ASSET MANAGEMENT DPAM FUNDS

Ascent

Q2 2019

SUSTAINABLE PRINTING:

RECYCLED
Paper made from recycled material
FSC® C110642
www.fsc.org

Table of contents

Responsible editor: Hugo Lasat. Editing finished on 14.05.2019

06

SUSTAINABLE INVESTMENT

Putting sustainability at the forefront

09

RESEARCH

The added value of sustainability analysis for countries

Editorial

Dear reader,

Welcome to the Q2 2019 edition of Ascent, the quarterly expert magazine of DPAM regarding its analytical and management capabilities.

In the first article, we highlight monetary policy and portfolio risk. "Don't put all your eggs in one basket". This statement applies in particular to your investment portfolio. To be more precise, a well-diversified portfolio will optimally protect your capital during bouts of increased uncertainty and volatility in financial markets. This is a very simple rule which, unfortunately, is all too often ignored. Frederiek Van Holle makes a strong case for diversification.

In the second article, we delve into the added value of sustainability analysis for countries. The euro crisis showed the extent to which high debt renders a state's financing vulnerable to shocks on financial markets and substantially undermined the status of risk-free investments. Many states lost their coveted AAA rating granted by extra-financial rating agencies.

On the other hand, the COP 21 calls upon investors to assume responsibility for the financing that is required for the energy transition. In this respect, government bonds represent a major source of financing and provide considerable leverage as well.

In the last article, we have the experts from LuxFLAG focus on various sustainability issues. LuxFLAG is growing into a true pan-European labelling company, thanks to the strong support of the regulatory framework and an increasing network of institutional investors.

We do hope this edition was of interest to you.

Best regards,

Hugo Lasat,
CEO Degroof Petercam
Asset Management

Multi Assets

Monetary policy and portfolio risk

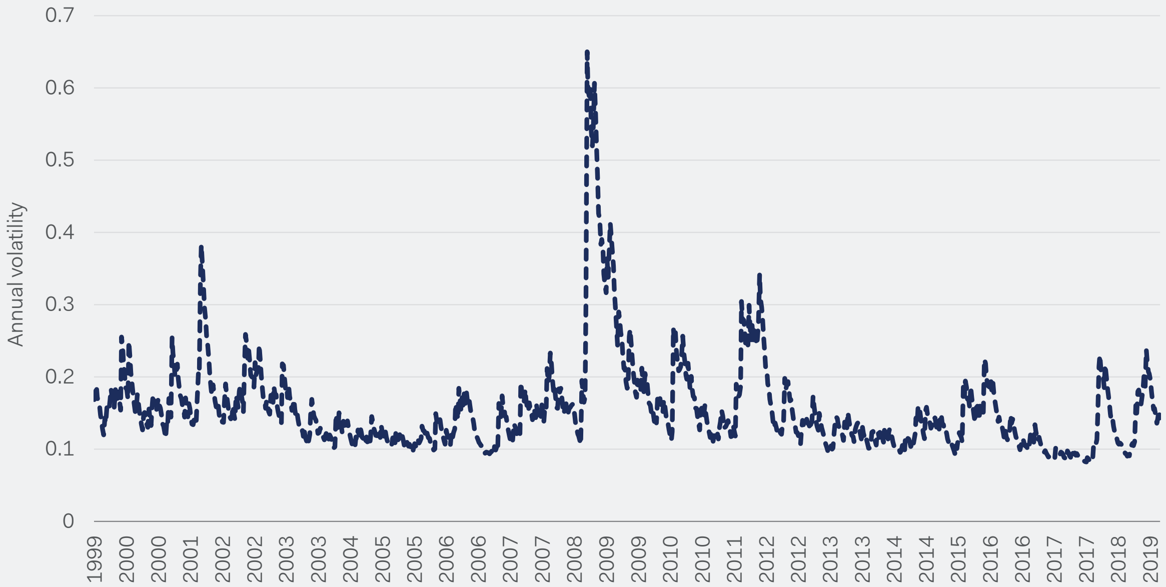
"Don't put all your eggs in one basket". This statement applies in particular to your investment portfolio. To be more precise, a well-diversified portfolio will optimally protect your capital during bouts of increased uncertainty and volatility in financial markets. This is a very simple rule which, unfortunately, is all too often ignored.

