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# Establishing an International Investment Program and Policy Statement: Lessons Learned


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# Establishing an International Investment Program and Policy Statement: Lessons Learned

- **Practical Corporate International Portfolio Considerations**
  (Ivan Troufanov, Assistant Treasurer, BioMarin Pharmaceutical Inc.)
- **International IPS**
  (Linda Ruiz-Zaiko, President, Bridgebay Financial Investment Consultants)
- **Euro Short Duration**
  (Patrick Barbe, Head of Eurozone Fixed Income, BNP Paribas Investment Partners)

# Practical Corporate International Portfolio Considerations

# Practical Corporate International Portfolio Considerations

- **Global Cash Flow Forecast**
- **Global Tax and Repatriation Strategy**
- **Foreign Exchange Risk and Hedging Strategy**
- **Local Tax and Regulatory Requirements**
- **Reporting and Accounting Considerations**

# Global Cash Flow Forecast

- Systematic Global Cash Forecast helps identify global cash pools
- Size, geographical location and currency for target investment portfolios overseas
- Regular Cash Forecast updates help to avoid surprises for change in cash and target investment allocations around the globe
- Specific Targets in global cash liquidity needs are helpful in outlining the immediate liquidity buckets vs. strategic cash breakout

# Global Tax and Repatriation Strategy

- Treasury needs to get involved in global tax and repatriation strategy
- Regular dialog with global tax department helps avoid surprises which would require non-optimal global cash movements
- Plan ahead with respect to sizable global repatriations and reinvestments

# Foreign Exchange Rate Risk and Hedging Strategy

- **Establish Foreign Exchange Risk Strategy with respect to international investment portfolios and its particulars: active or passive hedging strategy, foreign exchange gain/loss limit, selections of derivatives – forward contracts, options, option combinations**
- **Link Foreign Exchange Risk Strategy to Global Corporate Foreign Exchange Risk Policy**
- **Establish consistent method of tracking Foreign Exchange Risk Strategy performance**

# Local Tax and Regulatory Requirements

- **Understand local tax and compliance regulations before deciding on the locations for global investment portfolios**
- **Some jurisdictions may significantly limit the security selection available and even prohibit investments in interest bearing securities**
- **Include local restrictions and limits in specific investment policy to ensure compliance**

# Reporting and Accounting Considerations

- **Reporting requirements should be assessed such as possible global roll-up or stand-alone reporting**
- **Functional currency selection and foreign exchange translation requirements**
- **Foreign Exchange Hedge Accounting strategy to support active Hedging strategy (if chosen)**

# International
# Investment Policy Statement

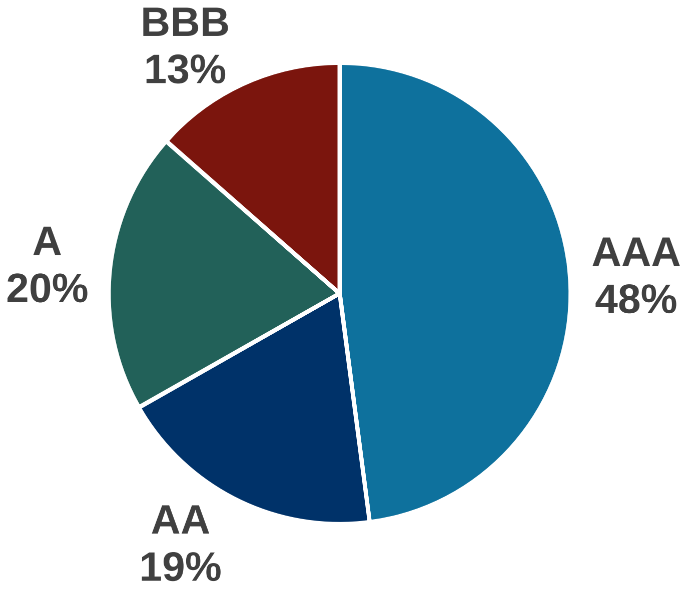
# Eligible Securities for Euro Portfolio

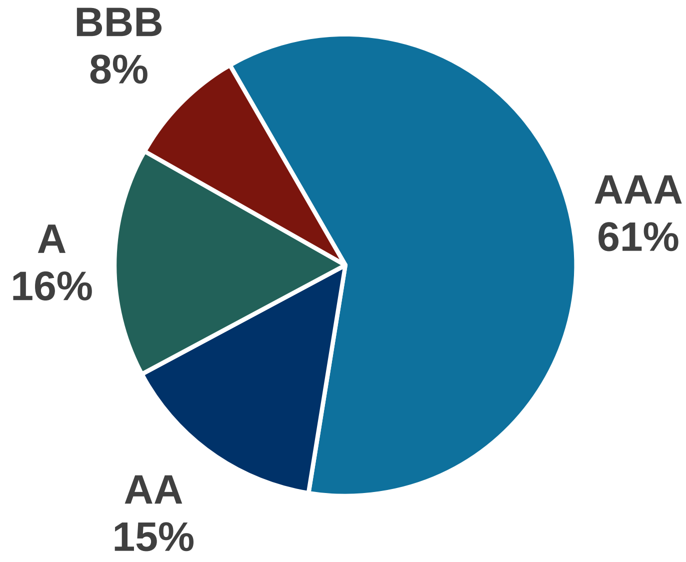
- Sovereign bonds
- Supranational bonds
- Local authority bonds
- Covered bonds
- Euro ABS
- Corporate Notes
- Euro CP, CD
- UCITS

