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Multi Sector Fixed Income Whitepaper

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Welcome to CAMRADATA's Multi Sector Fixed Income Whitepaper

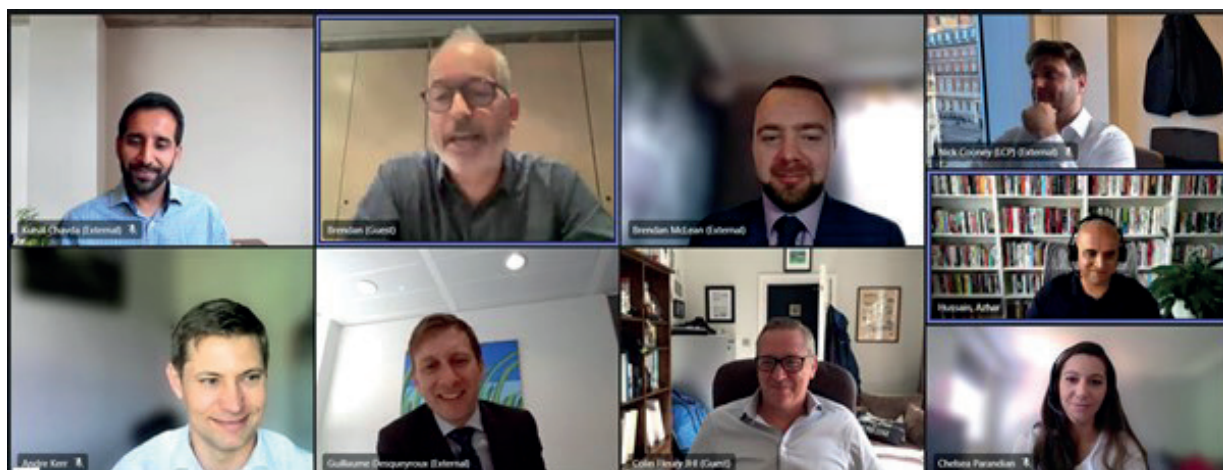
So far 2022 has proven torrid for credit investors. Few strategies look good on an absolute-return basis. Some respite in May has led glass-half-full commentators to suggest that the worst may be over – that there are buying opportunities thanks to markets' overly hawkish expectations of tightening by the Fed. The conditions which have brought us here are, however, so extraordinary that clarity, if not optimism, is in short supply. There is little guidance from previous episodes of rising inflation. Parts of the economy are still suffering from lockdown damage; others are reviving strongly. Higher prices are hurting consumers and yet many are richer than they have ever been thanks to furlough and enforced thriftiness over the past two years. War has stoked commodity prices at a time when the global economy is taking tentative steps to alter its energy mix.

These complications read across to bond markets, where lower-rated credit hides some zombies that have survived hitherto on rock-bottom rates; overleveraged businesses controlled by private equity; some great opportunities ready to bounceback from the pandemic; and stable payers that are none of the above.

This CAMRADATA whitepaper will examine how Multi Sector Fixed Income, with relative freedom to invest across fixed income markets, have fared during recent turbulent times; and how they can serve investors in the years ahead.

Multi Sector Fixed Income Roundtable

The CAMRADATA Multi Sector Fixed Income Roundtable took place in London on 21st June 2022.



MARKETS SUFFERED BADLY in the first half of 2022, with very few bond indices in positive territory and several exhibiting double-digit losses. By the third week in June, Loans were down 4% while High Yield had lost 13% and Investment Grade (IG) almost 15%. Inflation, exacerbated by the Russian invasion of Ukraine and Covid-related supply chain blockages, forced policymakers into action.

The CAMRADATA multi-sector fixed income roundtable thus began by reviewing bond markets and discussing whether there had been refuges for go-anywhere, long-only strategies. Guillaume Desqueyroux, co-manager of the Sanlam Credit Fund and invested mainly in Global IG, High Yield (HY) and Unrated, said that the shorter the duration in your portfolio, the better: "The inversion of the curve was painful but still the best place to be." He included cash as an option here.

Colin Fleury, co-manager of Janus Henderson's Multi-Asset Credit Strategy (MACS), said that securitized and floating-rate issues had been "relative saviours". Both outperformed significantly on a total return and excess return basis, although that still left drawdowns.

He highlighted Asset-Backed Securities (ABS) for taking out some of the rates impact.

Fleury stressed that the Janus Henderson MACS had been tactically favouring loans and securitized before this year. "We have started looking the other way as High Yield got cheaper," he said.

His final mention was for cross-over index protection trades. "They haven't saved us but did deliver some protection."

Azhar Hussain, head of global credit at Royal London Asset Management and co-manager of its MACS, said that cash has been the only saviour so far this year. He has held 5-10% in the strategy. Loans he did describe as a safe haven, although he qualified that they have insulated against rate volatility, not spread volatility.

Gowies, Hussain joked, were not even return-free investments these days, down more than most credit indices. He said that being active in High Yield had really helped "set us up nicely for an environment that is full of uncertainty."

Kunal Chavda, director, fixed income research at bfinance, confirmed the managers' summaries: "Everything had been

really badly hit this year with few places for credit investors to hide," he said. "The efficacy of diversification across credit asset classes to mitigate the downside from risk-off events has been reduced."

Looking to the wider picture, Chavda said that the impact of inflation on supply chains was proving hard to unwind, meaning fundamental credit analysis remains key.

Andre Kerr, head of investment research at XPS Group, a pension fund consultancy, saw one small comfort in that the strengthening dollar might have dampened losses. He agreed that cash is always a safe haven, but noted that defensiveness was being eroded by rising prices.

Kerr suggested that illiquid assets, an increasing percentage of pension funds' total allocation, might have had some protection. Fleury questioned whether illiquids looked resilient merely because they weren't marked to market. He noted that Private Credit strategy returns seem to still be marketed around 6-8%. "That range hasn't moved for a while. If that is true, then public markets are now a

“I hear this phrase ‘unprecedented’ a lot from managers, but I disagree with that: what we have seen are extremely rare conditions, but not unheard of or unpredictable.”

screaming good buy,” he said.

Nick Cooney, senior consultant at investment advisory firm, LCP said that Private Credit was not part of MACS in LCP's categorisation. He explained that the firm did recommend one MAC at the high end of returns that could allocate over 50% to CCCs. Other recommendations, however, are lower risk, lower return.

On Private Credit, Cooney said the valuation argument was relevant. “It's a question in the current environment whether to have private credit or liquid bonds.” He suggested investors had more control over private credit than covenant-lite public issues which offered fewer actions to take against borrowers, but relative valuations in the current environment were important.

