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HIGH YIELD CREDIT

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LEADER

HIGHER AND HIGHER

Nearly 30 years after Michael Milken ushered in a new asset class, the changes he helped to bring about in the financial world live on. Allowing companies with lower credit ratings to access capital while enabling savvy creditors to collect solid returns, high yield bonds have now become a trillion dollar asset class and a staple in many fixed income portfolios.

Here, Citywire talks to a range of experts to track the market's development, its transformation into a respected global asset class and the strong strategic reasons for employing a high yield manager today. You can read about that on page four.

More recently, US corporate credit underwent a shakeup of sorts after Trump finally managed to pass his tax package – a deal he described as 'an incredible Christmas gift for hard-working Americans.' Although the move was cheered by many high yield investors, the devil, as always, is in the detail. A cap on interest deductibility presents a serious headwind for highly leveraged companies, likely forcing investors to reach for higher rated bonds. See page seven for more on this.

And finally, on page 20, we take a closer look at the active versus passive debate within the high yield universe. Active bond managers have generally outperformed their passive counterparts, and given the rough market conditions that can beset the high yield market, it's no surprise that active funds can offer a safer route to higher returns than an index.

I hope you will enjoy this issue!

ALEX STEGER
EDITOR
CITYWIRE

ASTEGER@CITYWIREUSA.COM

(+1) 646 532 2961

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MOVING ON UP: THE EVOLUTION OF HIGH YIELD BONDS

Looking beyond traditional, US-focused bonds has helped high yield investors earn better returns

ROB ST GEORGE

Most investors trace the origins of high yield bonds back to Michael Milken and Drexel Burnham Lambert in the 1970s and '80s. But as Milken himself has pointed out, the history of this kind of debt stretches back much further – to Alexander Hamilton financing the revolutionary war and to European investors lending the money that built America's infrastructure.

Whatever their provenance, the market for high yield bonds has evolved significantly in recent decades and has also maintained its essential role in the efficient functioning of the economy.

'I have been involved in the high yield market since the early 2000s, and the first and most obvious difference is just the size of the market,' said David Mihalick, head of US High Yield Investments at Barings. For example, the US high yield bond market now stands at roughly $1.3 trillion – more than double its size only 15 years ago.

The composition of that vast marketplace has changed in important ways too. 'In the early 2000s and leading up to the great recession, it was heavily dominated by leveraged buyout activity,' Mihalick explained. 'While that is certainly still a very important part of the market today, it is a smaller percentage of the market.'

LOAN RANGERS

The modern conception of this universe has also broadened beyond traditional high yield bonds. For example, it now incorporates securities such as loans. The traded US loan market is worth about $1 trillion in its own right today, having grown from virtually nothing. 'Fifteen years ago, the loan market was considered a private market,'

Mihalick recalled, 'but we have really seen it converge with the high yield market since then.'

For investors, being able to span both conventional high yield bonds and loans adds valuable new levers to portfolio management, compared with the limitations of operating solely within the outmoded asset class silos.

'One of the biggest benefits is that you can get the same underlying credit exposure while also significantly reducing the duration of the portfolio because the loans have floating rates,' Mihalick argued.

As well as expanding the investment pool, including loans within a credit allocation exposes portfolios to different technical factors. Loans, for example, tend to be less volatile than bonds; one reason being that part of the buyer base for loans is collateralized loan obligations (CLOs), which provide permanent capital and therefore help to insulate loans from the vagaries of retail money flows.

Loans are also senior secured securities within the capital structure and enjoy a lower risk profile. As a result, they should offer higher recovery values in default events.

THE GLOBAL MINDSET

However, diversification across security types is only one aspect of a modern credit investor's toolkit. High yield bonds can no longer be regarded as a primarily US-based asset class. In recent years high yield markets have blossomed around the world, making a global mandate imperative.

Of course, this extends the opportunity set, but it also offers exposure to bonds from similar types of issuers and of similar credit quality, but which are subject to different technical factors. 'The technicals of each market can cause spreads to gap out for a relatively short period of time, which can create a very good buying opportunity for what are similar underlying credit profiles,' Mihalick said.

For instance, the collapsing oil price from 2014 to 2016 affected the US high yield market more than its European equivalent. That said, the reverse was true when the eurozone crisis of 2011 and 2012 pushed volatility higher on the other side of the Atlantic, but had less of an impact in the US.

Paired with the fact that these are risk assets, the diversity and scale of the global high yield market – made up of around 3,000 corporate issuers – means that careful research and security selection must be priorities.

THE THREE Rs: RESEARCH, RESEARCH, RESEARCH

'To do that credibly, you have to have a large team,' Mihalick said. For example, Barings has high yield portfolio managers, analysts and traders in both the US and Europe. 'We very much believe that you need to make local investment decisions. It is very difficult for a US-based team to consistently and effectively

underwrite European credit, just as it is the other way around,' he added.

'If you're a US-based investor assessing a European retailer, you can look at the numbers all you want, but if you have never visited the stores and are not familiar with local factors, it is very difficult to make a qualitative analysis.'

Mihalick's process is therefore based on fundamental bottom-up research, complemented by a top-down view for certain macro-driven sectors such as energy and commodities. Security selection drives the performance of his fund through the cycle, with a portfolio of between 200 and 300 issuers that is diversified enough for protection against surprises but sufficiently concentrated for the best ideas to make a material difference.

However, because the high yield market is cyclical, some investors may wonder whether it is better to allocate to it tactically rather than strategically. 'History suggests that in any risk asset it is possible to time exposure, but it is not probable that you will do so well consistently,' Mihalick warned.

TIME IN THE MARKET, NOT TIMING THE MARKET

As high yield cycles can turn quickly, particularly when the market is driven by technical considerations, attempting to jump in and out around dips is perilous. 'Those tend to correct themselves fairly quickly, so for most investors reallocating from loans to bonds or from the US to Europe takes too much time,' Mihalick said.

'For most of our investor base, high yield has become a core allocation. Our conversation with them is not whether they should be in high yield, but whether they should be increasing or decreasing their exposure based on relative value.'

So what is the answer to that question today? Taking the fundamentals first, a robust global economy is keeping default rates low. 'In the companies we are invested in, we do see the effects of synchronized global economic growth,' Mihalick explained. 'Earnings are good and balance sheets are in pretty good shape, so the companies we invest in are fairly healthy.'

Technical analysis is encouraging too. 'It is an undersupplied market today, with a lot more institutional money globally seeking yield in this very low-rate environment,' Mihalick said. 'A lot of demand for the product with insufficient supply means the market's technicals are strong.'