# Covered Bonds

- Senior, Secured Bank Obligations
  - Favorable EU regulations
  - Highly liquid
  - Full recourse debt
    - Preferential claim under a default
  - Credit rated higher than its senior unsecured debt
  - Cover Pool – principal and interest
    - Mortgages stay on bank's balance sheet
    - Ongoing monitoring
- Special Purpose Vehicle (SPV) prohibited
- European Bail-in Regulations

# Euro Covered Bonds



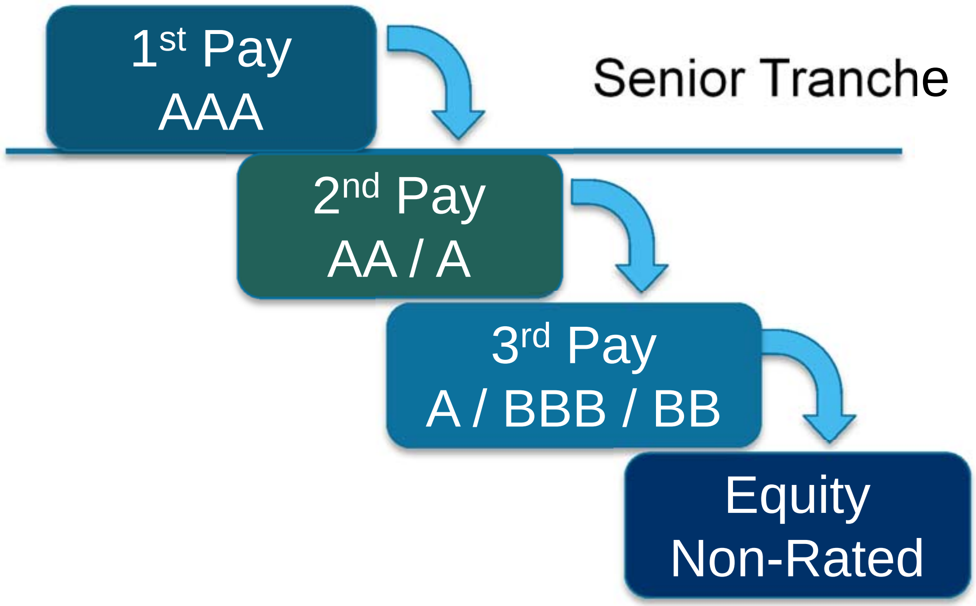

| EMU Covered Bonds Index 1-3 Yrs | |
|---|---|
| 1 Year Return | 2.58% |
| Duration (Years) | 1.81 |
| Avg. Credit Rating | AA |
| # Bonds | 215 |

| EMU Covered Bonds Index 1-5 Yrs | |
|---|---|
| 1 Year Return | 6.34% |
| Duration (Years) | 3.76 |
| Avg. Credit Rating | AA+ |
| # Bonds | 161 |

Source: Bank of America Merrill Lynch Index. As of 10/15/2014

# Euro ABS Asset Class

- **Higher Yields (Same Credit Rating)**
  - Corporates
  - Financials
  - Covered bonds
- **Robust Structure**
  - Subordination
  - Reserve fund
  - Excess spread
- **Floating and Fixed Rate**



# Euro ABS Asset Class

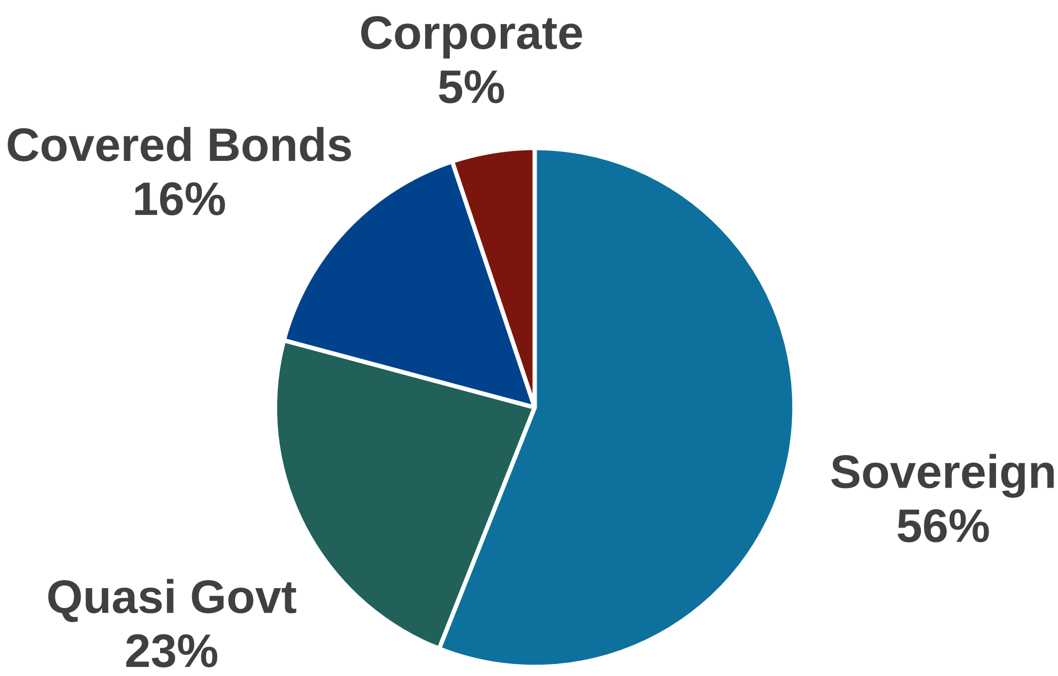
- **European Countries**
  - Legal framework
  - Country specific risks
- **Senior Tranches**
  - First to be paid
  - Subordinated tranches absorb losses first
  - Default rates low during the financial crisis
- **No European Sub-Prime Deals**