Chelsea Parandian, Senior Investment Consultant at Aon, a global investment consultancy, said: “I just don't think there have been many places to hide in 2022. I hear this phrase ‘unprecedented’ a lot from managers, but I disagree with that: what we have seen are extremely rare conditions, but not unheard of or unpredictable.”

She noted that some managers had made prudent moves before the Russian invasion, including into shorter-duration High Yield and commodity-linked issuers.

Brendan McLean, head of investment research at Spence, a UK pension fund consultancy, said that higher-risk, higher-return MACS had generally fared better than their lower-risk, lower-return peers. “It is counter-intuitive in falling markets,” he said, “but greater exposure to Loans was a major explanatory factor due to their low duration.”

No flight to safety

Managers were then asked how they would rate their strategy's performance for the first half of the year? “We've been in line with our promises,” responded Fleury. “We have said that we are a low-duration fund. That hasn't always helped us before in periods like March 2020. However, we have stayed true to that and it has helped our relative performance in 2022. We have said we would expect to perform relatively well in a rising inflation, rising rates environment and we have seen this play out. We have also said that we would expect to generally outperform peers in more challenging credit market conditions and it appears this has been the case.”

Regarding benchmarks, Fleury said Janus Henderson's MACS tended to outperform a 50/50 High Yield/Loans index during difficult market environments and we saw this again in the first half of 2022.

For RLAM, Hussain said he too used a 50/50 benchmark, and is 50 bps up this year on that composite so far, which he rated as an okay interim result: “We are where we should be from a risk perspective. We are highly liquid. There is currently virtually zero Emerging Market and IG allocation, while exposure to short duration is pretty high.” He said RLAM was starting to bring the Loans basket down.

“Europe is likely in recession, with the U.S. not far behind,” said Hussain. “We are focused on the impact on the credit markets here, and given the high levels of uncertainty aren't trying to guess the minor policy decisions. From a positioning perspective you could say we are ‘hiding in the front end’.”

He was pretty confident that

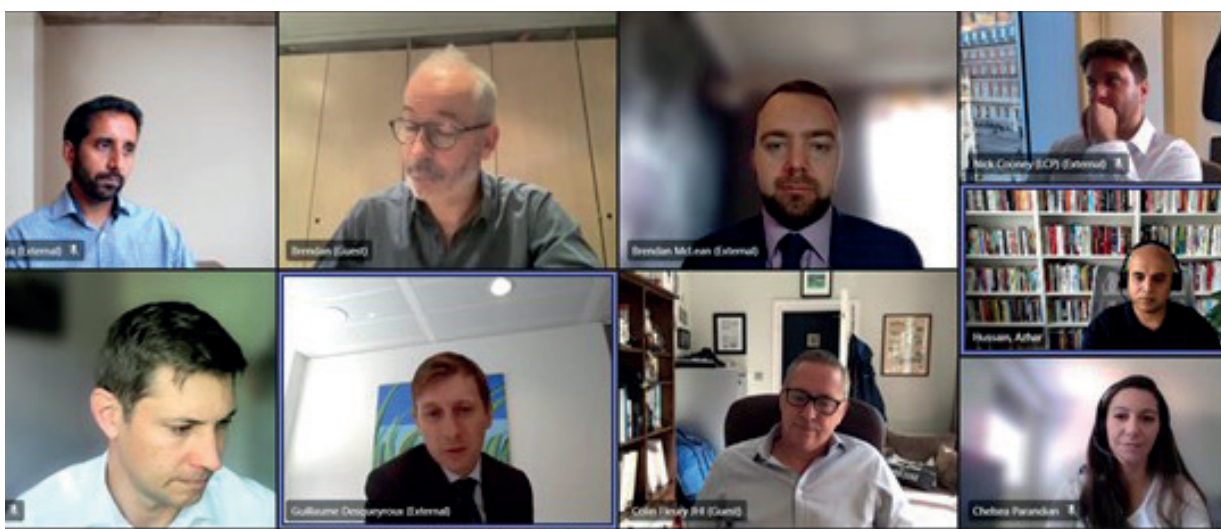
there will be positive returns over the next two years. But he warned asset owners to be prepared for much more pain, especially in private markets. “I have never believed in the illiquidity premium argument for large-scale private credit, as most of that yield premia was for additional risk. Given current valuations between public and private debt, I do think currently we have an illiquidity discount, as you are getting paid less in private credit markets for more risk and more illiquidity,” said Hussain. “Paying a premium not to be told the prices until it blows up; that's not a particularly nice place to be and that's the state of the current private credit market. Given the amount of capital raised in private versus public markets, it's not a surprise that the risk is concentrated here.”

Hussain reckoned that public markets would be beneficiaries by not being contaminated by this shake-out.

Regarding the Sanlam strategy, Desqueyroux said he was disappointed with the negative performance number year-to-date but satisfied with how the Fund has held up against its peers in the tough market backdrop.

He described the Fund's returns as consistent. “We are happy to sit through the next cycle,” he said. “Basically, we manage financials: they do the heavy lifting in the strategy,” he explained. “Non-financials complete the portfolio and secure the liquidity.”

Desqueyroux foresaw an encouraging outsized alpha in portfolio names when markets come back. “A 1-to-2-year exposure to BBB non-financials can be very rewarding in today's markets. We



“High Quality saw a real reversal of fortunes, said Cooney. The moral was that different styles work in different regimes.”

keep eyes on players who will offer rate-sensitivity,” he said. “The High Yield lifeline might break.”

On manager performance, Cooney said it was quite noticeable the managers after COVID who looked good on a risk-return chart. He saw differences between these performers and other MACS with shorter duration. That changed again with this drawdown versus March 2020, sending others into the top quartile. “High Quality saw a real reversal of fortunes,” said Cooney. “The moral was that different styles work in different regimes.”

Cooney added that funds’ structure had played a part - UCITS limits on Loans has been detrimental in some cases.

Kerr noted that in previous market volatility, there has been a flight to quality and MACS had performed relatively well. “This year, with the exception of cash, there has been nowhere to put your money and get growth,” he said. He noted, however, that trustees weren’t questioning or complaining. “They have been quite understanding, cognisant of the situation in Ukraine. They are not finding fault with their managers, which is reassuring for them,” said Kerr.

Fleury then responded to McLean’s comment on the fortunes

of higher-return-target managers.

