TOBAM
CORE INVESTMENTS

DIVERSIFICATION DASHBOARD

October 2016

Diversification Ratios®

TOBAM's Diversification Ratio® (DR) measures to what extent a portfolio is diversified. The DR² (square of the diversification ratio) measures the number of effective degrees of freedom to which a portfolio is exposed.
As the table shows, the "broad market" indices leave diversification on the table. In addition to a snapshot of each market's DR², the table shows the DR² of a well-diversified portfolio, and the fraction of available diversification used by the index.

Universes	DR² Index diversification	DR² Maximum diversification®	% diversification used by index
All Countries World	4.24	13.50	31.4 %
World	4.02	12.00	33.5 %
Canada	3.94	9.82	40.1 %
US Equity	2.96	7.62	38.8 %
Emerging Markets	3.67	7.54	48.6 %
Pacific Ex-Japan	2.21	5.53	40.0 %
UK Equity	2.54	3.95	64.3 %
Japan	1.85	3.69	50.3 %
EMU	1.91	3.58	53.2 %
US Credit	3.13	4.31	72.7 %

Source: TOBAM, figures as of September 30, 2016

The commodity sector conundrum: a case for diversification in the US credit space

This month's Diversification Dashboard highlights the unusual market conditions currently prevailing in the US Credit market, and what we believe is an attractive opportunity for diversification.
We discuss in this note the commodity sectors and their concentration in the benchmark, the rising default rates, and spread compensation (or lack of thereof).
We make the case that the relentless rally in the benchmark's biggest concentrations, and a widening disconnect with the operational and fundamental background of the commodity complex, set the stage for a diversified approach to investing in credit.

1. The BofA Merrill Lynch US Corporate & High Yield Index is biased towards commodity / energy sectors.

The credit market positioning is heavily concentrated towards energy names, an even more striking fact when looking at risk-weighted concentrations.

Chart 1: Sector concentrations in the index

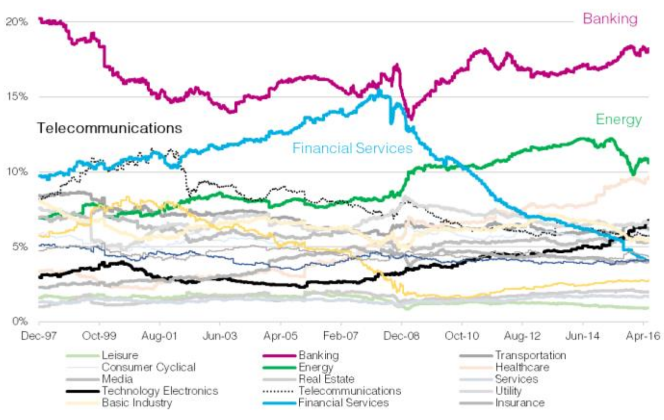
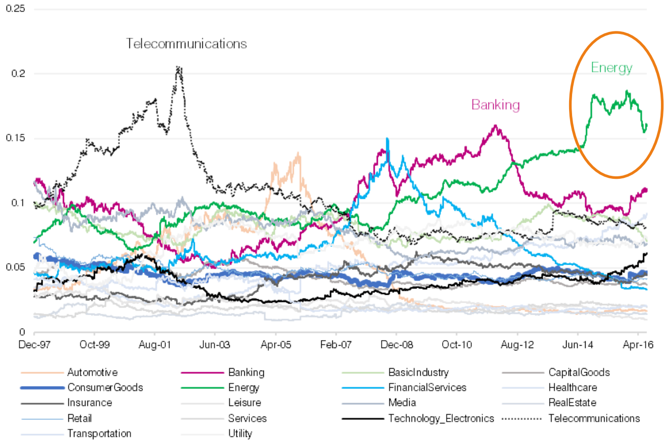


Chart 2: Risk-weighted sector concentrations in the index



Source: TOBAM, Bloomberg. Data as of September 30th 2016
Concentrations in chart 2 weighted using Duration Times Spread (DTS)