# Euro ABS Selection

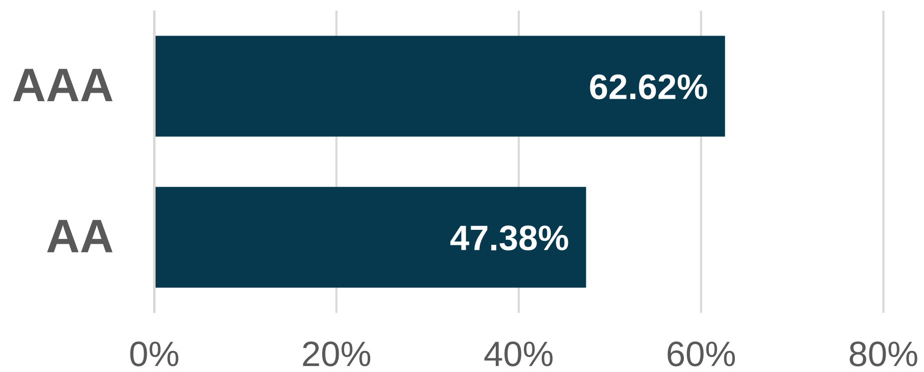
- Geographic Concentration
- Legal Structure and Jurisdiction
- Tax Regulation

- Collateral
- Scenario and Cash Flow Stress Test
- Originator/Servicer Experience
- Timely Investor Reports

# Euro Benchmarks

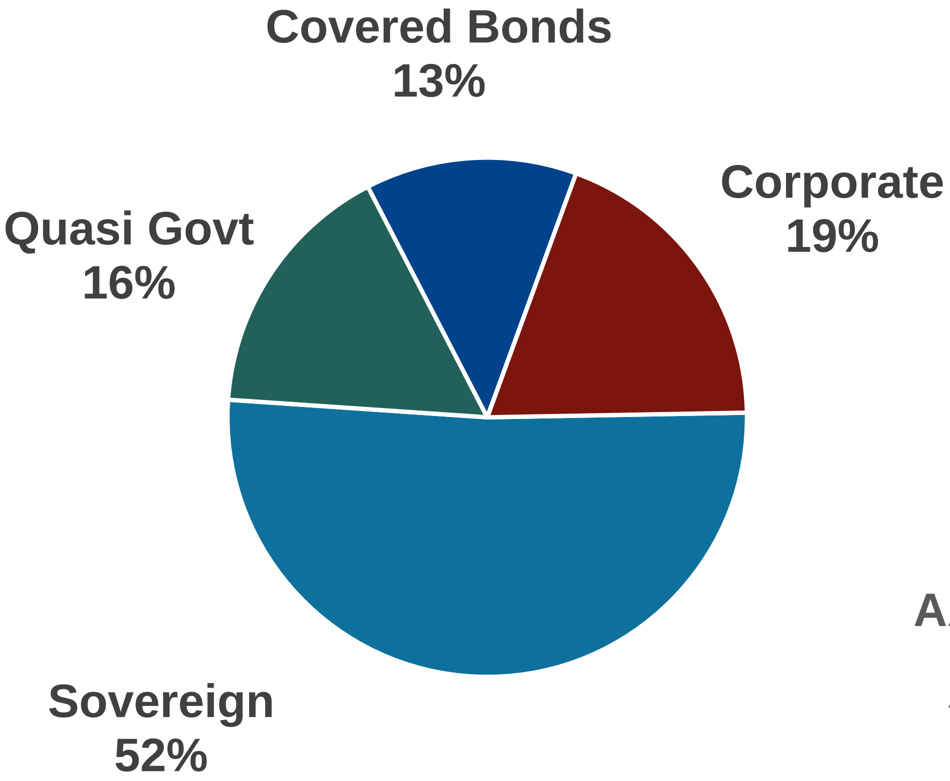



| EMU Broad Market Index 1-3 Yrs AAA-AA | |
|---|---|
| 1 Year Return | 1.18% |
| Duration (Years) | 1.86 |
| Avg. Credit Rating | AA+ |
| # Bonds | 434 |