RISK VERSUS REWARD

Of course, none of this has gone unnoticed, prompting some concern that the good news is already priced in and valuations have become elevated. 'There is no debating that spreads today are tighter than they were a couple of years ago, but the credit environment is much better than it was a couple of years ago,' Mihalick said. 'The spreads you get should be measured relative to the risk you're taking.'

As an active manager, he is also able to buy only the most attractive risk-adjusted opportunities, rather than being compelled to own the whole market. 'If we look at the market today, you may argue that the BB-rated credits – so the higher-quality part of the high yield market – are fully valued,' Mihalick said.

'But if you get down to the B and CCC-rated parts of the market, which tend to be the most inefficient parts of the market where fundamental credit research can make a big difference, it still feels like there is reasonable value.'

A global perspective helps here too, as aggregate index-level spreads can be misleading. European spreads, for example, may seem tight on a headline basis. 'But if you go to the next layer down and look at B-rated credits in Europe, there are some very attractive opportunities,' Mihalick said. 'It is about having the resources to go out and find those opportunities where they present themselves.'

TAXING QUESTIONS IN HIGH YIELD

Could a detail in the Republican tax reforms hold back high yield bonds?

ROB ST GEORGE

'When I signed the tax cuts six weeks ago, it set off a tidal wave of good news that continues to grow every single day,' president Trump declared in early February. 'Before the ink was dry, companies were announcing thousands and thousands of new jobs and enormous investments to their workers.'

Plenty of businesses will indeed have celebrated tax reform, but some will be sweating over the impact of a relatively minor section of the 1,000-plus pages of legislation.

Before the passage of the act, there had been no limit on the amount of interest companies could deduct from their earnings. However, under the new regime, these deductions will be capped at 30% of earnings before interest, taxes, depreciation and amortization. Furthermore, from 2022 the depreciation and amortization allowance will also be stripped from that threshold so that the 30% maximum can only apply to earnings before interest and taxes.

This seemingly minor tweak will ultimately increase the tax bills of companies that had previously been able to write off their interest payments, meaning that – all else being equal – heavily indebted bond issuers will suffer depressed cash flows.

This has not gone unnoticed by bond analysts. According to S&P, almost half of the high yield issuers it rates have interest expenses of more than 30% of their earnings before interest, taxes, depreciation and amortization. Nearly three quarters of these issuers have interest expenses above their earnings before the interest and taxes limit.

That is not to say that all the high yield issuers in these baskets will face problems though. S&P has warned that 'The limits have a more pronounced effect on highly leveraged companies with lower interest coverage and higher debt leverage ratios.' Meanwhile, Moody's

Investors Services has predicted that 'The loss of the full deductibility of interest expense may be most apparent at ratings of B3 or lower.'

'While the drop in the corporate tax rate should serve as a supporting factor for the corporate bond market, the limits on interest deductibility may actually negate those benefits for the some of the lower-rated, highly leveraged issuers,' explained Collin Martin, senior fixed income research analyst at the Schwab Center for Financial Research.

CCC, THERE'S YOUR PROBLEM

'For investors who own high yield corporate bonds today, either as individual holdings or through a fund, we think it makes sense to move up in quality, focusing more on the double and single B-rated parts of the high yield market and reducing exposure to investments with CCC or below ratings, because they tend to have the most leverage,' Martin continued.

Adam Richmond, head of US credit strategy at Morgan Stanley, agreed that the new cap on interest deductibility represents a headwind for the most highly leveraged companies. It's another reason to be cautious about high yield bonds in the CCC-rated territory.

Richmond added that the final version of the limit was a modestly better outcome for credit issuers than an earlier draft of the Senate's proposed bill. He rejected the thesis that it would encourage companies to delever their balance sheets in the short term.

'The cost of debt is still very low for most issuers, animal spirits have been rising and tax cuts may drive confidence even higher,' Richmond said. 'These dynamics are not consistent with conservative corporate behavior, in our view.'

More broadly, Richmond argued that although corporate credit could benefit from some aspects of the tax reform – such as through stronger earnings growth under the corporate tax cuts and perhaps through lower investment grade supply as companies repatriate their overseas cash – the legislation was not likely to prove a bullish driver of credit spreads at this point in the cycle. 'We think credit investors should hope for anything that keeps the cycle going: modest growth and a patient Fed,' he said.

NET POSITIVE

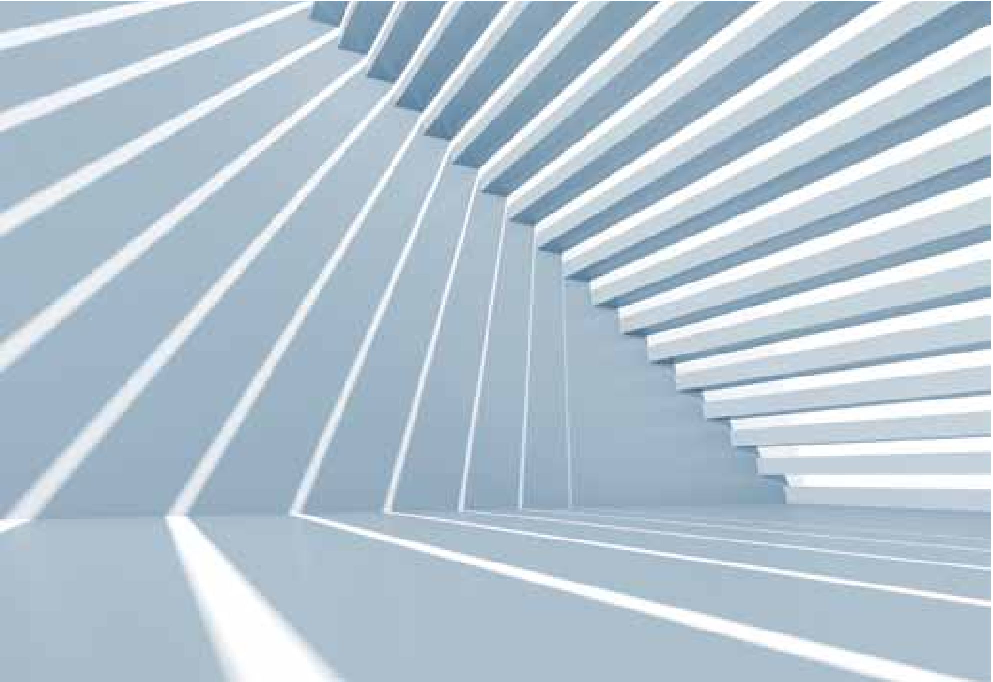
For Sharmin Mossavar-Rahmani, chief investment officer for the investment strategy group at Goldman Sachs, the limits on interest expense deductibility and the reduction of net operating loss carry forwards were indeed less than positive for the highly leveraged issuers of debt out there.