“At the start of the year, weaker credits did relatively well when it was more of a rate-volatility story. As markets have started to price in the risk of recession, this dynamic has changed.”

Black Swans in the vicinity

Parandian then asked the managers if they saw more shocks ahead.

“I am more of a pessimist,” she admitted. “What would be the black swan event in the second half of the year?”

Hussain said it was a tricky question to answer when the black swan was a metaphor for what you never expect to see. Nevertheless, he suggested turning off the gas flowing into Germany would be the catalyst to tip Europe into recession.

“I’ve seen forecasts of a shrinkage in GDP of 3-12% as a result,” he said. “It’s an incredibly high risk: spread duration rather than rate duration protects you here.”

Hussain recommended simplifying investment decisions, with an emphasis on cashflow predictability. “If it is a deep recession, be prepared for it. Don’t be too greedy.”

He said RLAM’s yield was currently almost 8% with spread duration of only 2-3 years, which he described

as very healthy characteristics to buffer against a rise in defaults.

“We have financials who’ve taken a bit of a haircut,” said Desqueyroux, “which is definitely a stockpicking consideration. The flight to quality didn’t happen but in the next few months it might.”

Switching scope to the micro, he recommended big names that had sorted out their cost base and customer loyalty, thereby improving their strong value-chain. “In High Yield, you can envisage companies with smaller balance-sheets with targeted pieces of the value-chain, and more likely price-takers. If these issuers hadn’t sorted out their cost structure last year, they will feel the pressure,” warned Desqueyroux.

He did note that with short-duration holdings, even if there are company-specific problems, the Sanlam Credit Fund will see 20-25% of its capital coming back within twelve months. With this cash to reinvest, Desqueyroux described its current strategy of small steps to improve credit notches while still pushing the yield up by 1-2%. “That is our mindset,” he said.

“Earlier in the year we felt we had to compensate for losses. Now we move closer to the safe places higher up the capital structure.”

Fleury concurred that recession was almost certain in many Developed Markets but may not happen simultaneously across countries. “Central banks find themselves in a position where they need to engineer a slowdown to control inflation,” he said. “We are

therefore structurally cautious.”

Fleury said that assessing the market implications of a Black Swan event (such as major gas supply interruption in Germany) is complicated by the possible reaction functions of central banks and governments, which are hard to predict. “As a manager, you have to work through scenarios rather than just base cases,” he said.

“We tend to go back to trying to find good credits,” he continued. “If we can avoid those worst-affected companies and sectors, then over the long run we can avoid defaults materially eating into that 8% yield.”

Fleury felt that Desqueyroux was perhaps oversimplifying with his division of Investment Grade and High Yield vis-a-vis pricing power. “From a business perspective, a large HY company may have as much pricing power as an IG one,” said Fleury. “It is true that an IG company may have greater financial resilience to absorb costs that they cannot pass through.” But he noted the market price risk of an ailing IG issuer slipping to below IG.

“It’s an unusual environment,” said Hussain. “Companies have built up inventories that won’t get sold. Auto suppliers, for example, are de facto leveraged liabilities for the car manufacturers. They aren’t on balance-sheet but the latter cannot function without them.” He suggested supermarkets were in a similar relationship with their big suppliers. Thin margins exacerbate this problem and were the suppliers to go bust, supermarkets would suffer. To complete the picture, Hussain noted that as a result of two major leveraged buy-outs, more supermarkets in the UK had fallen to High Yield status, with much of that debt sitting in private credit hands

“The background seems dark,” said Parandian, “but as so often is the case, we see concurrent opportunities. When is the right time to buy into weakness?”

Hussain replied that you look for contractual cashflows, from the likes of cable operators. “It’s not just about ratings. If you look at BBB-, it is an incredibly risky segment

“In fast-moving environments such as this, consultants need to stay close to managers to understand the thinking process behind changes to portfolio asset allocation on both a strategic and tactical basis.”

of the market. High Yield, on the other hand, has become higher quality than historically; and the BB names in the HY market look pretty resilient.”

Desqueyroux saw attraction in cashflows from utilities via their senior debt. Within Financials, he recognised that the banks have had a tough time on the equity side but that has resulted in a decade of improving capital strength.

Sanlam is even more constructive on insurers. Desqueyroux noted that they do not take the direct hit from soaring food or energy prices. Having said that, they will face inflated claims but Property & Casualty departments will have the opportunity to readjust premiums. And that is after a period during COVID of low claims. “In the last few years insurers were facing a lower-rate environment urging them to get a more efficient operational model. Now their investment portfolio will also contribute to the bottom line,” he said.

On income, Fleury said the Janus Henderson MACS was achieving around an 8% yield. “That yield is going up if rates go up because so much of what we own is variable-rate,” he added. Like Hussain, he reckoned that the Janus Henderson MACS strategy has a material income cushion to absorb losses if they come through.

On macro-politics and dark shadows, Kerr said that Germany can afford to continue to use fossil fuels for its energy production even if it strains the national commitment on decarbonising. He could not, however, see the Ukraine conflict ending quickly. “It could take years to resolve, which will have a huge impact on inflation in energy, transportation and grains.”

For Kerr, that matters more for bond portfolios than equities. He said that consumers’ changes

of habits of consumption come through in credit spreads faster than equity prices.

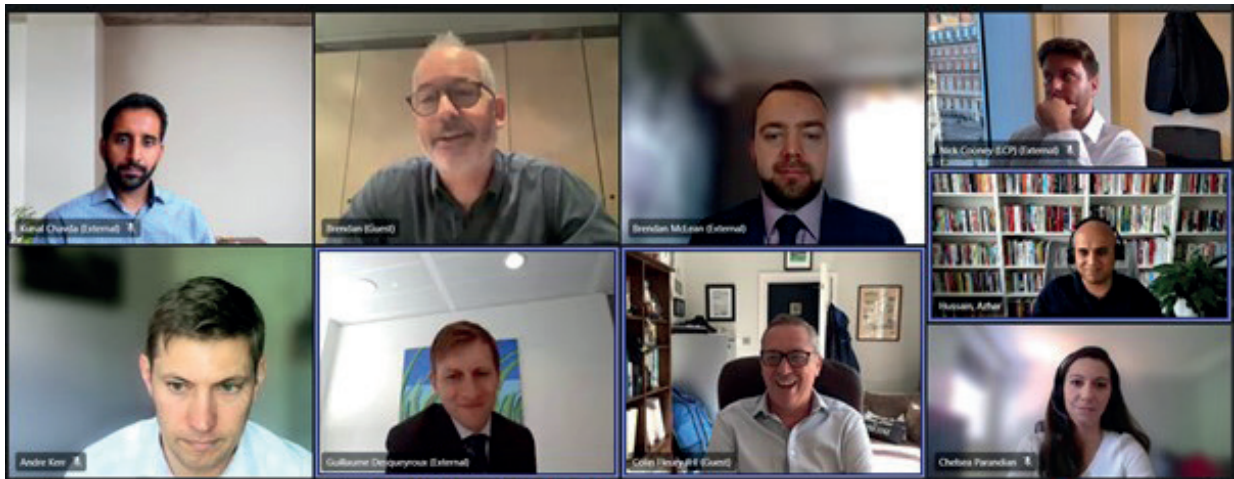
Chavda said that from his perspective, consultants are much less equipped to forecast macro-shifts than asset managers: “In fast-moving environments such as this, consultants need to stay close to managers to understand the thinking process behind changes to portfolio asset allocation on both a strategic and tactical basis.”

