

Current spread levels reduce the potential for further spread tightening. Meaning that even though we continue to believe BBB bonds should outperform higher rated bonds, we would consider it sensible to slightly attenuate our overweight on credit and start adding some higher quality bonds to portfolios.

According to our analyses, based on index data since 2000, a diversified investment-grade portfolio performance can be broken down as follows:

- **For a portfolio fully invested in a foreign currency:**
 - ~60% of the performance is due to the currency choice
 - ~30% to the government total return
 - ~10% to the credit selection
- **For a portfolio fully invested in the reference currency:**
 - ~75% is due to government market total return
 - ~25% to the credit selection

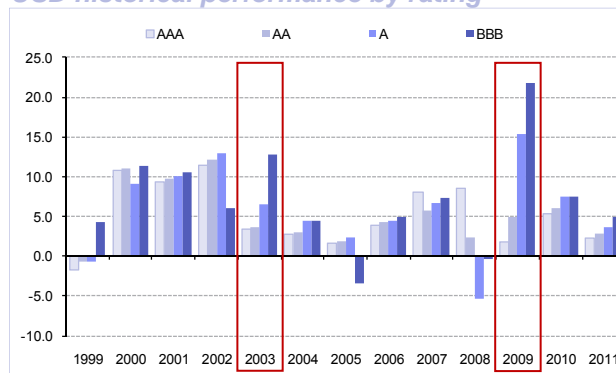
Of course those are long-term percentages: Through the business cycle, performance weight may change significantly depending on the business cycle and rate cycle stage.

Historical credit performances

Looking at the historical performance by rating, BBB bonds often outperform AAA bonds: most of the time this outperformance is due to the carry and not due to spread tightening.

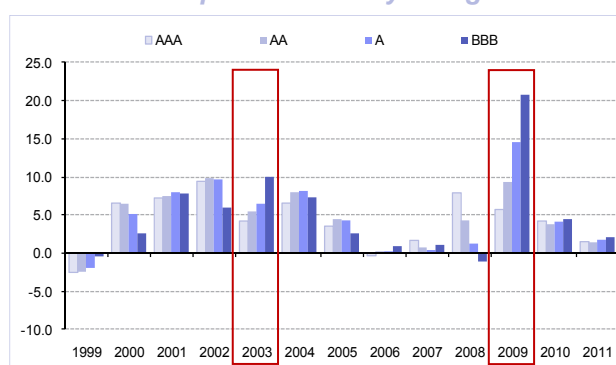
Of the last 13 years, only two were 'credit' years (2003 and 2009 while the economy was exiting from a recession). For the other years, buying low rated bonds instead of high quality bonds was not really rewarded either in terms of absolute performance or in relative terms versus AAA.

USD historical performance by rating



Sources: MSCI Eurodollar until 1999, then CS Liquid Eurobonds Index

EUR historical performance by rating



Sources: MSCI Euro Debt until 1999, then CS Liquid Eurobonds Index

More value in high rated than in low rated

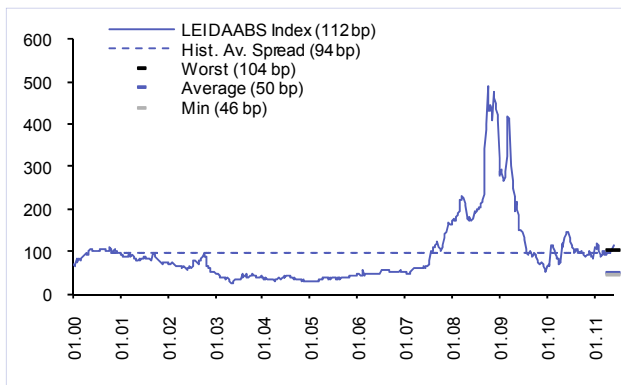
When we compare current spreads to historical default rates, we conclude that currently **there is more value in high investment grade bonds than in low investment grade bonds.**

We have calculated the required spread to compensate for the default rate from Moody's with a recovery rate assumption of 30%. We have calculated required spread for the average default rate, the worst default rate and the minimum default rate since 1920.