'Even so, these unfavorable components must be weighed against the tax reform's advantageous elements to gauge their overall impact,' Mossavar-Rahmani said. 'Crucially, our work suggests that the bill's reduction in the corporate tax rate and the treatment of capital spending as a fully deductible expense more than offset its negative impact for the vast majority of high yield firms. In fact, the equivalent of 78% of high yield bonds outstanding based on par value are better off under the tax reform.'

So if the Tax Cuts and Jobs Act is not going to derail high yield, and may even buoy the asset class, are there any real fundamental concerns? After all, on a par-weighted basis, only 1.34% of high yield bonds defaulted in 2017 – one of the lowest rates since the financial crisis. Surely the only way is up?

'While we certainly acknowledge that the current rate of improvement in both defaults and credit spreads is unsustainable, we do not think that fact undermines the case for high yield credit in 2018,' Mossavar-Rahmani said. Goldman Sachs estimates that the high yield default rate will remain below average at 2% this year, based on several factors.

First, the US economy should remain robust – an important consideration for high yield



issuers given that nearly three quarters of their sales originate domestically. Second, key leading metrics such as the Moody's Liquidity Stress Indicator and covenant stress indices are approaching all-time lows. Third, there is little refinancing risk, as just 8.8% of existing debt matures within the next two years and interest coverage stands near record highs. Fourth, the share of issuance represented by low-rated CCC bonds over the past two years is less than half its average in the run-up to the credit crash.

LOOKING BEYOND INVESTMENT GRADE

Goldman Sachs expects returns of around 3% for high yield bonds in 2018, with a slightly better performance of between 4% and 5% for bank loans, reflecting their appealing 0.25-year durations and the ongoing investor demand for floating rates, particularly now that three-month Libor is above the 1% Libor floor that more than 90% of bank loans possess.

'While these returns may pale in comparison with the 13.2% annualized gains that high yield bonds have delivered since 2009, they remain attractive relative to investment grade fixed income, where we expect rising rates to generate worse returns,' Mossavar-Rahmani said. 'Even if interest rates remain little changed while the US economy continues to expand, the loss-adjusted return should still trump that of investment grade bonds, in our view.'

On the other hand, Christopher Hyzy, chief investment officer of US Trust, was underweight corporate high yield in general. Even so, he was still able to identify some opportunities within the broader asset class.

'In our view, valuations are rich, especially for lower-rated credit tiers,' he said. 'Within high yield, an allocation to leveraged loans may be prudent due to the floating-rate coupon, secured status and minimal yield give-up to unsecured bonds.'

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THOMAS MCDONNELL
US High Yield Investments,
Barings

MULTI CREDIT INVESTING: EMBRACING THE HIGH YIELD OF TODAY

Over the past decade, the growth and expansion of the global high yield markets has contributed to a transformation in investors' attitudes toward the asset class, with many investors viewing high yield as a core, strategic contributor to their portfolio. In fact, many investors today, rather than questioning *when* to invest in global high yield, are questioning *how*.

One answer may be through a high yield multi credit approach, which can have several benefits both in the current environment and through a full credit cycle.

WHAT IS HIGH YIELD MULTI CREDIT?

The definition of multi credit is far from standardized. At Barings, we think of multi credit investing as a 'corporate focused' rather than 'go-anywhere' strategy that consists primarily of allocations to the 'core four' high yield sub-asset classes – US high yield bonds, US loans, European high yield bonds and European loans – with the ability to make opportunistic allocations to collateralized loan obligations (CLOs) and stressed and distressed credits (special situations):

CORE ASSETS	**OPPORTUNISTIC ASSETS**
The 'core four' sub asset classes account for roughly 75% of the assets in Barings' high yield multi credit strategy.	The remaining 25% of our strategy consists of opportunistic allocations to CLOs and special situations.

FINDING VALUE THROUGH THE CREDIT CYCLE

While the US and European high yield markets tend to exhibit some correlation and share similar risk/return profiles, these markets have historically been punctuated by periods of dislocation, during which prices have become decoupled from underlying fundamentals, creating widely different opportunities at different points in the credit cycle. This variation in performance and pricing between high yield

sub-asset classes is often the result of headline risk or technical factors, which are typically temporary and sentiment-driven. While these factors may drive prices down in the short term, they have often been followed by a relatively quick recovery, particularly in cases where the underlying fundamentals remain solid. A multi credit strategy can help an investor take advantage of the short-term opportunity that has arisen, by positioning investors to promptly reallocate assets to the area that may be offering the most value at any given point in time.

The benefit of being able to quickly and efficiently reallocate capital during a market dislocation was particularly apparent in 2015, when the US high yield bond market, with greater exposure to energy than the European market, experienced significant spread widening despite the fact that many issuers were benefiting from lower commodity prices. Within the US market, bonds had significantly more exposure to energy than loans, and therefore offered better return potential when the market recovered. Managers with the ability to look at the high yield markets from a broader perspective were in a position to capitalize on this market dislocation; in many cases, those who shifted into US high yield bonds benefited a year later when the asset class went on to outperform.

FLEXIBILITY IS KEY

When an opportunity emerges in a specific area of the global high yield markets, a timely response is of the essence. In recent years, there have been a number of instances in which an opportunity came and went relatively quickly, including the 2011 eurozone crisis, 2013's 'taper tantrum' and the 2016 Brexit vote. The fleeting nature of such opportunities can prove challenging for investors, who often lack the flexibility to respond in real time.

It is therefore unsurprising that many investors choose to delegate their reallocation decisions to well-resourced investment managers with large, global high yield teams. At Barings, we have 71 high yield investment professionals across the US and Europe, providing the resources and expertise required to thoroughly analyze the fundamentals of every credit we underwrite. As pricing opportunities come and go across the core four markets, we dynamically reallocate investors' capital toward opportunities as they emerge, all while keeping a close eye on potential technical risks.

THE TRUE STRENGTH OF A MULTI CREDIT APPROACH IS EXHIBITED NOT DURING PERIODS OF CALM, BUT RATHER DURING MARKET DISLOCATIONS

THE CURRENT OPPORTUNITY

While global high yield markets had a strong run in 2016 and 2017, we continue to see many positive indicators – strong fundamentals, generally low default rates, improvements in global growth and the possibility of a potential tailwind from US tax reforms – that continue to support the markets. Against that backdrop, we believe that the high yield bond and senior secured loan markets across the US and Europe were roughly neck-and-neck on a relative value basis at the end of 2017, although US bonds began to look more attractive as the markets experienced increased volatility in early 2018.