2. On the back of recovering commodity prices, these sectors have performed strongly so far this year.

Chart 3: IG performance by sector

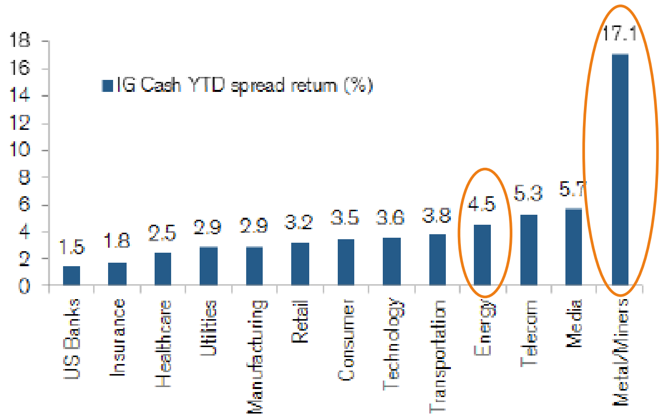
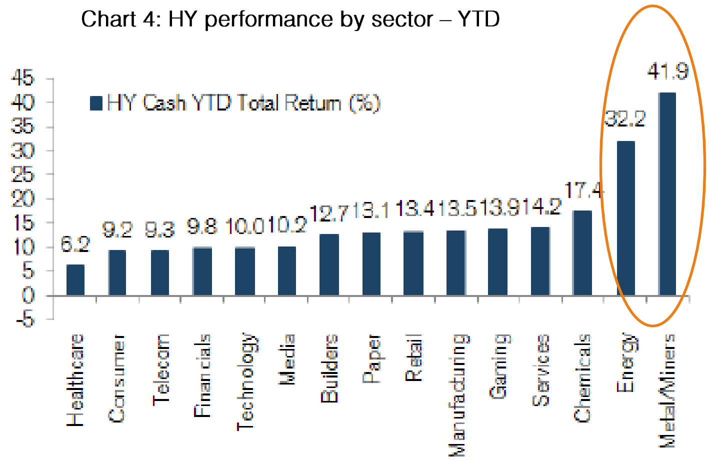


Chart 4: HY performance by sector – YTD



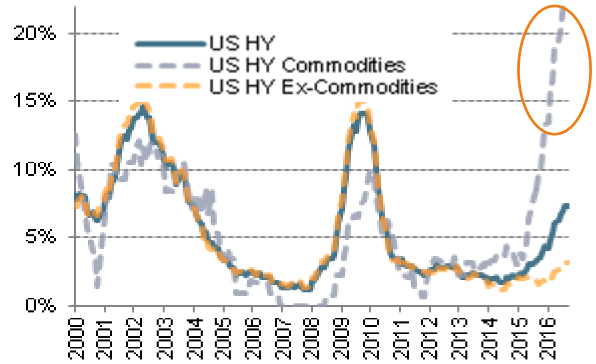
Source: Credit Suisse – Data as of September 30th 2016

3. But commodity names are still very much fundamentally distressed, with depressed oil prices and default rates rising fast.

Chart 5: Oil prices (West Texas Index) down -54% in 2.5 years

Source: Bloomberg. Data as of September 30th 2016

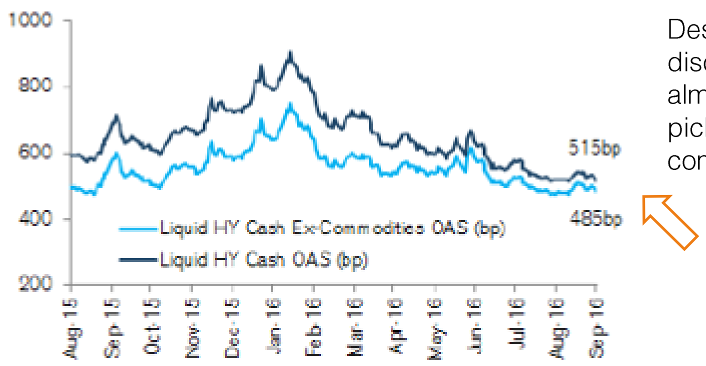
Chart 6: Default rates - Last 12 months



Source: Creditsights. Data as of September 30th 2016

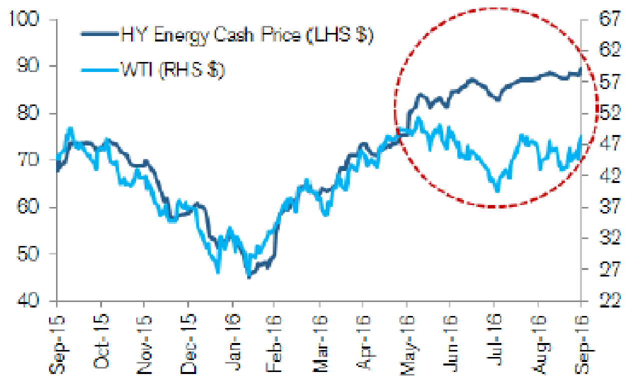
4. This weak fundamental picture has explained the spread pick-up between commodity names and the rest of the market. More recently though, following months of a strong rally in commodity sectors, this discount has shrunk dramatically.

