields higher, and we therefore have prepared for a rising rate environment by moving the portfolio's overall duration level close to zero.

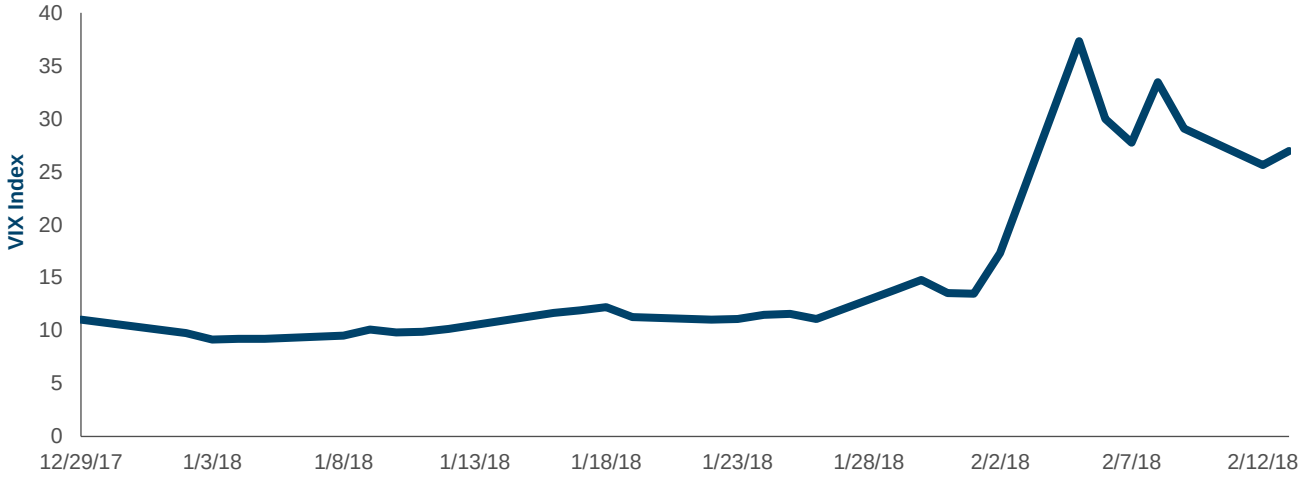
We are closely monitoring inflation because we believe that there is potential for price pressures to start rising modestly as a result of stronger global growth, higher oil prices, and tight labor markets in several developed countries. There are also signs that inflation has reached a bottom in emerging markets, with the exception of some isolated situations such as Mexico. Given that consensus inflation expectations still remain subdued, even a tentative rise could catch markets off guard and lead to a repricing in core bond markets that pushes yields higher.

Meaningful political risks persist, too. Although the Trump administration has delivered tax reform, significant uncertainty still surrounds the U.S. president's ability to deliver on many of his campaign promises. Direct fiscal stimulus in the form of infrastructure spending has been delayed, while the U.S. government continues to pursue trade protection measures that could have negative ramifications for the global economy if implemented. In Europe, concerns over populist, anti-EU forces have receded, but the Italian general election in March has the potential to reignite them. In addition, noise surrounding the UK's exit from the European Union is likely to continue through 2018. In emerging markets, several large countries face election risk this year, including Mexico, Brazil, Russia, and Malaysia.

The combination of risks present in the market has already resulted in a major spike in volatility in early February (see Figure 1). We expect further volatility throughout the rest of the year.

Figure 1: **VIX Index December 31, 2017 through February 13, 2018**

As of February 13, 2018



Source: Chicago Board of Exchange.

MAINTAINING A CLEAR-EYED APPROACH

The uncertainty dominating the market environment should provide a tailwind for the DGB strategy as we seek to identify sectors and individual securities that are mispriced as a result of temporary market dislocations. We will continue to follow our trusted investment process and strive to maintain a portfolio that strikes a balance between country, duration, and yield curve positioning to take advantage of relative value opportunities globally while also managing downside risks.

The role we play is to serve as the “defensive anchor” in a fixed income portfolio and we compliment other multi-sector strategies with higher reliance and exposure to credit. Our approach has been described by some as being “constrained unconstrained,” and is at the more conservative end of the risk scale, with a strong focus on downside risk management. We believe, the strategy offers a diversified, global portfolio of high quality fixed income securities with a core focus on an active allocation to government bonds and selective credit opportunities. Although we remain mindful that our cautious positioning did not pay off last year, we strongly believe that given the likelihood of further market volatility and rising yields in 2018, our portfolio positioning and overall approach will deliver the best results for our clients this year.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material: Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates which may affect the value of an investment. Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default which may affect the value of an Investment.

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