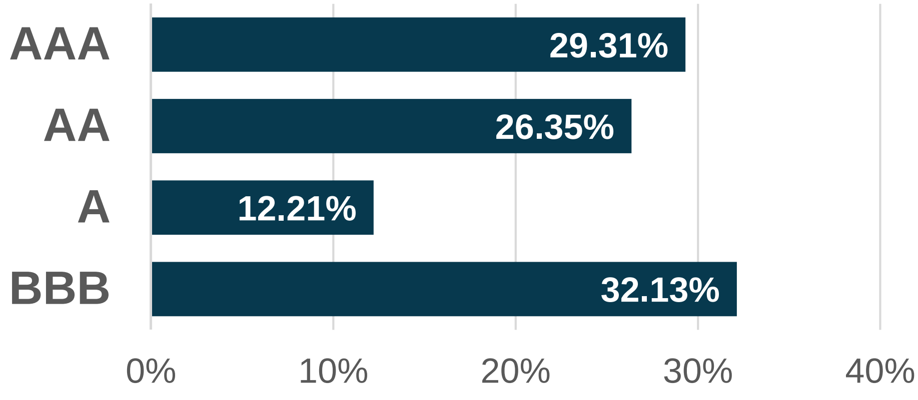



Source: Bank of America Merrill Lynch Index. As of 10/15/2014

# Euro Benchmarks




| EMU Broad Market Index 1-3 Yrs AAA-BBB | |
|---|---|
| 1 Year Return | 2.17% |
| Duration (Years) | 1.87 |
| Avg. Credit Rating | AA- |
| # Bonds | 1,039 |




Source: Bank of America Merrill Lynch Index. As of 10/15/2014

# Euro Manager Selection

- Comprehensive RFP
- Detailed agenda for all candidates
- Hypothetical portfolios
- Local research capabilities
- Market knowledge
- Specialized Euro expertise
- Trade execution during illiquid markets
- Risk management and stress testing
- Compliance controls
- Credit and structure research

# Euro Short Duration

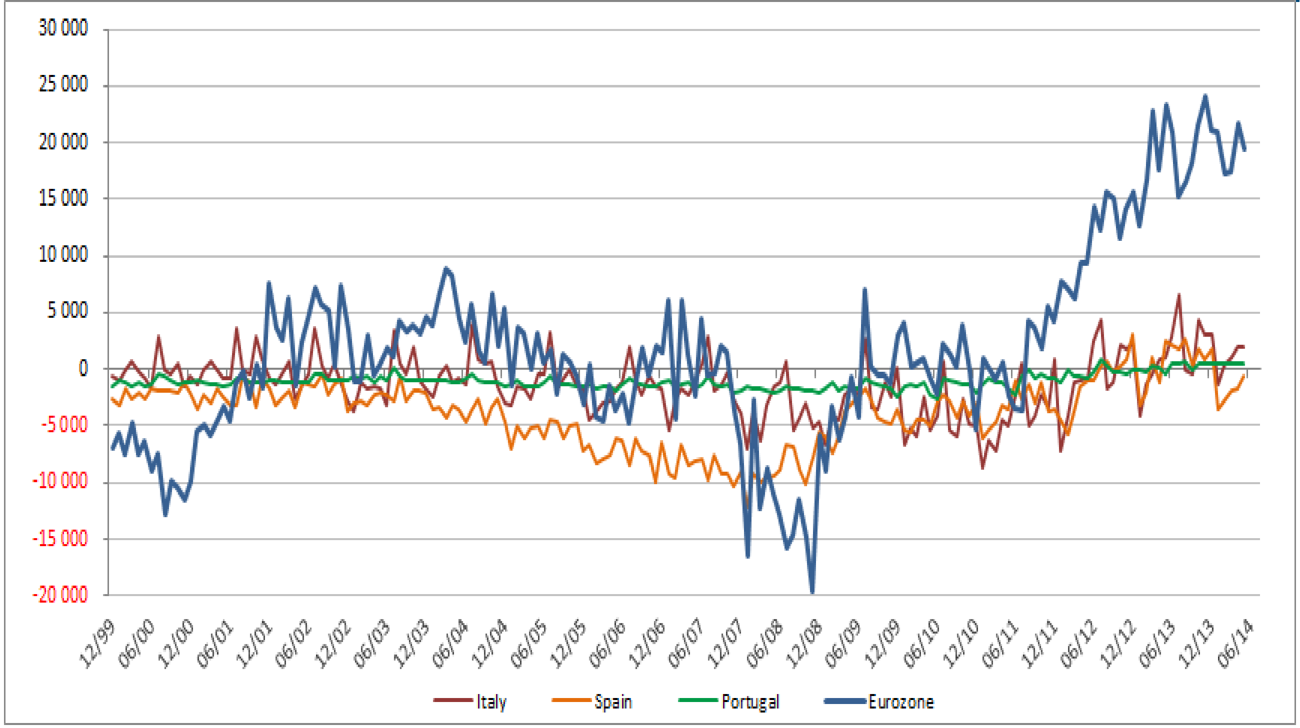
# The Eurozone fundamentals versus the USA