Why is this? Well, putting this rule into practice does require some expertise. **Portfolio diversification** is determined by three factors. Firstly, there is the **weighting of the various positions in the portfolio**. This choice is made by the investor or portfolio manager. The following two factors are linked to the characteristics of the various assets, namely volatility and correlations. The first parameter is a measure of the magnitude of return fluctuations and the expected downwards risk. For example, the volatility of European equities will be higher than that of safe German government bonds. In an efficient market, this higher risk will translate into a higher expected return. The second parameter reflects the **relationship between the various positions in the portfolio**. Here, certain assets typically move in tandem (positive correlation), while an increase in one particular asset may systematically result in a decrease in another asset (negative correlation).

Portfolio diversification can be **optimised** by combining various assets with the lowest possible, possibly negative, correlation. In this way, the failures will be offset by the successes.

So, given a certain allocation, portfolio risk will depend on volatilities and correlations, which vary over time. For example, when the financial crisis erupted in 2008, stock volatility rose from about 17% pre-crisis to over 60% during the crisis. Today, equity volatility remains low and clearly trends down again since the volatility shock at the end of last year. The correlation between equities and government bonds was typically positive until the end of the 90s, and has gone negative since then.

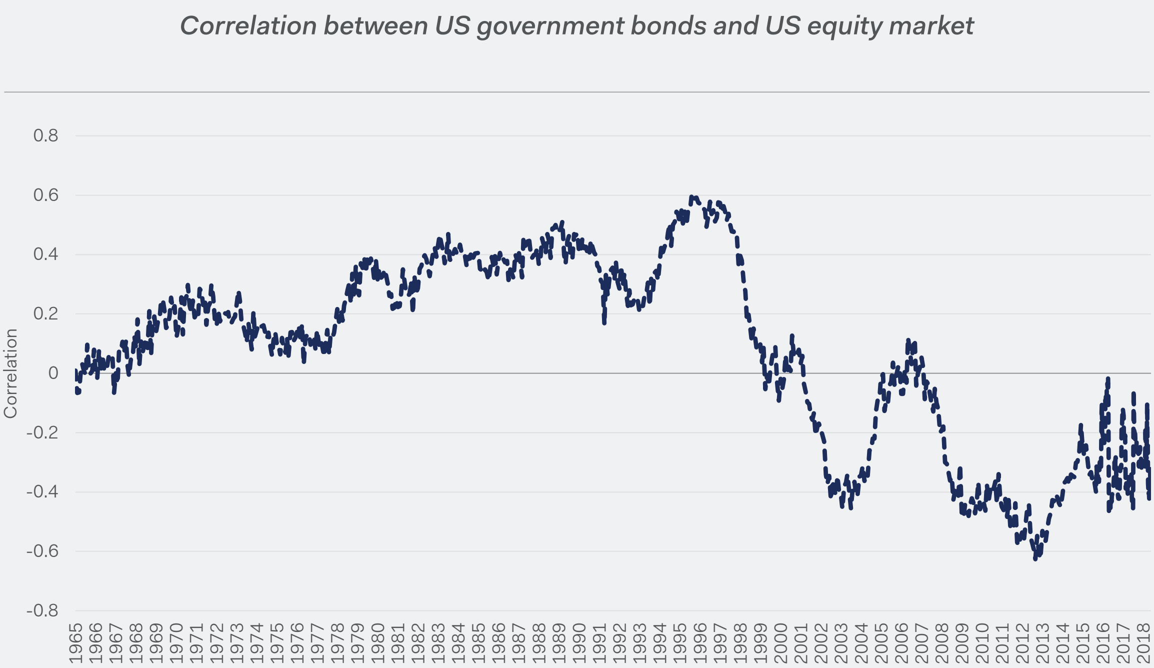
Global equity volatility



Source: DPAM, Factset

This time variation in correlations and volatilities is driven to a significant extent by the **macro-economic framework**. Recent academic research has demonstrated that monetary policy is an important key. Very accommodating monetary policy may have opposite effects on risk perception. On the one hand, this often leads to greater risk appetite. Here, the central bank is inflating asset prices and pushing interest rates down. A positive wealth effect and the search for higher-yielding assets push investors towards more risk. The current low volatility and low (tightening) spreads on high-yield bonds are an example of this. On the other hand, if the central bank overstimulates, this may send a negative signal to markets about the actual state of the economy, resulting in increased risk aversion. At present, the result seems to be skewed to higher risk seeking.