He said he was less pessimistic than Kerr about fixed income. He distinguished, especially with regards to MACS, between high conviction and high returns: “When it comes to fixed income, for the most part investors are not expecting to shoot the lights out; it’s more of a measured approach to seeking the best risk adjusted returns with a view to minimising the downside. Those MAC strategies that focus on sub-investment grade securities need to take a higher conviction approach to portfolio construction as they are more exposed to the asymmetric nature of the fixed income risk profile and subject to a lower degree of liquidity in their underlying assets.” said Chavda.

New frontiers

Cooney then explained a research project he conducted at LCP’s research partner (Frontier Advisors) in Australia to look at attribution of returns by MACS: the twin goals were to work out how to assess a manager by security selection with regard to outperforming an index; and secondly, manager skill in terms of dynamic allocation between sectors of credit.

“It is difficult to assess individual credit selections,” Cooney told the CAMRADATA panel. “But if you look at sector rotation between sub-classes, such as Loans and



High Yield, there is not much evidence that managers could switch at the best times." There was evidence, however, for beneficial "off-benchmark" sector allocation. Managers who went looking beyond Loans and High Yield could increase returns considerably. "Looking at managers over time, they trace a line: High Risk; High Return," said Cooney. "But when they add more sectors, they start to go to the top left of the chart. We found managers doing a bit more in the tool kit were adding value and expect this to hold in the current environment."

McLean said multi-credit managers in the previous period had outperformed more because of their top-down, asset allocation calls but now, in a much more dislocated world, active stock selection is going to add the most value.

Hussain agreed. "Post-Global Financial Crisis, it has been a pretty benign climate," he said. "Defaults haven't been significant; central banks have rode in hitherto to support markets. Now we are likely to be in a structurally higher default climate. So this time is different. We are not in control of every risk, especially in High Yield, so it's really important to know your credits on a bottom-up as well as top-down perspective. There is a long tail of names for which you don't know the likely outcome in a recession, so you could end up with far more losses by being overdiversified."

Kerr was asked whether multi-sector credit managers were

"Ultimately managers need to be better at demonstrating the impact of their dynamic asset allocation decisions and how these differ from mechanistic rebalancing."

claiming top-down allocation skills when in fact it was mechanistic rebalancing, something that would have happened anyway. Kerr said: "We see some of this: managers using asset allocation to hedge divergence in return-targeting." But he reckoned that ultimately it was hard to attribute skill in allocation calls. "Ultimately managers need to be better at demonstrating the impact of their dynamic asset allocation decisions and how these differ from mechanistic rebalancing."

Kerr did follow McLean and Hussain's point that stock selection was going to matter going forward because we have had such a benign environment for credit throughout the last decade.

Desqueyroux said that we are experiencing an ongoing difficult situation, which governments would be tempted to address as before. "We have created an addiction. I struggle to see a sustained recession without further intervention." But he said it was hard to predict which sectors will be well looked after. That kind of unknown would impact portfolio management.

Kerr suggested that the cynical take on rising rates from the Fed and Bank of England was to give them headroom in eighteen

months' time to cut rates.

"I don't think that is a cynical view at all," responded Fleury. "It's a natural reflex of central banks given the position they are in."

He said that the jury is still out how quickly consumer demand will turn around. He sensed that recessions were still six to eighteen months away.

"From a rate perspective, the US has a real inflation issue," he said. "This is not just about commodity prices: there is wage inflation there."

Desqueyroux added there were already comments coming from U.S. companies that they have overstaffing and will be freezing hiring and IT projects. On the U.S. labour force, he noted that over the last five years there has been a 700,000 shortfall due to a lack of immigration but also early retirement during Covid. The latter may have to partially come back in a recession scenario.

"Although I feel fundamentally cautious, I believe that now will still prove to be a good time to invest in MACs," said Fleury. "There is risk of more spread-widening, but I believe it will turn out to be a decent time to be investing, especially if our stockpicking remains strong and we use the asset allocation optionality within the strategy well."

Roundtable Participants



Colin Fleury

Head of Secured Credit

Personal Profile

Colin Fleury is Head of Secured Credit and co-manages the Multi-Asset Credit and Asset-Backed Securities strategies at Janus Henderson Investors. Prior to joining Henderson in 2007, Colin held secured credit portfolio management roles at Deutsche Bank AG and Abbey National Treasury Services plc. He also has secured debt structuring, underwriting, and advisory expertise from roles at Shell International, where he was a senior advisor on the M&A and financing team, and at Credit Suisse, where he was a vice president in the global project finance group. Colin's early career also includes experience in secured UK real estate and SME corporate lending and spans multiple jurisdictions in Europe and worldwide.

Colin is an associate of the Chartered Institute of Bankers and a graduate of the Credit Suisse Corporate Finance and Capital Markets Programme. He has 36 years of financial industry experience.



Janus Henderson Investors

Company Profile

Janus Henderson is a global asset manager with more than 340 investment professionals and expertise across all major asset classes. Our individual, intermediary and institutional clients span the globe and entrust us with more than £274.2bn of their assets*. Our commitment to active management offers clients the opportunity to outperform passive strategies over the course of market cycles. Through times of both market calm and growing uncertainty, our managers apply their experience weighing risk versus reward potential – seeking to ensure clients are on the right side of change.