# The Eurozone: a surplus area ensuring stability despite weak economy

**Most countries implemented reforms successfully: current account balances turned positive**

→ **Cash inflows by 15 bn minimum per month**

Current account (EUR mn): surplus even in peripheral countries



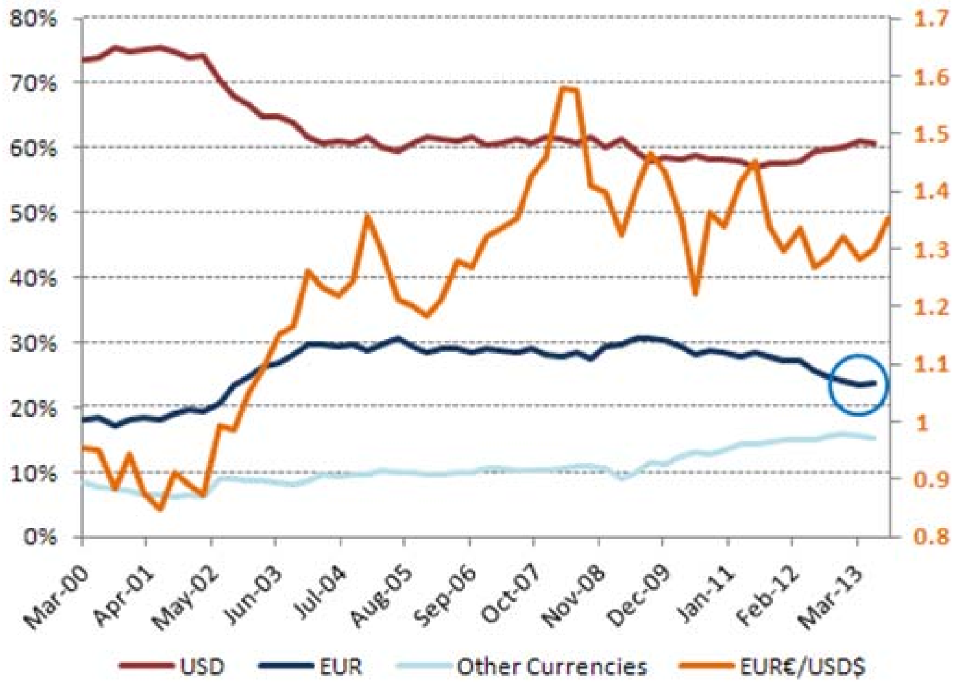

*Source: Bloomberg from January 2000 to end September 2014*

Support to the Eurobonds and the currency

# The “Emerging savings” underweighted the Eurozone

- **The euro currency lost its reserve status due to the state debt crisis**
- **But the German Bund is the only remaining true AAA all around the world**

Emerging Central Banks cut their exposure to the euro




Source: Cofer / Bloomberg/ BNP Paribas AM / September2013

To protect their savings, long-term investors should buy Eurobonds

# The Eurozone will take time to exit from the crisis

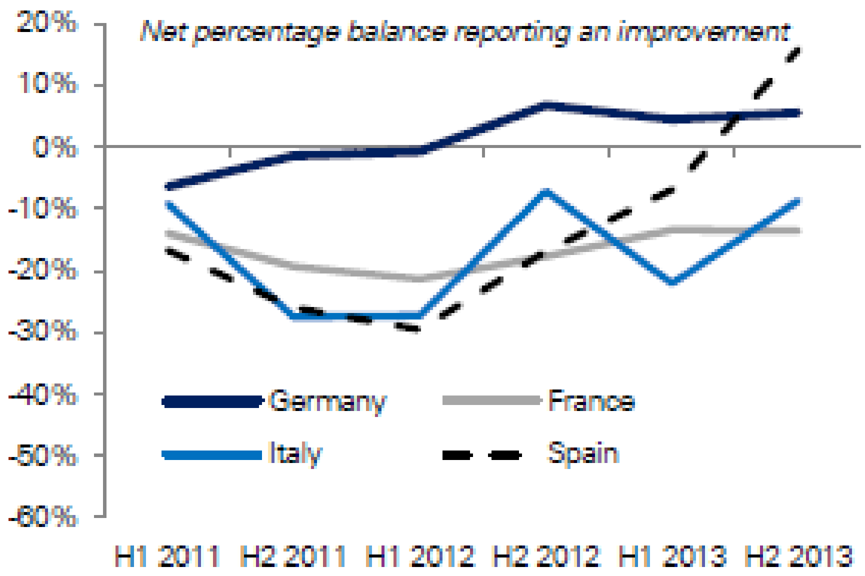
**…because of the choice for fiscal discipline before growth support**