To this end, the true strength of a multi credit approach is exhibited not during periods of calm, but rather during market dislocations. While it may be difficult to pinpoint precisely when these dislocations will occur, they do, inevitably, occur. A multi credit strategy gives

managers the ability to quickly and efficiently redirect investors' allocations in real time, in response to these dislocations, and positions them to pivot to those regions or sub-asset classes that they believe offer the best value at any given point in time.

AN INTEGRATED MULTI CREDIT HIGH YIELD STRATEGY CAN BE PARTICULARLY VALUABLE IN PROVIDING MANAGERS WITH THE FLEXIBILITY TO TACTICALLY SHIFT WEIGHTINGS AND CAPITAL ALLOCATIONS

When looking at the high yield markets today, corporate fundamentals look stable, with most companies in the US and Europe generating top- and bottom-line revenue growth and exhibiting reasonable balance sheet leverage. Global growth, which appears to be synchronized across North America, Europe and Asia, remains supportive. That said, there are a handful of potential triggers on the horizon that could cause volatility and price dislocation in the near term, including the ongoing Brexit negotiations, concerns over inflation and the reaction of the US market to higher interest rates. There are also a number of sector-specific risks in the US, particularly around energy, healthcare and retail.

An integrated multi credit high yield strategy can be particularly valuable in providing managers with the flexibility to tactically shift weightings and capital allocations to those regions or sub-asset classes that offer the most attractive relative value at any given time. In our view, managers with the ability to look holistically across these markets – through the use of a multi credit approach – are best positioned to capitalize on the ever-evolving opportunity set within today's global high yield markets. ■

VALUE IN HIGH YIELD SHIFTS OVER TIME

US LOANS
EUROPEAN LOANS
US BONDS
EUROPEAN BONDS

2011	2012	2013	2014	2015	2016	2017	
4.91%	24.19%	9.38%	5.25%	4.39%	18.32%	7.30%	HIGHER
1.82%	14.74%	8.97%	2.49%	1.15%	10.12%	6.16%	RETURNS
-1.23	10.51%	7.22%	2.10%	-0.38%	9.88%	4.25%	
-1.47%	9.43%	6.15%	2.06%	-5.38%	5.42%	3.71%	LOWER

SOURCE: BAML NON-FINANCIAL HIGH YIELD CONSTRAINED INDEX (US HIGH YIELD BONDS); BAML EUROPEAN CURRENCY NON-FINANCIAL HIGH YIELD CONSTRAINED INDEX (EUROPEAN HIGH YIELD BONDS); CREDIT SUISSE LEVERAGED LOAN INDEX (US LOANS); CREDIT SUISSE WESTERN EUROPEAN LEVERAGED LOAN INDEX (EUROPEAN LOANS). DATA TO DECEMBER 31, 2017. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

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SEAN FEELEY
US High Yield Investments, Barings

CHRIS SAWYER
European High Yield Investments, Barings

A GLOBAL APPROACH TO HIGH YIELD INVESTING

The global high yield market has grown steadily over the past decade, offering active managers an increasingly broad opportunity set from which to seek relative value. In recent years, interest in the asset class has been driven in part by investors seeking higher yields and returns amid a prolonged period of low interest rates around the globe. But the interest rate landscape is changing, and as investors look ahead to diverging monetary policies many are questioning how high yield bonds will factor into their portfolio allocations.

Historically, the asset class has delivered attractive returns through varying economic and interest rate cycles, presenting opportunities for active, experienced managers to add risk when appropriate returns are available and manage risk when conditions are unfavorable. From a relative value perspective, we see potential benefits for investors willing to diversify their exposure to Europe – a higher quality and slightly shorter-dated market than the US.

How can taking a global approach to high yield investing – versus US-only – benefit investors?
Sean: In our view, the overarching benefit of a global strategy is that it can give investors access to a much wider and more diverse universe of credits than a US-only strategy. At Barings, our global high yield strategy isn't limited to one market – we build our global portfolio out of our best ideas across the US and Europe.

Chris: The global high yield market, and Europe in particular, has also deepened significantly in terms of industry and issuer diversification. Today, the US and European high yield markets exhibit very different sector distributions. In the US, for instance, the largest sector is energy, while in Europe, sectors such as telecoms are more

prevalent. I would also point out that even when there is some overlap between the respective markets in a particular sector – for instance, retail – you are still looking at two very different end markets. For example, the US retail sector currently faces a number of challenges, such as excess square footage and the continued growth of internet shopping, while the factors impacting European retail are not necessarily the same. Within Europe itself, the issues facing a particular sector can differ from country to country as well.

Sean: A global approach also gives investors access to a larger opportunity set from which to seek relative value as the underlying attractiveness of each region's high yield market changes. Relative value tends to be influenced by factors such as interest rate expectations and geopolitics that sometimes have little effect on the underlying health of an issuing company. These factors can cause short-term dislocations, or instances in which prices decouple from fundamental value, giving nimble managers a chance to capitalize on over- or undervalued credits.

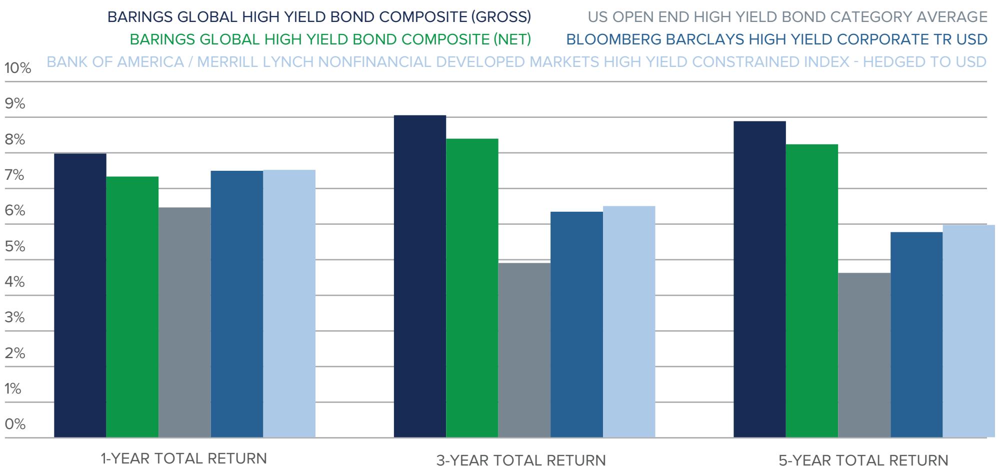
Can you give an example of a past market dislocation that ultimately led to an attractive buying opportunity?