The type of monetary policy is also a determining factor, as a **countercyclical monetary policy** typically puts more weight on its inflation target. It will therefore not hesitate to hike interest rates in an environment of stagnating growth and rising inflation (stagflation). In this environment, equities and bonds will fall in tandem, as bonds become a risky asset class (hence, a positive correlation). A pro-cyclical monetary policy will typically lead to falling interest rates in the event of disappointing growth. As a result, disillusioned equity markets will be supported by strong bond prices (hence, a negative correlation). The era of oil crises and inflationary shocks (late 70s, mid-80s) was characterised by a countercyclical monetary policy. However, the global decline in inflation and inflation fluctuations since the late 90s resulted in a comfortable environment for central banks. They could focus more on growth stabilisation and thus became pro-cyclical, resulting in negative correlations between equities and bonds. The figure below shows our long-term estimation of the correlation between US government bond returns and the US equity market returns. The shift in the correlation sign towards the end of the 90's is clearly visible. Note that this sign shift is a global phenomenon since we observe a similar pattern for most developed markets.

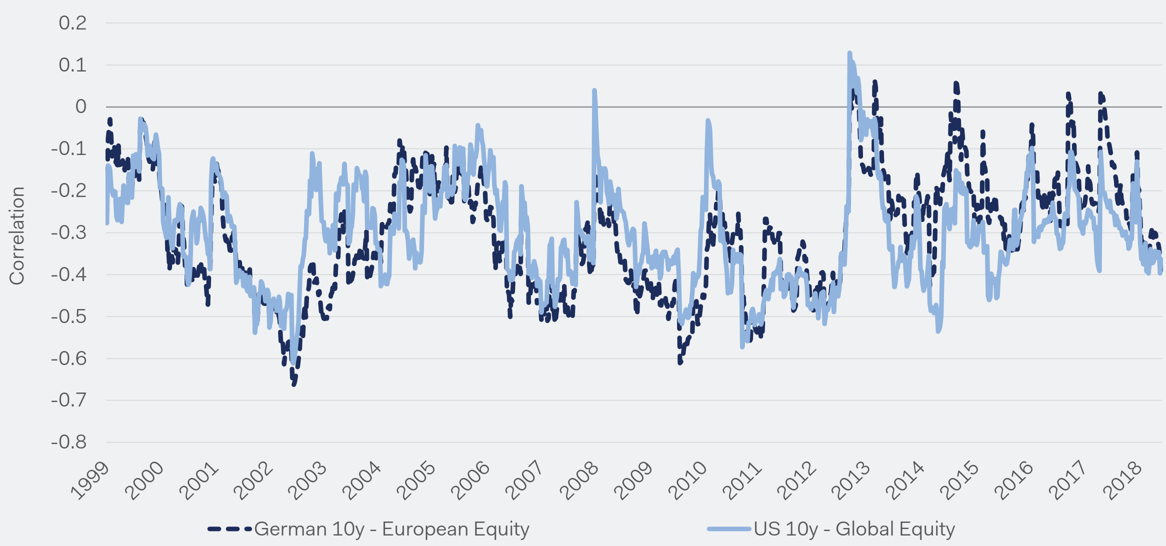


Source: DPAM, Factset

The **interaction between the inflation regime and the intent of monetary policy** is crucial for understanding correlations. Firstly, there is a clearly positive relationship between the level of inflation and the correlation between equities and bonds. During bouts of high inflation, correlations are invariably positive. However, as inflation falls, we also see a decline in correlation, even to negative levels with low inflation. However, this dynamic is not sufficient. We only see negative correlations if the low inflation environment is accompanied by loose monetary policy, and this is exactly the regime we find ourselves in today. However, if the monetary authorities switch to tighter monetary policy, we also see correlations turn positive, regardless of the inflation regime.