Chart 7: HY average spread with and without commodity names



Despite numerous defaults and low oil prices, the discount commodity names were trading at has almost disappeared: the 70bps to 100bps spread pick-up that investors used to earn for taking commodity risk has shrunk to almost nothing.

Chart 8: Disconnect between energy credits and oil prices



In the meantime, while the rebound from the lows in oil prices has stalled, HY energy bonds have continued to benefit from a risk-on environment. The disconnect between energy bond prices and the underlying fundamentals is widening.

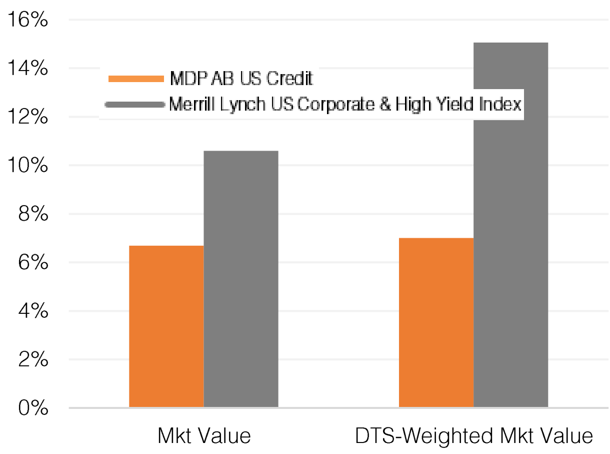
Source: Credit Suisse. Data as of September 30th, 2016

5. Such a mismatch between spreads on the one hand, and default rates and operational background on the other hand, is highly unusual. A well-diversified strategy would benefit if it were to normalize.

By permanently maintaining a high Diversification Ratio®, the Anti-Benchmark strategy diversifies across risk factors, away from the benchmark's biggest bets toward the commodity complex.

Chart 9: Diversification Ratios squared weights

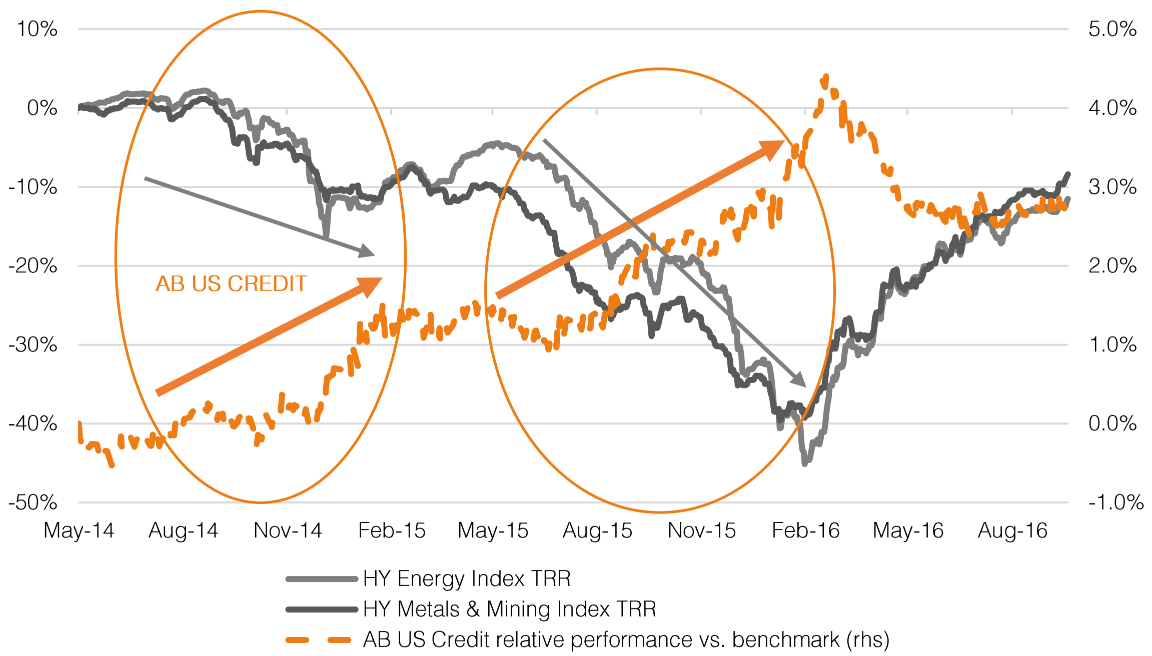
Chart 10: Credit energy sector weights and risk-



Source: TOBAM. Data as of September 30th, 2016

Hence, historically since inception, the AB US Credit strategy experienced its greatest periods of outperformance at times of stress in the commodity sectors.