Sean: One example of this was the energy selloff in 2015. The US high yield bond market, with greater exposure to energy than the European market, greatly underperformed as spreads significantly widened. Europe, on the other hand, was largely insulated from that volatility, partly because of its lower exposure to energy. Managers with depth and presence across these markets were able to capitalize on the dislocation in the US market, and those who increased their exposure to US high yield bonds ultimately benefited a year later when US bonds went on to outperform the other high yield sub-asset classes.

What are some characteristics that make European high yield markets particularly attractive?

Chris: Up until 2009, for many high yield investors, the go-to option was the US market. However, since that time, the European high

HOW BARINGS' GLOBAL HIGH YIELD STRATEGY STACKS UP



Source: Bloomberg/Barclays and Morningstar. Data to December 31, 2017. Please see GIPS Disclosure on page 19 for more information.
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

yield bond market has quadrupled in size, making it a much more material component of the global high yield bond market. With that growth, international businesses have more than just US markets to tap for credit and, as a result, high yield investors have a much broader set of investment opportunities. Therefore, for investors who view high yield as a strategic allocation within their portfolio, it makes sense to think global. And at Barings, that means investing in high yield bonds and loans, in both the US and developed Europe.

A holistic look at the high yield markets can also allow managers to identify opportunities more effectively. For example, within Europe, we currently see value in the single B-rated portion of the market, which has the potential to offer excess return with shorter duration than the overall US market. If interest rate risk is a concern for an investor, this subset of the European market could be an attractive investment option.

In recent years, secured issuance in the European high yield bond market has outpaced that in the US, resulting in the European market having a greater percentage of senior secured bonds, which are higher in the capital structure. Today, with high yield default rates below historical averages, some investors may not see the value in giving up a marginal amount of yield for senior secured status. However, at Barings, we like the downside protection potential of secured debt as we focus on the fundamental risks associated with an individual issuer, and not just the returns of an investment.

What are some of the reasons investors should consider global managers like Barings?

Sean: Because many companies now issue debt outside of their own country, or issue debt in multiple regions at very different prices, local, on-the-ground expertise is critical to uncovering the most attractive opportunities across global high yield markets. For example, when a European company issues debt in the US, managers like Barings, who have experienced and well-resourced investment teams in Europe, have the ability to evaluate the credit more effectively.

Chris: We see the value of that local knowledge time and again. For example, one of the best-performing names in our portfolios in 2017 was a German retailer. It's hard to uncover those opportunities without the knowledge base of our team, which consists of more than 70 dedicated, high yield investment professionals across the US and Europe. The size of our team means our analysts cover fewer credits, allowing them to dig deep into each individual issuer. We believe this breadth differentiates us, enabling us not only to pursue the best credits but also to constantly monitor the issuers we invest in. That knowledge base can also prove to be an important benefit when a company transitions from issuing bonds to loans, or vice versa. I can immediately think of two European companies – one in France, one in Italy – that have gone from issuing only European loans to issuing a mixture of European loans and bonds, to now including US bonds. Since Barings is active in both bonds and loans, monitoring such companies as they shifted their debt strategy was not a challenge, compared with a manager that only knows the bond or loan market, and maybe only in one jurisdiction.

Sean: Our long-term track record in managing both US and European credit and our presence in both regions gives us the flexibility to move fluidly between the two markets. Our global teams are in constant communication, which we believe puts us in a good position to identify and capitalize on relative value opportunities as they arise across geographies. The bottom line is that while the global high yield opportunity set is significant and continues to grow, in order to efficiently and successfully evaluate and access all the asset class has to offer, an integrated global team with the right level of resources and experience is critical. ■

BARINGS

MATTHEW NATCHARIAN, CFA
Head of Structured Credit Investments, Barings

CLOs: ACCESSING THE OPPORTUNITY

Investors in today's high yield market have a multitude of choices for how to access the attractive yields available, while tailoring the risk profile of their investment. Long gone are the days when US high yield bonds were the only option for investors. Today, loans – or more accurately, senior secured bank loans – are a large and very important part of the high yield universe, offering credit investors a more secure way to earn potentially attractive returns by investing as a senior lender in businesses rated below investment grade. Additionally, investors can adjust their duration exposure and diversify globally.

While adding senior secured loans to a portfolio is one way for investors to diversify and customize their high yield allocation, there are additional ways to customize a portfolio's risk and return profile by gaining loan exposure through collateralized loan obligations (CLOs). Slightly more than half[1] of the loans issued in the high yield market are purchased by CLO managers and function as the collateral in newly issued CLO deals – but in investment terms, a CLO is more than just a 'loan clone.' CLOs allow investors to buy securities backed directly by professionally managed portfolios of senior secured loans.

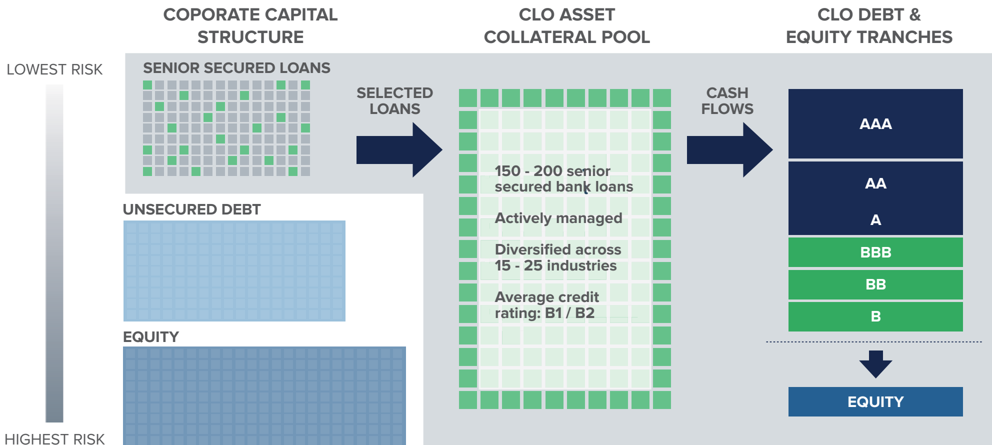
The securities issued by each CLO include high-quality (AAA, AA, A and BBB-rated) tranches that, due to their seniority in the capital structure, tend to be insulated significantly from potential losses, as well as more junior (BB, B-rated and equity) securities that provide a leveraged return typically yielding more than the underlying bank loans. The CLO market has helped to expand the global high yield market by providing customized risk and return profiles that appeal to a wide investor base.