So what does this mean for your portfolio? The current environment with cautious central banks and low inflation is resulting in a **strongly negative correlation between equities and bonds**. This means that a well-diversified portfolio can currently make use of a **strong bond component** (regardless of low interest rates). Interest rate risk is negatively correlated with equity risk, which has a stabilising effect. So, don't judge a high quality bond investment only on the interest rate. The investment decision will depend on the expected return, which in turn depends on the bond yield (carry) and the roll-down, but also on the diversification effect within a multi-asset portfolio.

Correlation between high quality government bond returns and equity markets



Source: DPAM, Factset

> Today, equity volatility remains low and clearly trends down again since the volatility shock at the end of last year. The correlation between equities and government bonds was typically positive until the end of the 90s, and has gone negative since then.

If the unprecedented QE of central banks would ultimately lead to higher inflation and possibly to the unwinding of stimulus, we can expect correlations to become positive. This obviously does not mean that bonds will no longer have a place in a diversified portfolio. Instead, the allocation between equities and bonds will have to be adjusted.

Diversification is the key to successful long-term investment. This requires dynamic portfolio management supported by thorough macro-economic analysis and sophisticated tools to measure correlations and volatility. Failing to understand such dynamics may result in portfolios that appear to be diversified at first sight, but in reality still present unwanted risk concentrations. These flaws will then become mercilessly apparent in declining markets.

Frederiek Van Holle, PhD
Quant Solutions

Sustainable Investment

Putting sustainability at the forefront

Increasing awareness of matters such as social inclusion, climate change and political achievements like the Paris Agreement has led society forward in the goal of sustainable development. And the financial sector has had and still has its own role to play. Institutional investors have made their voice heard through prominent divestments from controversial assets.

In addition, the new investors known as the Millennials are changing market perceptions of finance. Assets in ESG (Environment, Social, Governance) funds have surged massively in the past years. Even the most traditional managers and early critics are now structuring products to become ESG-focused, while others have already made the switch to ESG years ago. We seem to be finally getting most on board to do the right thing. Or do we?

Why substance matters

Sustainability has become a big deal and an appealing sales story, which certainly brings advantages but undoubtedly also poses challenges. Leaving out substance makes the industry a fragile bottleneck. Every other actor is now claiming to be sustainable, which makes it necessary to differentiate the real drivers of change from the pretenders. What matters is what lies underneath and how it is communicated. Would you think it honest if a company heavily marketed its newly issued financial instrument, but at the same time continued to do 99% of its business non-sustainably?

In addition, it is not enough to focus only on the E or the G and leave the S completely out of the mix (or indeed any other combination of focusing on two factors and leaving one out). Even though a company might have very low carbon emission rate due to the industry it operates in, working conditions and social factors should also be accounted for. Recent examples have proven models to be wrong, with entire villages being

displaced to build dams in Asian cities for example. It is imperative to take into account both the positive and the negative impacts of an investment decision. This is why sustainable investment funds in particular need to do the right thing, proving to their investors that there is substance behind the companies in which they invest.

The good, the bad and the ugly

Even though the majority of companies already publish Corporate Social Responsibility reports, about 20% of the largest companies worldwide do not report at all on sustainability matters according to the Global Reporting Initiative. ESG data therefore remain challenging to collect. However, data sources in general and the quality of reports have improved vastly in the past few years. Reporting will adopt an even more important role in sustainability frameworks and the setting of standards in the future, making it easier to identify the good, the bad and the ugly. Recently published proposals by the EU Technical Expert Group (TEG) are geared towards disclosing not just how climate change might influence the performance of a company, but also the impact of the company itself on climate change. In future, integrated reporting, combining financial and extra-financial factors, will help to build sustainability into strategic decision-making.

Trust is good, control is better

Nowadays, rigorous policies and internal sustainability experts are considered a must by experienced practitioners to ensure that the ESG strategy is properly executed and the companies in the portfolio are in line with predefined policies. The message to investors can even be intensified by external control entities such as quality labels which give investors the necessary peace of mind after a multi-dimensional analysis has been performed. But what can be done to help companies in the transition to sustainability and how do we react to those that don't want to change?