Chart 11: AB US Credit relative performance vs. benchmark, and BofA HY Energy and Metals & Mining sub-indices.



Source: Credit Suisse. Data as of September 30th, 2016

Conclusion

- This disconnect between the gloomy fundamental picture of the commodity market and investors' appetite for Energy and Metals & Mining bonds might prove difficult to hold.
- Spreads and default rates are closely related, and the higher risk profile of commodity names should warrant a higher risk premium.
- The rally in oil prices has stalled, while energy bonds keep rallying.
- If these relationships were to normalize, the benchmark with its high concentrations in Energy and Metals & Mining should suffer.
- We believe these market conditions in the US Credit market strongly support the case for a diversified approach, such as the one applied in Anti-Benchmark US Credit.

Appendix
Anti-Benchmark® US Credit Overview

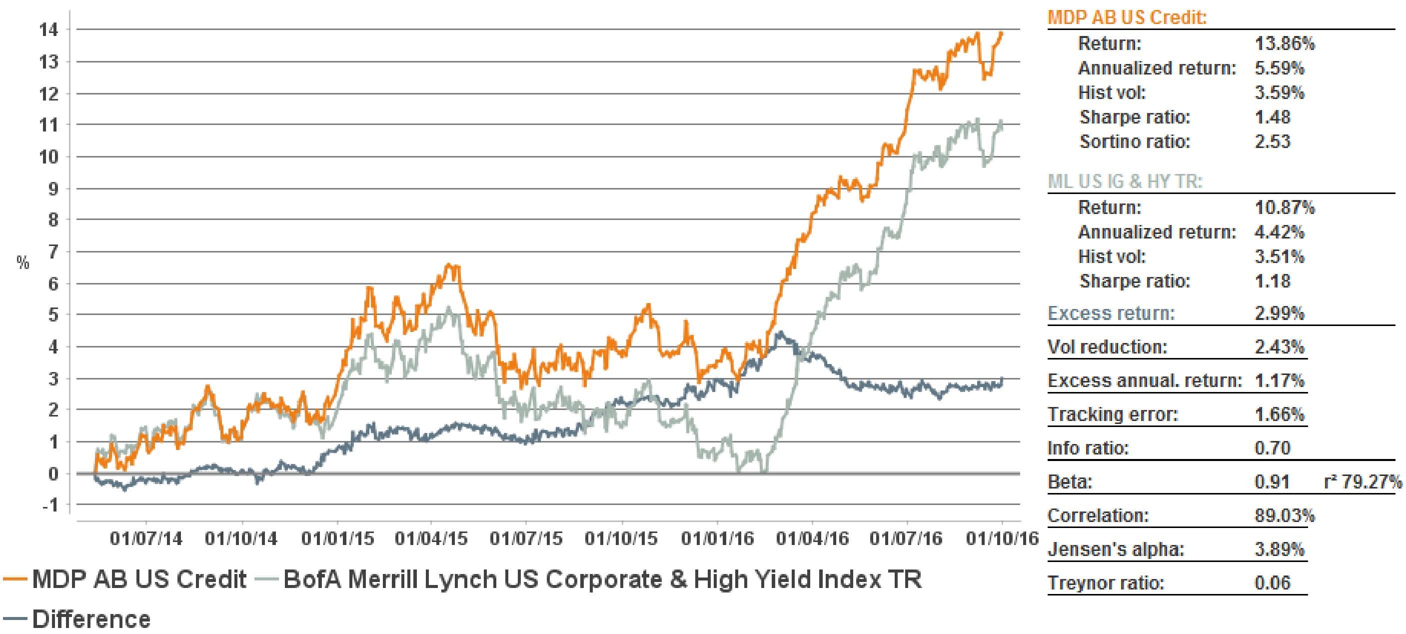
Objective:

- Achieve higher diversification and minimize exposure to the risk concentrations inherent in issuer-weighted bond indices to support building a more efficient credit portfolio
- Outperformance is driven by the benefits of diversification

Characteristics:

- Launch Date: May 12, 2014
- Investment universe: BofA ML US Corporate & High Yield Index
- Long-only, no leverage, fully invested across both US IG and HY markets
- The strategy matches benchmark average duration and spread (+/-10%)
- Strategy assets in excess of $330 million
- Well-diversified credit portfolio comprised of attractive securities from a fundamental and technical standpoint.

Chart 12: Performance since inception (as of September 30th, 2016)



Source: TOBAM – Returns are gross of fees. Past performances are not indicative of future results nor are they reliable indicators of future performance. Figures and data as of September 30th, 2016.

For more information

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