→ **The economic improvement is underway in Europe, except for France & Italy**

→ **Reforms in Spain worked while social system benefits support households**

Credit conditions improved significantly in Spain

Euro SME survey about credit conditions




Source: Deutsche Bank, European Commission as at end 2013

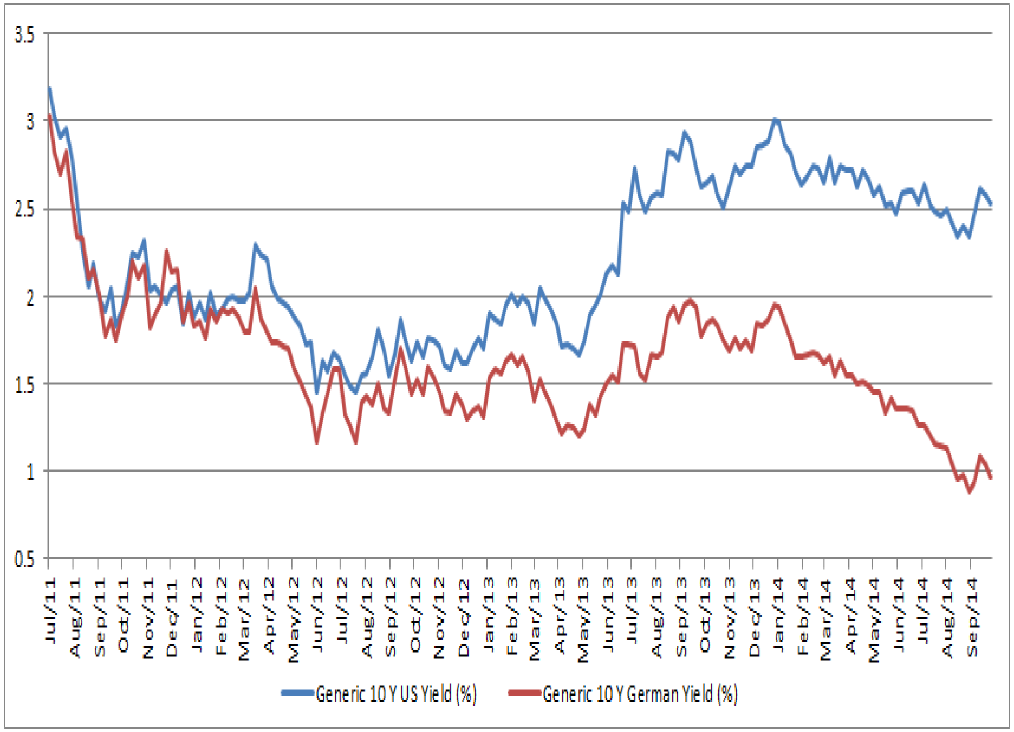
The economic recovery based on reforms is taking a long time

# The ECB's monetary policy differs from the Fed's

**US and German Bund rates decoupled thanks to the ECB's "forward rate guidance"**

- **The ECB just cut its refi rate to 0.05% & deposit rate to -0.20%, with full allotment to the bank cash demand**
- **The ECB launched a new Targeted LTRO (Long Term Refinancing Operations) program ending in 2018**

German 10 Y and US 10 Y yields : decoupling thanks to the ECB...




*Source: Bloomberg, ESA/ BNP PAM, September 26, 2014*

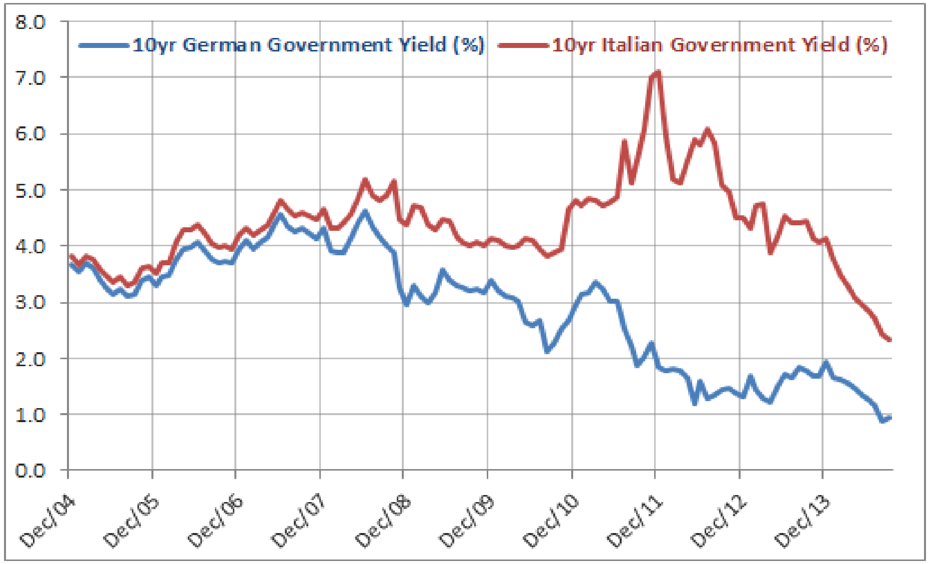
**ECB key interest rates to remain at a very low level for an extended period of time**

# The Euro "forward guidance" offers bond support

## "Forward guidance" means significant cash injection at low rate level for years

- **ECB on hold till at least 2016 and probably 2018 : to support the real economy funding**

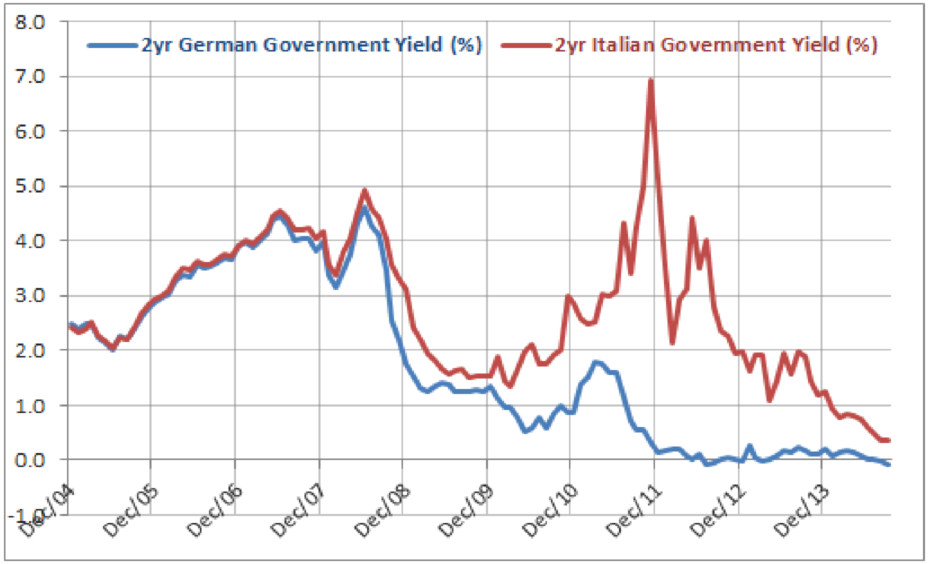
**→ All Investment grade bonds maturing within 5YR will trade below 0.75%**