Note: LuxFLAG is an international and independent non-profit labelling agency for sustainable investment products. DPAM's full range of eight actively managed sustainable sub-funds received the LuxFLAG label in 2018.

Engage or divest?

Engagement and voting on sustainability matters are changing the investment conversation of today. The active dialogue with companies is increasingly being used to boost ESG practices and set up the right incentives to solve material ESG concerns. Those incentives have become an integral part of the active management process and are spearheading the transition to sustainability. If a company has no intention to progress and makes no tangible improvements, shareholders should see and use divesting as their measure of last resort. Ambitions are no longer enough today; there must be clear targets and reporting on the progress made. Fostering long-term best practices will add value to the whole industry. At the end of the day, sustainability aspects should not only be considered as operational advantages. It is also and above all about incorporating ESG aspects at the top of the value chain. As a result, active management will continue to play a key role in making the future of finance a sustainable one.

Sachin Vankalas,
Director, Operations &
Sustainability
LuxFLAG

Julie Didier,
Head of Marketing &
Communication
LuxFLAG

Sustainable Investment

The added value of sustainability analysis for countries

On the one hand, the IMF reiterated its cautious stance with regard to the surge in global debt levels. Indeed, in 2016 this amounted to USD 164,000 billion, equivalent to 225% of global GDP.

The euro crisis showed the extent to which high debt renders a state's financing vulnerable to shocks on financial markets and substantially undermined the status of risk-free investments. Many states lost their coveted AAA rating granted by extra-financial rating agencies.

On the other hand, the COP 21 calls upon investors to assume responsibility for the financing that is required for the energy transition. In this respect, government bonds represent a major source of financing and provide considerable leverage as well.

From added value to investment decision-making

The sovereign bonds of more sustainable countries have proven to be more resilient during crisis periods. When looking at the 2008 euro crisis, Scandinavian countries or other countries that are generally well positioned in the rankings **have held up much better** than, for example, Southern European countries.

Many links have been proven between ESG factors and a country's long-term economic growth and development. Already in the sixteenth century, a link had been established between the environment/geography/climate and a country's agricultural system, in other words access to food for the people, possible diseases and economic growth.

Academic research has also demonstrated a **correlation between the quality of a country's governance institutions and its debt default**

risk. Overall governance acts as the cornerstone for the implementation of policies that foster other sustainability dimensions (social and environmental). As a matter of fact, governance relates to the quality, stability and predictability of the policies that have been implemented. This will enable institutions to be resilient in the light of the endogenous and exogenous events that affect states. This stands in contrast to unsustainable factors such as corruption, lack of freedom, red tape, etc. which are detrimental to foreign investments in particular.

Fiduciary duty

It is now a **fiduciary duty** for investors to integrate ESG factors into their investment processes and risk management. Government bonds, which are thus issued by countries, are not an exception to this rule.

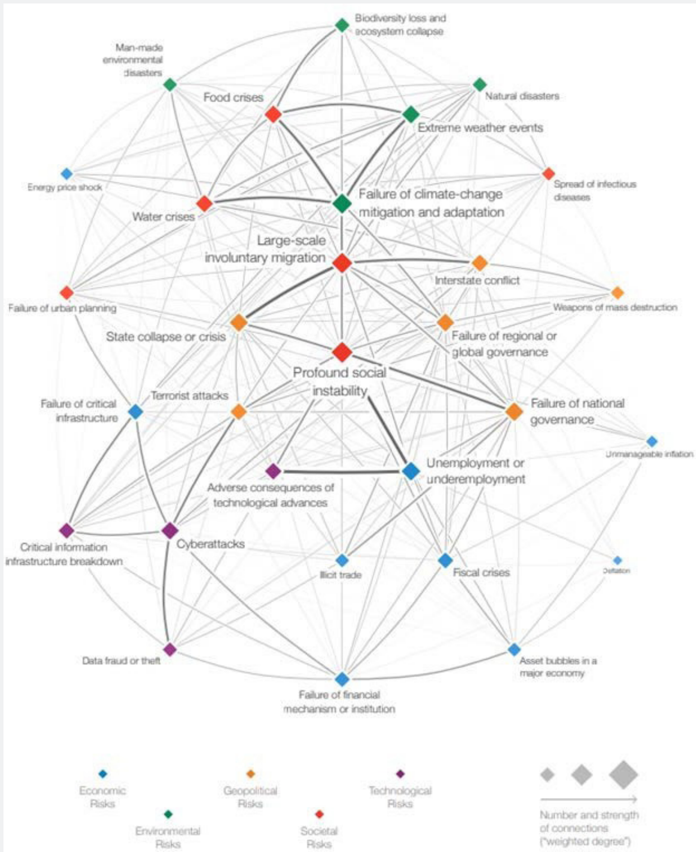
Indeed, 30% of the portfolios of occupational retirement provision institutions (referred to as IORPs or pension funds) are exposed to sovereign bonds. The ESG risks associated with this investment must therefore be included in the Statement of Investment Principles ("SIP"), risk management and portfolio construction.