**Source: Janus Henderson Investors. Staff and AUM data as at 31 March 2022. AUM data excludes Exchange-Traded Note (ETN) assets.*

Roundtable Participants



Azhar Hussain
Head of Global Credit

Personal Profile

Azhar has 21 years direct experience of investing in an array of strategies across the Global Fixed Income and Leveraged Finance arenas. He trained as a chartered accountant with Deloitte before starting his investment career as a high yield credit analyst at Gulf International Bank in London. He subsequently became Head of Corporate Debt responsible for IG & HY absolute and relative return strategies. He left to join Insight as Head of HY & Leveraged Loans before joining RLAM initially as Head of Global High Yield where he has successfully launched strategies across the Global Credit spectrum.

Azhar holds a BA in Economics & Law from SOAS, University of London and obtained a MSc in Behavioural Science from the London School of Economics in 2018.



Royal London Asset Management

Company Profile

Royal London Asset Management (RLAM) is one of the UK's leading investment companies, having built a strong reputation as an innovative manager, investing across all major asset classes. RLAM manages over £163.8 billion of assets (as at 6 April 2022), split between equities, fixed interest, multi asset investing, property and cash, with a market leading capability in sustainable investing.

Products include funds and segregated accounts investing in government bonds, investment grade, high yield and unrated credit, equity income and equity growth across global developed markets, as well as UK property and cash and short-term money market instruments.



Guillaume Desqueyroux

Fund Manager

Personal Profile

Guillaume holds an MBA from the University of Dayton (USA), a Masters from Toulouse Business School (France) and is a CFA Charterholder.

After a spell at KPMG, Guillaume joined HSBC and its credit risk department for 4 years before joining Peter Doherty to lead the internal credit research in 2016.

Guillaume has gradually specialised in Financials and their subordinated debt to generate extra alpha for the various risk appetites of the funds. He also moved into a Portfolio Manager position since 2018.

Guillaume manages the Sanlam Credit Fund, Fixed Interest Fund and the Short Dated Fund with Darren Reece and supports Peter Doherty in managing the Hybrid Capital Fund.



Sanlam Investments

Company Profile

Sanlam Investments is an independent boutique asset management business based in the UK.

Specialising in providing differentiated strategies to investors, we are the international investment engine for our parent, the Sanlam Group. This means we have all equity alignment, autonomy, agility and above all the hunger for success that makes us a boutique asset manager, but with the stable backing and resources of a much larger investment house. We take our roles as stewards of our clients' assets and good corporate citizens very seriously. We incorporate dedicated ESG research into all our investment decisions and actively engage to bring about change.

Roundtable Participants



Chelsea Parandian

Senior Investment Consultant

Chelsea Parandian is a Senior Consultant in Aon's Investment Manager Research team who specialises in Fixed Income. Her expertise spans liquid credit including Multi-Asset Credit and Absolute Return bond funds. In addition to her role, Chelsea also leads on integrating Diversity, Equity & Inclusion to Aon's manager research. Prior to Aon, Chelsea worked on the Fixed Income & Alternatives research team at Stanhope Capital and prior to that at EIM Ltd.

She holds a BSc in Management from Bayes Business School (formerly Cass Business School).



Kunal Chavda

Director, Fixed Income

Kunal is a Director within the Fixed Income team focusing on multi-sector fixed income strategies, structured credit and LDI solutions. Prior to joining bfinance in March 2020, Kunal worked as a Senior Consultant at Buck, where he led all public and private market fixed income research and strategy for UK pension schemes.

Kunal previously worked as a portfolio manager at Barclays Wealth & Investment Management, running a book of multi-asset and fixed income portfolios focusing on Court of Protection, charity and corporate clients. Prior to this he worked at the bank's corporate banking arm. Kunal holds a degree in Mathematics from the University of Birmingham.





Nick Cooney

Senior Consultant

Nick is a Senior Consultant at LCP in London and is responsible for high quality investment and manager research across a range of global fixed income opportunities. He has international experience helping some of the world's largest institutional investors meet their objectives and has expertise across traditional credit and more esoteric solutions.

Nick is Head of Liquid Credit at LCP and is a senior member of the Private Credit Team. He has a degree in Economics from Durham University and is an MBA Candidate at DUBS.



Brendan McLean

Head of Manager Research

Brendan is Head of Manager Research and is responsible for recommending and monitoring investment managers across all asset classes. He joined Spence in 2017 after working for a variety of firms, including an investment consultant and a family office.

Moderator



André Kerr

Partner - Head of Investment

André joined XPS' Investment Consulting practice in 2017 and heads the Leeds Investment team, providing all aspects of investment advice to UK defined benefit and defined contribution pension schemes.

André is head of XPS' Fiduciary Management Oversight Service. Prior to joining XPS André spent 4 years providing investment advice to UK pension schemes on a delegated basis. André also sits on the committee shaping the industry standard for evaluating the performance of fiduciary management and is a qualified actuary.

André is a senior member of XPS' credit research team and is actively involved in researching illiquid credit opportunities, he has been involved in credit research for 9 years, during which he worked on a multi manager credit fund.