*Source: Bloomberg, ESA/ BNP PAM, Sept 30, 2014*

- **Long end protected by low inflation and global cash in excess**

**→ Bullish rally, but with volatility due to the US bond market impact**



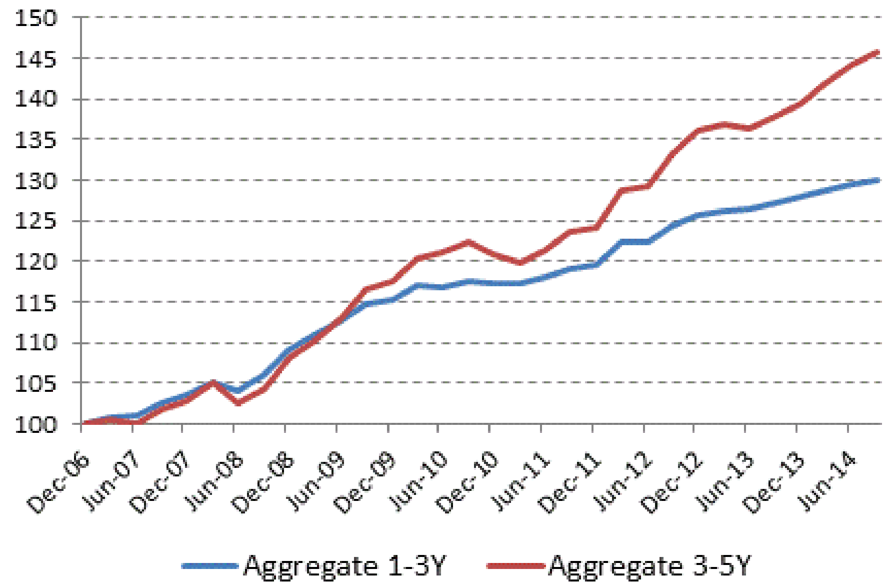

*Source: Bloomberg, ESA/ BNP PAM, Sept 30, 2014*
*Past or current yields are not indicative of future returns*

# Lessons learned from the usual investment guidelines of our US clients

# The usual guidelines analysis

## Maturity Constraint

| Performance from 2007 to Q3 2014 | Aggregate 1-3Y | Aggregate 3-5Y |
|---|---|---|
| **Average Quarter** | **0.85%** | **1.23%** |
| **YTQ3 2014** | **1.53%** | **4.43%** |
| VaR 95% | -0.10% | -0.22% |
| Positive Hit Ratio | 84% | 84% |
| 2011 | 2.29% | 3.22% |
| 2008 | 5.77% | 5.99% |
| 2007 | 3.56% | 2.80% |
| MaxDrawDown | -0.73% | -1.51% |
| Recovery - Year | 0.4Q - 2008 | 0.2Q - 2008 |



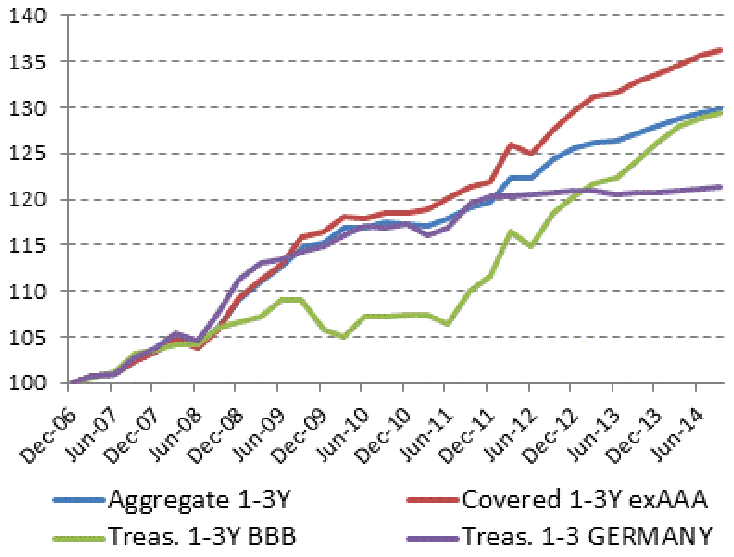

- **Incremental returns on short- to medium-term maturities**
- **Up to 5 years, the same level of risk: low, and offset by the “roll down”**
- **Rational: ECB policy is driving these yield curve sector segments**