UNDERSTANDING THE BASICS

CLOs are backed by a diverse pool of senior secured, broadly syndicated bank loans – typically 150 to 200 loans, spanning 15 to 25

[1]Source: JP Morgan, Credit Suisse Leveraged Loan Index. Data to January 31, 2018.

CLOs OFFER INVESTORS A RANGE OF RISK/RETURN PROFILES



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industries. The majority of loans in a CLO are first-lien bank loans, which means the loans are secured by the borrower's assets and rank first in line for repayment in the event of the borrower's bankruptcy.

CLO tranching – illustrated above – enables different risk/return options for investors. The desired tranche ratings are achieved through diversification, leverage and by employing a cash flow waterfall designed to protect debt holders. Cash flows are paid sequentially from the top of the capital structure, starting with the most senior CLO tranches. For example, the highest-rated debt tranche – AAA – gets paid first. The cash then rolls down to pay subsequent tranches in order of their ranking – AA comes next, followed by A, and so on down the capital structure.

WHAT ARE THE MAIN BENEFITS?

1. RETURN POTENTIAL

CLO mezzanine and junior tranches can offer investors a higher yield than they might earn on many core fixed income securities with similar risk profiles. This potential yield premium comes from leveraging the credit expertise of professional bank loan collateral managers. The CLOs' term-financed structure enables the collateral manager to focus on credit risk over the life of the CLOs, insulating them from daily market volatility and allowing them to focus on credit risk. CLOs have provided what we view as attractive returns to income-seeking investors over the past decade, especially as interest rates reached and maintained historical lows for an extended period. Even as rates start to rise, the yield premium of CLOs remains an important factor, given that spreads between BB loans and BB CLOs are currently around 270 bps.[2]

As a seasoned high yield manager, we understand the critical role that avoiding or limiting losses can play in potentially achieving attractive risk-adjusted returns for our investors. Against that backdrop, it is important to note that during the CLO market's more than two-decade history, the asset class, in addition to offering a potential yield and return advantage, has defaulted far less frequently

[2] Source: JP Morgan, Credit Suisse Leveraged Loan Index. Data to January 31, 2018.

than similarly rated corporate credit.

This track record is a testament to the resilience of senior secured loans. Even during the global financial crisis, as some investors worried CLOs could suffer the same fate as similar-sounding but fundamentally different forms of structured investments, CLOs emerged intact, and in many cases, went on to provide attractive returns for investors who focused on the underlying credit fundamentals and rode out the storm.

The performance of the asset class is also a result of the structural protections built into CLOs and the benefits an actively managed portfolio of loans can provide. Managers of actively managed CLO portfolios have the flexibility to buy and sell individual bank loans, to enhance gains or mitigate risk, as the credit quality of a loan within its collateral pool waxes and wanes.

2. A BUFFER AGAINST RISING INTEREST RATES

When interest rates rise – as they are starting to in the US – investors holding fixed coupon bonds may see the value of those bonds fall. The spread premium CLO investors are currently able to earn versus comparable assets such as investment grade corporate bonds, asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS) is further enhanced by the fact that CLO debt tranches have floating rate coupons that reset quarterly, which can serve as a good hedge against rising interest rates.

3. DIVERSIFICATION

CLOs can offer diversification in three important ways:

- **When added to a portfolio of traditional high yield bonds**, CLOs can offer the additional benefits of a floating-rate coupon, a lower default history and structural protection from potential defaults in the underlying bank loan portfolio.
- **Investing in a portfolio of CLOs is ultimately investing in an ultra-diversified portfolio of broadly syndicated loans.** Within a CLO itself, diversification comes in the form of a portfolio with 150 to 200 loans spread across 15 to 25 industries. By actively managing the underlying loan pool of collateral during the reinvestment period, managers help ensure portfolio diversity is maintained over time. Investing in individual bank loans typically does not offer an investor the same diversification or risk/return profile.
- **Geographically,** the continued growth of the European CLO market has aided in the expansion of the global CLO opportunity set.

HOW TO ACCESS THE OPPORTUNITY

Until fairly recently, it has been difficult for private investors and their advisors to access opportunities in CLOs, but that situation is slowly changing. In particular, with the advent of high yield multi credit strategies, investors have a means of accessing the broader opportunities within the high yield universe, including the potential benefits offered by CLOs.

At Barings, our high yield multi credit strategy comprises allocations to bonds and loans in the US and Europe, with the ability to make opportunistic allocations to CLOs and stressed and distressed credits. We believe this approach can be particularly beneficial, as it gives managers the flexibility to pivot to those regions or sub-asset classes that offer the most attractive opportunities at any given point in time. ■

RISK PROFILE

While we see many benefits to investing in CLOs, it is also important to consider the potential risks. Like other below investment grade investments, CLOs are subject to credit, liquidity and interest rate risk. Investors may also be exposed to price fluctuations and/or losses, which can result from changes in overall market conditions or issuer-specific fundamentals. At Barings, our primary goal is to deliver attractive risk-adjusted returns for our clients. To best manage risk, we conduct rigorous, bottom-up credit analysis in our initial underwriting process and regularly track key credit metrics to ensure the investment thesis for each credit that we invest in remains intact.

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BARINGS GLOBAL HIGH YIELD FIXED INCOME COMPOSITE / REPORTING CURRENCY: USD / SCHEDULE OF PERFORMANCE RESULTS

Date	Annual Return Gross of Advisory Fees	Annual Return Net of Advisory Fees	Benchmark BofA/Merrill Lynch Global Non-Financial DM HY Index	Asset-Weighted Dispersion	3-Year Annualized Std Dev. (Composite)	3-Year Annualized Std Dev. (Benchmark)	Total Aggregate Assets at End of Period (USD$ MM)	Total Firm Assets at End of Period (USD$ MM)	Percentage of Firm Assets	# of Portfolios at End of Period
12/31/2017	7.99%	7.34%	7.53%	NM	3.99%	5.43%	1,167	284,789	0.4%	<=5
12/31/2016	14.31%	13.62%	16.92%	NM	4.53%	5.75%	700	178,724	0.4%	<=5
12/31/2015	5.10%	4.47%	-3.89%	NM	4.55%	4.96%	211	163,934	0.1%	<=5
12/31/2014	3.27%	2.65%	2.81%	NM	N/A	N/A	43	157,257	0.0%	<=5
12/31/2013	14.33%	13.65%	7.64%	NM	N/A	N/A	49	142,832	0.0%	<=5
12/31/2012^	13.69%	13.29%	10.56%	NM	N/A	N/A	39	116,633	0.0%	<=5

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NM The asset-weighted dispersion deviation of five or fewer portfolios or periods of less than a year is not meaningful.