How can a country's sustainability profile be assessed and defined?

It makes sense to refer to the three **sustainability dimensions** which are studied for companies, i.e. **E, S and G**.

Climate, social, technological and other risks are inextricably linked to one another. This inter-connectivity between various risks is particularly well illustrated by the risk experts of the World Economic Forum (WEF). They demonstrate that it is important to adopt a **holistic approach to these three dimensions** - environment, social and governance - which are part and parcel of the fundamental analysis of countries and the sovereign debt they issue.

The interconnectivity of risks



Source: World Economic Forum, the Global Risk Report

Most definitely a relevant analysis!

Firstly, by looking into the aspect of transparency and democratic values, the analysis allows an initial assessment to be made of the political context of a country and its stability. The quality of its public institutions is evaluated, as well as its transparency or the lack thereof, in terms of corruption and press freedom, for instance.

It also involves looking into the **fundamental rights of civil society**, including political rights and civil liberties. Furthermore, the analysis of the population and its well-being also enables flaws and discontent to be detected within civil society which may give rise to instability, and which are detrimental to a sound investment climate.

In the framework of an investment in sovereign bonds, the contribution of the sustainability filter becomes even more important as market volatility increases and markets' performance goes down. This demonstrates the strength of the tool in better understanding risks.

Sustainable Development Goals (SDGs) to assess the relevance

As successors of the **Millennium Development Goals** (MDGs) which were launched by the United Nations between 2000 and 2015, the 17 **Sustainable Development Goals** (SDGs) aim to foster sustainable development on the economic, social and environmental front. They reassert human rights and the willingness to eradicate poverty, famine and inequality by the end of 2030.

The eight MDGs had obtained excellent results on all fronts. However, that success varied across the board, and the poorest and most vulnerable populations continue to be left behind.

Their successors, the SDGs, have primarily targeted governments as well as the public sector. It is very encouraging to see that these ambitious principles have been extended to the whole of the private sector as well as to investors. The Paris Agreement has greatly increased awareness. Therefore, the timing was just right. Indeed, substantial investments will be required to achieve all these objectives.

Nearly 200 countries have adopted the 17 social, environmental and economic objectives. They represent a unique opportunity to step up investments in the light of major environmental and social challenges.

Now, the question is why government bonds do not pay more attention to these **major challenges**, which are also **economic challenges**. Government bonds remain an important asset class for long-term investors after all. And yet, the universes and reference indices still do not fully take into account these dimensions.

Ophélie Mortier,
Responsible Investment
Strategist

Conclusion

As is often the case, it has taken an important crisis to unveil the flaws of certain economic and financial models that are unidimensional. In a context of a **globalising economy** facing major challenges such as the demographic challenge, the scarcity of natural resources and climate change, it seems obvious that states, as major actors in the economy, have a key role to play. They are pivotal to the sustainability of the systems that are put in place. Therefore, for an economy to operate efficiently, it must have an appropriate democratic framework, composed of effective and stable governance institutions. When there is a lack of investment in the well-being and knowledge of current and future generations, an economy jeopardises its sustainability perspectives. Without an objective of sustainable management of its resources and environment, it will incur significant costs to adapt to the major challenges our planet will be facing in a few years' time. Finally, failing to comply with international commitments (treaties, agreements, etc.) means that it is very likely that a state will renege on its commitments vis-à-vis its creditors. Hence, while this is an **extremely complex matter**, it is **essential to take a holistic view of countries as economic actors and actors of sustainable development**, and to analyse them according to a matrix taking into **account financial and economic criteria as well as social, environmental and governance dimensions**. This is comparable to what is increasingly being done for companies.