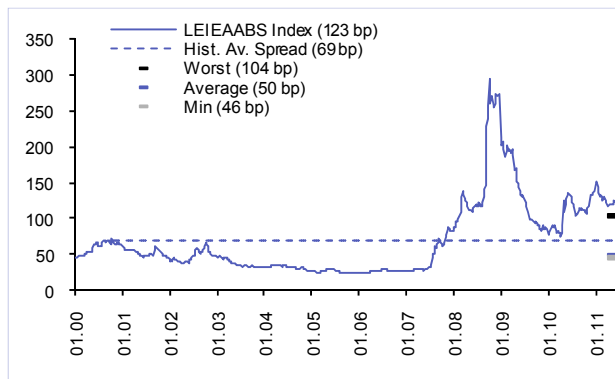
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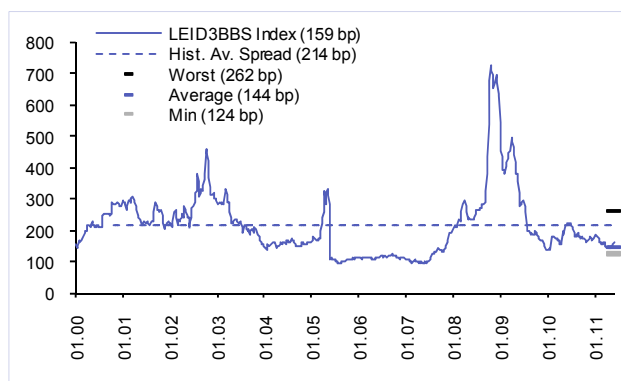
USD AA Spreads



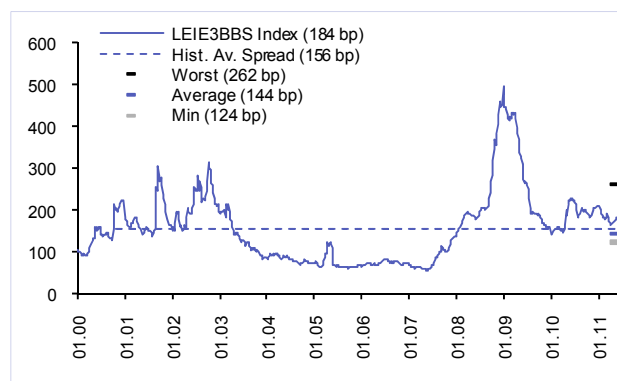
EUR AA Spreads



USD BBB Spreads



EUR BBB Spreads



Source: bridport's calculations

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As illustrated on the graphs above, current spreads in AAA and AA ratings compensate for the worst default rate seen on those rating tranches, while A and BBB spreads are in line with respective average default rates.

- AAA average 5 yr cumulative default rate: 0.2%
- BBB average 5 yr cumulative default rate: 3.5%
- HY average 5 yr cumulative default rate: 16.7%

On the other hand, we also remind you that the credit risk is asymmetric as the downside in case of default is much higher than the upside potential is from potential upgrades. Consequently, from a risk reward point of view, with current relatively low spreads BBB credits are less attractive.

Limited tightening perspective

Today, most of the outperformance we expect on BBB bonds will be due to the carry as **the potential for more spread tightening exists but is limited**, meaning that the outperformance investing in BBB instead of AAA will not be significant.

Time to increase exposure to high rated

We maintain our overweight on credit assets as we do not expect a significant spread widening in the coming months, however, we would like to smooth the tone and start adding some high rated bonds.

In conclusion, we would not change the weight of IG Credit in portfolios, but we would improve the rating average inside the IG Credit. We also remind you of our last investment case on covered bonds which also fits this move to higher rated bonds.