<=5 Five or fewer portfolios.

^ Returns from composite inception date of June 1, 2012 to December 31, 2012.

** In the second quarter of 2014, the composite name was changed from Global High Yield Bond to Global High Yield Fixed Income.

Compliance Statement: Barings, fka Babson Capital Management LLC, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Barings has been independently verified for the periods 1993-2016 as Babson Capital Management LLC. See firm definition for further information. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Global High Yield Fixed Income composite has been examined for the periods of 2014 – 2016. The verification and performance examination reports are available upon request.

Definition of the Firm: Barings, "Firm", provides investment management and advisory services to both institutional and individual clients. For purposes of compliance with the Global Investment Performance Standards (GIPS®), the Firm defines itself as consisting of the portfolios that it manages directly. In 2017, the previous subsidiaries of Babson Capital Management, "Babson", including Babson, were consolidated under the Barings name for GIPS purposes. Those entities included Babson Capital Management LLC, Cornerstone Real Estate Advisers LLC, Barings Asset Management Limited, and Wood Creek Capital Management LLC. In 2017, the firm assets represent the consolidated entity. A list of the Firm's composite descriptions is available upon request.

Policies: The Firm's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

Composite Description: The investment objective of the total rate of return vehicles included in this composite is to provide high current income generation and, where appropriate, capital appreciation. To achieve this objective, the portfolios within this composite will invest principally in a portfolio of below investment grade rated fixed and floating rate Corporate Debt Instruments, which are listed or traded on Recognized Markets in Europe or North America and issued by corporations domiciled primarily in North America and Western Europe. While the portfolios within the composite will invest principally in North American and European issuers, they may also invest in issuers located in other geographic areas, subject to a limit of 5% of Net Asset Value in issuers from Emerging Markets. Portfolios within the composite can either be managed completely by Barings LLC, fka Babson Capital Management LLC or managed with Barings LTD, fka Babson Capital Europe, a subsidiary of the Firm. Valuations are computed and performance results are reported in U.S. dollars. The minimum portfolio value requirement for inclusion in the composite is USD $5,000,000. The composite was created in June 2012.

Benchmark: The performance benchmark for the Global High Yield Bond composite is the Bank of America / Merrill Lynch Non-Financial Developed Markets High Yield Constrained Index (HNDC), Hedged to USD, but caps issuer exposure at 2%. This index tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or Eurobond markets. The benchmark total returns do not reflect fees or expenses that would have been incurred if an investor individually purchased or sold the securities represented in the index. The performance benchmark was changed effective as of 31st December 2015 from the Bank of America / Merrill Lynch Global Non-Financial High Yield Constrained Index (HN0C) to the Bank of America / Merrill Lynch Non-Financial Developed Markets High Yield Constrained Index (HNDC), with all of the historic benchmark performance data now illustrating the performance of the Bank of America / Merrill Lynch Non-Financial Developed Markets High Yield Constrained Index (HNDC).

Fees: Returns are presented gross of management fees, custodial fees, and withholding taxes but net of all trading expenses. Net of fee performance results are calculated by deducting from the gross monthly return the maximum annual fee charged of 0.60% for the strategy shown.

Performance Results: Results are calculated using a time-weighted total-rate-of-return formula and are expressed in U.S. dollars. The composite is asset-weighted; individual portfolios are valued daily on a trade-date basis and include accrued income. The composite and benchmark results assume the reinvestment of distributions. Performance results include all portfolios under the Firm's management that meet the Composite Definition. A portfolio is included in the composite when it is deemed that the investments made by the investment advisor fully reflect the intended investment strategy. Past performance is not a guarantee of future performance.

Assets, Composite Dispersion, Ex-Post Standard Deviation: The asset base used to calculate the composite's percentage of Firm assets includes both discretionary and non-discretionary portfolios managed by the Firm, and also includes non-fee paying portfolios. The asset-weighted dispersion calculation measures the deviation of individual portfolio returns around the aggregate composite return. Only portfolios that have been managed for a full annual period have been included in the dispersion calculation. No Dispersion is reported for periods with five or fewer portfolios (shown as NM). The three-year annualized ex-post standard deviation of the composite and benchmark are displayed above.

HIGH TIMES FOR ACTIVE MANAGERS

Amid difficult market conditions, an active approach to high yield bonds may offer a safer route to returns

ROB ST GEORGE

Some investors may mentally equate high yield with high risk, but that need not be the case for those accessing the asset class through an active intermediary. Those taking a passive approach, on the other hand, necessarily accept the full market's risk.

'Allocations should be with an active manager favoring higher-quality securities, in our opinion,' said Christopher Hyzy, chief investment officer at US Trust. 'Current valuations lead us to be cautious on allocations to index-based solutions in high yield, as we prefer to be up in quality at this point in the cycle. While spreads could stay at current levels or grind tighter, especially if the economy continues to perform as we expect, the incremental rate risk and signs of excessive optimism – such as refinancing waves and collateralized loan obligation (CLO) activity – signal the risk/reward is unfavorable.'

The performance of active managers in the high yield space bears out Hyzy's view. As the table below shows, the average active fund has consistently outperformed the main high yield index.

AVERAGE TOTAL RETURNS IN THE US DOLLAR HIGH YIELD SECTOR

TIMEFRAME	AVERAGE ACTIVE FUND	MARKIT IBOXX USD LIQUID HIGH YIELD INDEX	AVERAGE ETF
1-year	5.8%	5.7%	5.5%
3-years	16.2%	16%	13.8%
5-years	25.2%	25.2%	22.5%

Data to January 31, 2018 / Source: Citywire (Performance net of fees)

Although the average fund has tended to beat the benchmark by only a few basis points, it is worth remembering that investors cannot buy

the index directly. Rather, they must access it via passive products that diminish that index's returns through their own fees and tracking errors. So while active managers are only just ahead of the benchmark, they do generate significantly greater excess returns than the average passive fund.

SLICK RETURNS

The elevated risks at this stage of the high yield cycle mean that it is also instructive to review the experience of managers in this sector during its most recent bear phase.