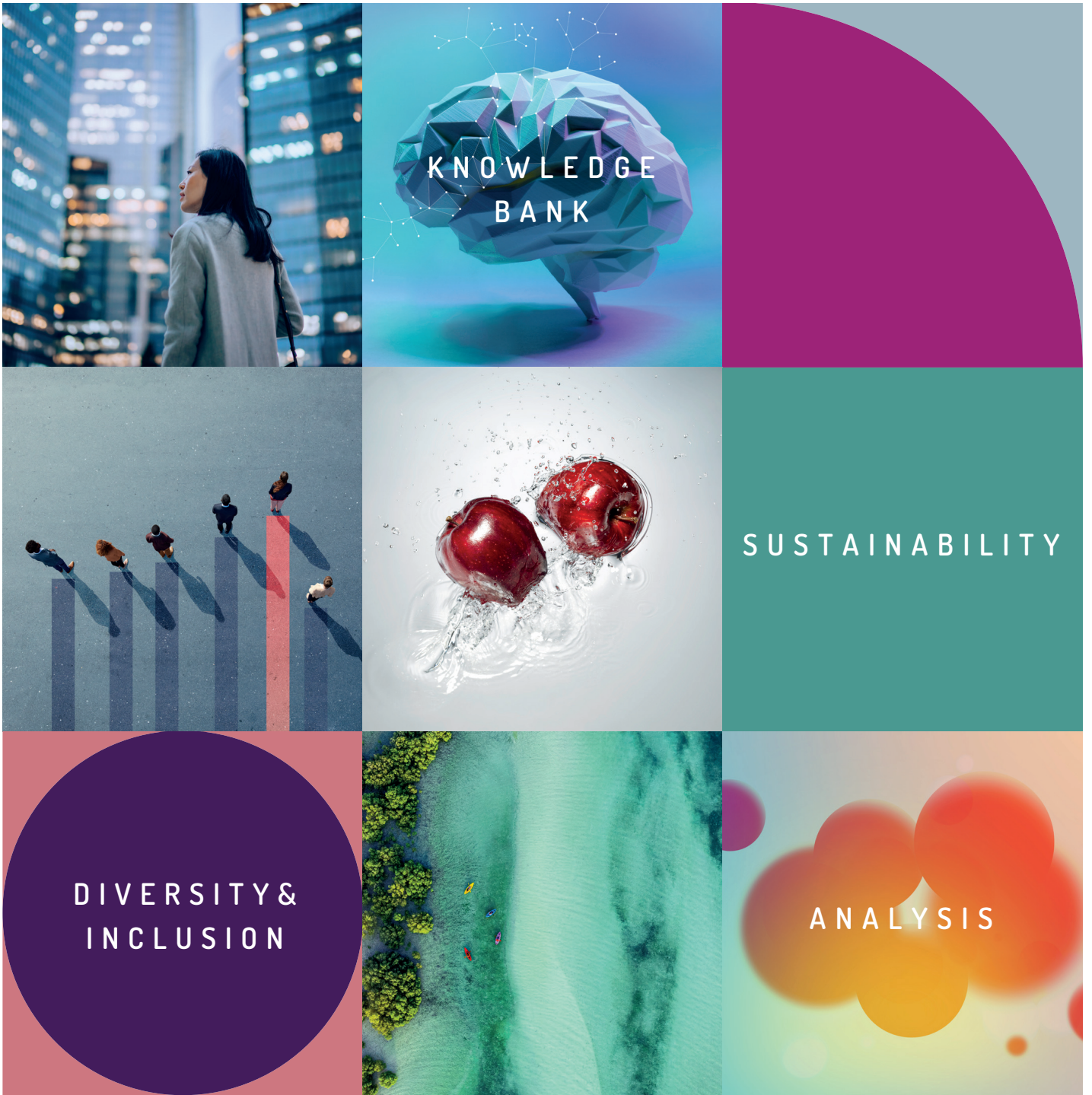
Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees. He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE. Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.



Bringing data to life

We provide institutional investors, including pension funds, insurance companies and consultants, with data and analysis to assess, research and report on their investments.

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CAMRADATA

A bird in the hand: are yield returns king again?

Janus Henderson
INVESTORS

“As investors consider their portfolio positioning, we believe managing duration in both equity and fixed income within a multi-asset portfolio can yield favorable results relative to a duration-agnostic approach.”



Author

Seth Meyer

Portfolio Manager, CFA

Warren Buffet, CEO of Berkshire Hathaway, famously said the following during a speech at Allen & Company's 1999 Sun Valley Conference: *“Now, Aesop was not much of a finance major, because he said something like, ‘A bird in the hand is worth two in the bush.’ But he doesn't say when.”* Mr Buffet went on to say that the cost of borrowing determined the price of when. *“And that's why,”* he continued, *“sometimes a bird in the hand is better than two in the bush and sometimes two in the bush are better than one in the hand.”*

Mr Buffet was pointing out that the current value of a financial asset is not only affected by the level of interest rates and expected future returns, but also by the timing of future returns. In essence, the further into the future the payoff on an investment, the more sensitive it is to changes in interest rates. All else equal, in a falling rate environment, investors are rewarded for investment returns to be received further into the future (think growth stocks and long duration bonds), while in a rising rate environment, investments that have a shorter payoff duration tend to fare comparatively better (think value stocks and short duration bonds).

Mr Buffet shared this anecdote at a time when technology stocks were enjoying record price returns and sky-high valuations. What he was paying attention to was that at the time, interest rates were already on the rise, and the higher discount rates were going to smack the prices of growth stocks whose nosebleed valuations were predicated on the expectation of profits a very long way in the future. In many ways, the backdrop of 1999 might not be too dissimilar to the environment in which we presently find ourselves.

Exhibit 1 illustrates this concept. Two hypothetical investments have the same \$100 payoff, but their payoffs take place in different years. Ignoring the effect of reinvestment, Investment A, with a payoff in year 3, performs relatively better when rates fall, while Investment B, with its payoff in year 1, does relatively better when rates rise.

Exhibit 1: Hypothetical impact on asset prices in rising and falling rate environments

Hypothetical investment	Payoff profile	Change in present value if:	
		Rates fall from 3.5% to 1.5%	Rates rise from 1.5% to 3.5%
Investment A	\$100 in year 3	+6.0%	-5.7%
Investment B	\$100 in year 1	+2.0%	-1.9%

Source: Janus Henderson Investors.

Expanding the Application of Duration

While our example is a simple one, if we take this concept to the real world and extend the timeline of the expected payoff, and if the change in interest rates becomes more pronounced, the “when” effect substantially impacts relative returns between asset classes, all else equal.

The sensitivity of asset prices to the timing of returns is a concept with which bond investors are well acquainted. But while duration has typically been an important risk to evaluate within bond allocations, it isn't as much discussed regarding multi-asset portfolios that include an allocation to equities. There are legitimate reasons for this, most notably that duration is more difficult to quantify on equity securities because the terminal value is unknown (unlike a bond), and cash flows are variable, unlike stable bond coupons. There is, therefore, a high degree of ambiguity in calculating duration on equities.

Nonetheless, in our opinion, it's safe to say that equities are typically long-duration instruments. According to a 2010 paper from S&P Indices (Blitzer, Dash & Soe), between 1976 and 2010, the long-run historical average duration of the S&P 500® Index was 23.7 years.

High yield bonds – a low duration option within equity allocations

As investors consider their portfolio positioning for a higher rate environment, we believe managing duration on both the equity and fixed income sleeves within a multi-asset portfolio can yield favorable results relative to a duration-agnostic approach. As we think about managing duration in an equity sleeve, investors might consider using high yield bonds to achieve that purpose, for the following reasons:

1. High yield historically has been positively correlated to equity markets – the 30-year correlation on the Bloomberg Corporate HY Index and the S&P 500 is 0.64. If this positive correlation continues, investors may be able to rely on high yield fixed income to compliment, and move in correlation with, their equity allocations.
2. Low duration – going back to 1992, the duration on the Bloomberg Corporate HY Index has averaged 4.2 years, considerably lower than Blitzer's estimated 23.7 years for the S&P 500®. Therefore, if investors are looking to be more defensive and reduce overall portfolio sensitivity to interest rates, an allocation to high yield bonds within their equity sleeve may help to achieve that.
3. Returns and risk – while high yield bonds have a significantly lower duration, the asset class has still been able to capture over 70% of the return of the S&P 500 since July 1992. (For the 30-year period from 1 July 1992 to 29 June 2022 the Bloomberg Corporate HY Index returned 6.9% annualised, compared to 9.8% for the S&P 500). Therefore, we believe that by adding high yield to equity sleeves, investors can play duration defence without being entirely "risk-off".