→ **The efficient limit is the average life of the whole portfolio**

# The usual guidelines analysis

## Government Constraints

| Performance from 2007 to Q3 2014 | Aggregate 1-3Y | Covered 1-3Y exAAA | Treas. 1-3Y BBB | Treas. 1-3 GERMANY |
|---|---|---|---|---|
| **Average Quarter** | **0.85%** | **1.01%** | **0.85%** | **0.63%** |
| **YTQ3 2014** | **1.53%** | **1.96%** | **2.61%** | **0.60%** |
| VaR 95% | -0.10% | -0.10% | -0.27% | -0.10% |
| Positive Hit Ratio | 84% | 87% | 77% | 81% |
| 2011 | 2.29% | 2.99% | 3.92% | 2.62% |
| 2008 | 5.77% | 5.62% | 2.91% | 7.30% |
| 2007 | 3.56% | 3.40% | 3.67% | 3.74% |
| MaxDrawDown | -0.73% | -0.88% | -6.63% | -0.54% |
| Recovery - Year | 0.4Q - 2008 | 0.4Q - 2008 | 0.2Q - 2010 | 0.2Q - 2009 |

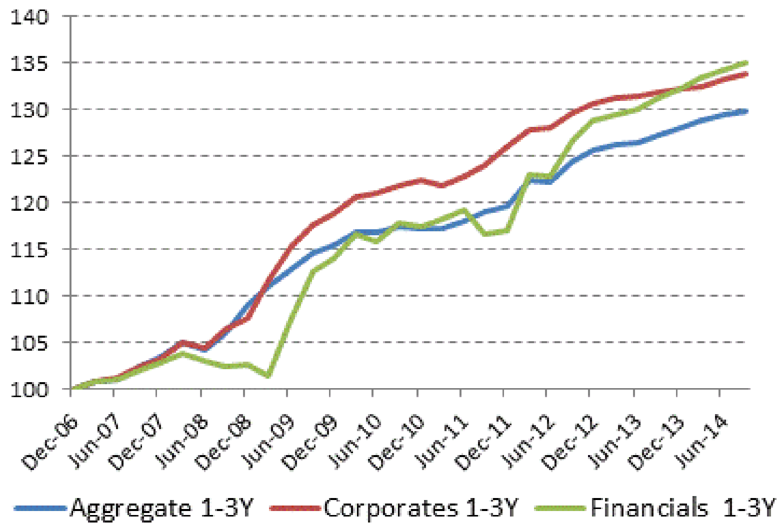



- **All investment grade government bonds performed yoy on short term maturities what ever the period of time during the crisis**
- **In fact, issuer diversification reduced volatility**
- **The new bail-in bank directive protects government and covered bonds**
- **The covered bond market is regulated by law: a bank bond reinforced by collaterals**

# The usual guidelines analysis

## Sector Constraints

| Performance from 2007 to Q3 2014 | Aggregate 1-3Y | Corporates 1-3Y | Financials 1-3Y |
|---|---|---|---|
| **Average Quarter** | **0.85%** | **0.95%** | **0.99%** |
| **YTQ3 2014** | **1.53%** | **1.26%** | **2.10%** |
| VaR 95% | -0.10% | -0.10% | -0.12% |
| Positive Hit Ratio | 84% | 94% | 77% |
| 2011 | 2.29% | 2.92% | 0.09% |
| 2008 | 5.77% | 4.18% | 0.21% |
| 2007 | 3.56% | 3.32% | 3.08% |
| MaxDrawDown | -0.73% | -2.01% | -2.18% |
| Recovery - Year | 0.4Q - 2008 | 0.8Q - 2008 | 0.6Q - 2011 |




- **Short-term funding needs are ensured by the ECB operations**
- **The ECB “forward guidance” supports cheap loans for corporates: reducing credit risk**
- **Improving diversification without increasing risk: mainly a liquidity issue**

→ **Financial sector risk is not offset by performance (2008, 2010-2011)**

# Our best guidelines for a Eurobond portfolio

**Euro Aggregate 1-3 yr**

| Main Characteristic proposed | |
|---|---|
| Benchmark | Barclays Euro Agg 1-3 yr |
| Leeway vs Benchmark | +1 / - 1.5 yr |
| Max individual maturity | 60 month |

| | Min | Max | Max per Issuer |
|---|---|---|---|
| Gov & Gov Related | 0% | 100% | 25% |
| Corporate | 0% | 50% | 2% |
| Financial (Eurozone) | 0% | 15% | 2% |
| Financial (Non Eurozone) | 0% | 15% | 2% |
| Covered | 0% | 50% | 3% |

A lower-volatility euro aggregate portfolio

# Conclusions and Recommendations

**Outlook for 2014 year-end**

- **ECB on hold for years - no rate hike before 2016 or even 2018:**
  - ✓ **Rate compression below 0.75% till 7 years maturity**
- **Euro core rates in 2014-2015:**
  - ✓ **Decoupling with the US rates for maturities below 7 years**
  - ✓ **A YC steepening**
- **Large banks already prepared to the AQR: positive for financial sector and high beta names**
  - ✓ **Search of yields in subordinated banks & BBB corporates**
- **Increasing volatility due to global market (FX)**
  - ✓ **Added value coming from active & fundamental portfolio management**

**Product Recommendations**

- **Neutral to bullish in duration through**
  - ✓ **Covered bonds**
  - ✓ **Non AAA government debts**
- **A YC flattening exposure by overweighting 3-5 maturity band**
- **A carry search on peripherals short-term debts**
- **A corporate exposure to the 3-5 maturity band**
- **Style: active bond management of the whole Eurobonds “aggregate” universe on a 3-year horizon**