Contact details

DPAM FUNDS
dpamfunds.com

TWITTER
@BDP_**EN** @BDP_**NL** @BDP_**FR**

LINKEDIN
linkedin.com/showcase/degroof-petercam-am

HEAD OF INTERNATIONAL SALES
Tomás Murillo
+32 2 287 92 71
t.murillo@degroofpetercam.com

FRANCE
Ives Hup
+33 1 73 44 57 46
i.hup@degroofpetercam.com

Alexandre Touma
+33 1 73 44 57 60
a.touma@degroofpetercam.com

Vincent Valles
+33 1 73 44 56 90
v.valles@degroofpetercam.com

GERMANY
Thomas Meyer
+49 69 27 40 15 295
t.meyer@degroofpetercam.com

Melanie Fritz
+49 69 27 40 15 243
m.fritz@degroofpetercam.com

Axel Ullmann
+49 69 27 40 15 306
a.ullmann@degroofpetercam.com

Patrik Hanser
+49 69 27 40 15 885
p.hanser@degroofpetercam.com

ITALY & TICINO
Alessandro Fonzi, CFA
+39 02 86337 223
a.fonzi@degroofpetercam.com

Aniello Pennacchio, CFA
+39 02 86337 316
a.pennacchio@degroofpetercam.com

Alessandra Tosi
+39 02 86337 315
a.tosi@degroofpetercam.com

SPAIN, PORTUGAL & LATAM
Amparo Ruiz Campo
+34 91 572 03 66
a.ruiz@degroofpetercam.com

Victor Asensi
+34 91 572 03 66
v.asensi@degroofpetercam.com

Nicolas Da Rosa
+34 91 572 03 66
n.darosa@degroofpetercam.com

THE NETHERLANDS
Marco van Diesen
+32 2 287 92 62
m.vandiesen@degroofpetercam.com

Roy Braem, CFA
+31 20 573 54 05
r.braem@degroofpetercam.com

SWITZERLAND & AUSTRIA
Ulrike Kaiser-Boeing, CFA, CAIA
+41 22 929 72 23
u.kaiserboeing@degroofpetercam.com

Mélanie Schaus
+41 22 929 72 12
m.schaus@degroofpetercam.com

SCANDINAVIA, UK & IRELAND
Marco van Diesen
+32 2 287 92 62
m.vandiesen@degroofpetercam.com

LUXEMBOURG
Olivier Terras
+352 45 35 45 23 05
o.terras@degroofpetercam.lu

HEAD OF FUND DISTRIBUTION BELGIUM
Thomas Palmblad
+32 2 287 93 27
t.palmblad@degroofpetercam.com

DISTRIBUTION BELGIUM
Frédéric Collett
+32 2 287 93 06
f.collett@degroofpetercam.com

Stéphane De Bruille, CFA
+32 2 662 83 61
s.debruille@degroofpetercam.com

Tim Vercammen
+32 2 287 91 83
t.vercammen@degroofpetercam.com

HEAD OF INSTITUTIONAL SALES (MANDATES) BELGIUM
Hilde De Jaeger
+32 2 287 95 84
h.dejaeger@degroofpetercam.com

RELATIONSHIP MANAGERS BELGIUM
Catherine Champagne
+32 2 287 92 60
c.champagne@degroofpetercam.com

Dino D'Angelo
+32 2 662 83 14
d.dangelo@degroofpetercam.com

Willem Huyghe
+32 2 287 97 46
w.huyghe@degroofpetercam.com

Bernard Jans
+32 2 287 97 10
b.jans@degroofpetercam.com

Yves Lepercq, CFA
+32 2 287 90 62
y.lepercq@degroofpetercam.com

Michel Van Meerbeek
+32 2 287 98 60
m.vanmeerbeek@degroofpetercam.com