In 2015, the Markit iBoxx USD Liquid High Yield index dropped by 5% as the collapse in the oil price put many high yield issuers from the energy industry under pressure.

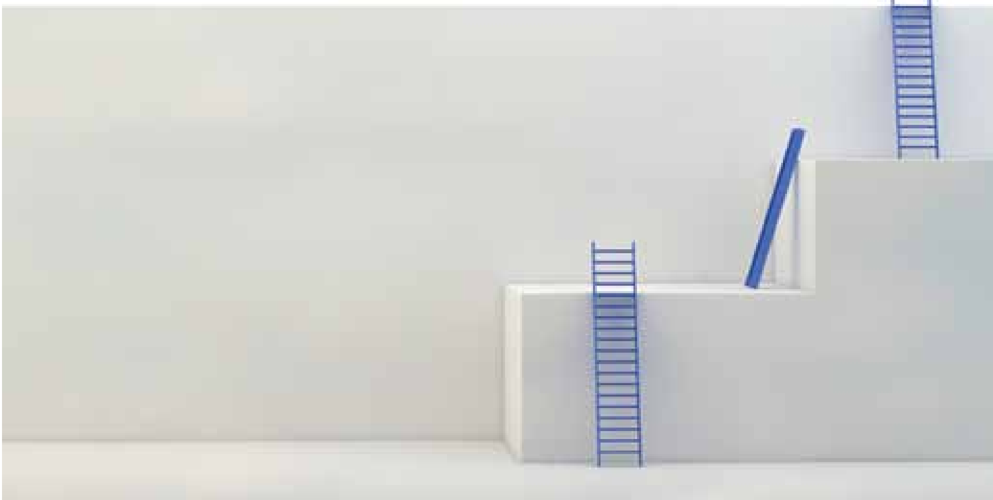
The average active fund managed to cushion that fall, slipping by only 4.3% that year. More impressively, the median manager – minimizing the skew created by the tail of strategies that had bet more on oil firms and lost heavily – was down by just 3.6%, outperforming the index by 140 basis points even after fees.

With data from Citywire Discovery, it is also possible to examine active managers' risk-adjusted numbers during this drawdown. In 2015, the average fund had an information ratio – which also takes account of volatility – of 0.57. For the year to January 31, 2018, the average information ratio is also positive at 0.17.

What's more, 2015 underlines the importance of maintaining a strategic allocation to high yield rather than attempting to time the market tactically. For the full year, investors pulled a net $41.7 billion from active high yield funds – equivalent to 15% of all the money in the category – mostly in the second half of the year as panic took hold. Those withdrawing from the sector not only locked in whatever losses they had incurred; they also missed out on a rally of around 25% that began in February 2016.

A COLD FEBRUARY

Today, investors are again taking flight from high yield. High yield bond funds have suffered net redemptions in 13 of the 15 weeks to early February, according to Bank of America Merrill Lynch Global Research. In the final four weeks of that period, global high yield funds saw a combined decline of $13.1 billion in their assets under management – the second largest ever, beaten only by the selloff of July 2014, which was prompted by Malaysian



> THE CURRENT REPRICING EPISODE HAS NOT MATERIALLY IMPACTED RELATIVE VALUATIONS
>
> **OLEG MELENTYEV**
> BANK OF AMERICA MERRILL LYNCH

Airlines Flight 17 being shot down over Ukraine. February's selloff follows a net exodus worth just shy of $22 billion from active high yield strategies in 2017, as recorded by Citywire Discovery.

Little of this pessimism seems justified. As the previous chapter set out, there are good reasons to expect a decent return from high yield over the medium term. But over the shorter term, too, investors should take some comfort.

The sell-off witnessed in early February provides a helpful case study. Although some had been concerned about high yield's correlation to equities, when volatility did strike, high yield bonds proved resilient. While the S&P 500 retreated by 4.3% in the month to mid-February, high yield was down by a much milder 2.3%.

'The flash crash in equities and a spike in equity volatility have made only a moderate impact on US credit and high yield so far,' said Oleg Melentyev, credit strategist at Bank of America Merrill Lynch. The negative effects were also felt more strongly in lower-quality issuers: BB-rated option-adjusted spreads were only 13 basis points wider in the week of February 5, the epicenter of the wobble, but the equivalent spread for CCC-rated credits increased by 34 basis points.

'Zooming out to the year-to-date interval shows the limited impact of this episode on our market,' Melentyev explained. The high yield index was flat to mid-February in total return terms, with BBs down by 0.6% and CCCs up by 1%. But in terms of excess returns, Melentyev pointed out that all of these segments gained roughly 1% or 2% through that month and a half. This contrasts with an actual loss of 1.8% on a total return basis in investment grade bonds and a 1.1% advance in loans over the same period.

GET BACK IN

'In credit, we made an argument that some giveback of recent gains is likely, and yet it is too early to be underweight the credit risk,' Melentyev said. 'Again, the relatively stable performance in high yield in the face of extreme moves in equities falls in line with our expectations.'

For those who expected far worse numbers from high yield amid the volatility in equities but have since been satisfied with high yield's solidity, Melentyev highlighted some potentially attractive re-entry points.

'The current repricing episode has not materially impacted relative valuations, as most quality components have moved more or less in unison,' he acknowledged. 'As such, we recommend adding to CCC risk here following some widening in recent days to bring the positioning back to modest overweight. We also like the spread curve flattening trades in BBs, where we previously advocated for overweight in long-duration versus short-duration BBs, hedged for interest rates. After the January move in rates, we thought this positioning makes sense even without hedging interest rates. We continue to like this trade from current levels.'

Of course, for those unwilling or unable to make such micro high yield calls for themselves, active managers are commended by their track record through both strong and weak markets. The challenge for fund buyers is maintaining a long-run exposure to credit risk that can be so highly rewarded by the market in cycle after cycle.

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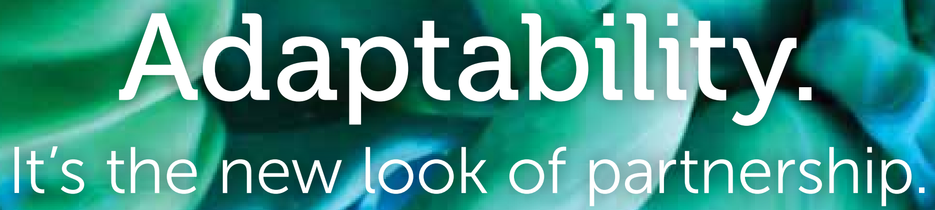

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