Exhibit 2: High yield calendar year returns vs. intra-year declines

Annual returns in high yield have been positive in 18 of 24 years, with lower intra-year drawdowns than the S&P 500



Source: Bloomberg, J.P. Morgan as of June 21st, 2022. YTD = year to date. **Past performance does not predict future returns**

Who is king of the castle?

It's been a long time since anyone has uttered the term, "Cash is King". Since the Global Financial Crisis, cash has been anything but King. But, in our view, if interest rates continue to rise, and remain elevated, higher yielding assets make sense for investors aiming to reduce overall portfolio duration while still maintaining exposure to risk assets. The higher yields on high yield bonds have pushed their real yield close to positive territory, while real yields on equities and cash remain deeply negative. Furthermore, with the recent sharp move up in Treasury yields and the widening of credit spreads, the yields on high yield bonds are close to being as attractive as they have been since the GFC, excluding the COVID selloff. In our view, this presents an attractive buying opportunity in high yield. And while it is possible that yields remain at, or increase further from, current levels, yields have historically tended to rally expediently after rising above 8.5%. Since January 2011, the Bloomberg Corporate High-Yield Index has only closed above current yield levels (+8.5%) on less than 7% of all trading days.

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Multi-asset credit: ideal for times like these

Azhar Hussain, Head of Global Credit at Royal London Asset Management (RLAM), argues that global high yield credit should have wider appeal, and that active multi asset credit funds are the perfect way to get this exposure.

Global high yield credit isn't for everyone, yet more investors could consider this asset class given its considerable yield attractions. The market has evolved hugely over the last 15 years and is now larger and of a much higher quality than during the Global Financial Crisis. With Covid providing the opportunity to issue new debt or refinance existing credits at ultra-low interest rates, high yield companies have pushed out debt maturities and are in particularly good health for this stage of the cycle.

Surely this is a bad time, though – with interest rates rising sharply and a likely recession within the next 12 months? A slowdown, particularly if it's a hard landing, would not be good news for high yield as defaults would increase. After all, while we might have been able to accommodate the initial need for higher interest rates, the subsequent invasion of Ukraine amplified the risks and we became more defensive.

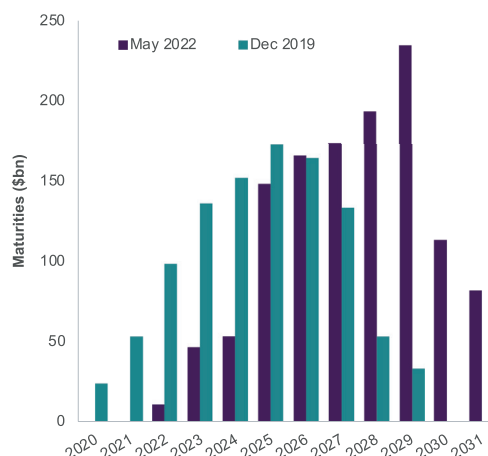
“High yield companies have pushed out debt maturities and are in particularly good health for this stage of the cycle.”

Default risk is overvalued

The high yield market is somewhat unsophisticated in its approach to defaults, however – it prices the possibility of defaults off previous cycles with no real consideration of the state of the prevailing market. With high yield spreads at over 640 basis points (bps) at the end of June, the implied five-year cumulative default rate for the impending recession is 33%. This compares to cumulative default rates of 25% during the Global Financial Crisis and 30%+ in the 1990s and early 2000s. The all-time high was 41% in the long and deep depression of the 1930s. So, the high yield market is discounting a major recession and commensurate level of defaults.

Yet this takes no account of the much higher quality and more robust nature of the high yield market today, even compared to 2008/9; nor of the current financial state of the issuers as we head towards the likely downturn. The global high yield market is much larger, having grown from \$1trn to \$2.4trn since 2009: meanwhile, issuers are bigger and of better quality. The average issuance has increased from \$400m to \$700m. At the same time, the average coupon rate is significantly lower, making it easier for issuers to service their debt.

Low near-term maturities



Past performance is not a reliable indicator of future results.

Source: BofA Global Research as at 31 May 2022.

On top of this, there are additional factors to note. The credit impact of Covid-19 was undoubtedly positive as companies had a sustained opportunity to issue bonds at ultra-low interest rates. Following the initial impact of the pandemic and the swift intervention of the Federal Reserve and other central banks, companies issued around \$1trn of high yield debt (representing 40% of the total market) and this has significantly pushed out the maturity wall (see chart).



Author

Azhar Hussain

Head of Global Credit
Royal London Asset
Management

Furthermore, energy remains one of the key sectors in high yield and has been turbo-boosted by the strength in oil and gas prices over the last 18 months. With the inherent asymmetry of credit investing, there isn't an equities-style bonanza: however, it is a useful tailwind for the asset class as we head towards a recession.

Given these factors – overall market quality, Covid-driven refinancings and the strength of the energy sector – we believe that the global high yield market currently overvalues defaults.

The ideal solution

For investors who feel that the residual risks are still too high given the macroeconomic uncertainty, we believe these can be managed through a disciplined investment process and active fund. Taking a selective approach with an emphasis on liquidity, we simplify the process of identifying which credits to buy and retain. We seek to analyse and value risk, rather than speculate on uncertainty. The recovery rate in global high yield is c. 40%, but we would rather exit a position early rather than incur losses.

The RL Multi Asset Credit Fund (MAC) has the flexibility to dial up the opportunities offered by high yield markets, yet can still offer good protection to more cautious investors. Its appeal at such an uncertain time can be summarised under duration, diversification and environmental, social and governance (ESG) sensitivities.

Duration has been fatal in fixed income markets this year and this could continue for some time yet. However, the average duration of the high yield market is just 4.1 years, compared to over 7 years for investment grade credit, and focusing on the front-end of the high yield market further mitigates duration risk. In MAC, we actively filled up the short-duration 'bucket' and increased the allocation to loans. These are floating-rate instruments and they have been the best-performing major credit asset class in 2022.

The fund is diversified and the asset-backed securities (ABS) and loan buckets have helped to partially mitigate market volatility. But crucially MAC is actively managed, and its profile will adapt as market risks unwind and we navigate through the credit cycle. What won't change is our sensitivity to ESG factors. While by no means a sustainable fund, we work closely with RLAM's Responsible Investment team to consider the ESG risks inherent in certain credits and take account of externalities.

In summary, sharply higher yields offer a significant buffer against the travails of a potential recession. Canny investors may reap the benefits by considering active multi asset credit funds tilted towards the front end of the curve.

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

To find out more about RLAM's range of investment solutions please visit www.rlam.com

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In a continuing volatile environment, investors are seeking a diversified solution with the potential to withstand a range of economic and market scenarios while providing a stable source of income.

By combining assets across the credit universe, the Royal London Multi Asset Credit Fund aims to achieve enhanced returns in a risk-controlled way.

- **Diversification** – focuses on ‘alternative’ credit sectors, such as global high yield, asset backed securities and loans.
- **Income** – exposure to higher yielding areas of the credit market.

- **Duration** – favours a shorter duration approach to mitigate against volatility or interest rate rises.
- **Expertise** – follows the same established philosophy as all of our actively managed credit funds.

To find out more, please contact us at institutional@rlam.co.uk or visit www.rlam.com

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Outlook for the credit markets

What is the outlook for the remainder of the year?

This is the \$1 million question and, at the moment, very difficult to answer (inflation-dependent obviously, so likely \$1.3 million by the end of this article). If risk-free rates continue to reprice because of high inflation and spreads continue to widen because of the worsening technical picture, then we could see the 'all in' cost of debt continue to rise, which could be problematic for some issuers, particularly those that have a lot of debt to refinance this year. At the sector level, the key thing for investors to consider in an inflationary environment is the inflation sensitivity and demand elasticity for the product/service provided by the issuer and critically the ability of the issuer to pass on rising input costs. In the primary market, new issuance should be possible, but issuers will have to be selective and use the appropriate or available windows when seeking to get deals done (like in late May or early June).

“Investors who can deploy capital now can pick up some decent yields”

An alternative scenario is that we see a 'stagflation' scenario where the market comes round to the idea of inflation being more or less embedded, but ultimately this crushes economic growth because consumer living standards suffer serious erosion and demand weakens. In this environment, with little or no economic growth, risk free rates would come down, which is supportive of government bond markets. However, if there is a collapse in growth, this would result in a deteriorating picture for corporate fundamentals, which would put upward pressure on spreads. The positive is that all-in yields would remain high, which means that credit should find favour with investors who have shunned the asset class in recent years because yields (particularly in the IG space) have been so low.

What solutions can investors utilise in the current environment?

The inflation shock and subsequent re-pricing of risk-free rates has undeniably been hard for some investors. In a long-only fund, it is difficult to mitigate all of these risks, and more or less impossible to defy gravity, but we certainly found it useful to dial down our duration exposure since 2021 while focusing on our fundamental analysis. There is another positive to the recent turmoil: the opportunity to reinvest the proceeds of maturing securities at much better (some would say more realistic) yield levels. The period of QE and 'financial repression' is unprecedented in recent history and there was no playbook for central banks on how to exit from it; as such, it was always going to be difficult to move away from such stimulative policy settings. Within our strategy, 20% of our portfolio will mature or come back to us in the next 12 months; the timing to deploy that capital at much better yield levels is excellent in our view. Liquidity Management Exercises remain a feature of the current environment and could mean we see even more of our capital being returned during this period. Either way, there will be plenty of cash to deploy. Investors who can deploy capital now can pick up some decent yields.



Author:

Guillaume Desqueyroux

Fund Manager

The other thing to remember here is that dislocation creates opportunities for active investors, and it is important to take advantage of them when they arise. Our strategy is typically a blend of IG names (around 55% of the portfolio), around a third in BBs (with a focus on bonds that have the potential to be upgraded to IG status) and the remainder of the portfolio split between non-rated bonds and cash. Similarly, non-rated bonds can provide great investment cases, but you have to be prepared to do the work. Of course, not everyone wants to do this, and some investors can't hold names that don't have a credit rating from S&P or Moody's or Fitch, but the fact is there are opportunities out there to pick up yield at attractive risk levels if you are prepared to look.

While investors may reconsider their allocation away from the equity market into fixed income given the uncertainties, the credit market should offer an interesting alternative. While reducing the pure beta of the portfolio, the asset class maintains important upside potential, reinforced by recent repricing. The reset of yields remains a critical element which should help a cautiously constructive view for the asset class, above any risk-free rate exposure. Part of the broader asset allocation decision, the balance between credit risk versus duration risk needs to be fine-tuned for the coming months.

Is there more pain to come in rates? Possibly, it is near impossible to anticipate, so, we prefer to stick to the shorter end - which has already repriced so aggressively - and focus on our conviction investments to extract the best risk/return outcome. Our expertise lies in the additional reward over the government curve. We see higher rates as a driver of great momentum for banks and insurers to improve their NII and investment portfolio return respectively. We strongly advocate focusing on highly capitalised issuers - that may sound obvious but within our strategy we spend a lot of time focusing on asset quality and particularly on identifying companies that have already done the work to clean up their balance sheets. These are the companies that have given themselves the best chance to perform whatever comes next. For our holdings, we don't see a refinancing wall and the risk of default is very small and we are frequently in touch with management on areas of concern. And remember, debtholders give up growth potential in a company to shareholders; the corollary is that shareholders are the first line of defence if something does go badly wrong with the company (and the economy) while bonds benefit from healthy asset backing.

Lastly, in an uncertain environment, we would always emphasise a focus on the areas of the market which are likely to be the most resilient and which offer low levels of volatility. In our strategy, that means focusing on shorter duration IG names or those that have the potential to achieve IG status, but which offer an attractive yield pick-up in the interim. These shorter duration bonds are the names that are best placed to weather volatility. Moreover, on weak 'risk off' days, investors will look at the short duration IG names before contemplating anything else. Investors may then trade down on risk or quality - but equally they may go no further if markets remain unsettled. As we said earlier, nothing is invincible, but the shorter and IG end of the credit market looks significantly more attractive than it used to, at least in the UK and US. The ability to deploy capital into good quality names at the short end of the curve at attractive yield levels is a development that all investors should welcome as it represents a return to some form of normality in capital markets - even if the journey to get there has been quite painful.

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