PICTET 1805

Pictet Asset Management | Q2 2013 — For professional investors only

Emerging Debt Hard Currency Strategy

Quarterly Newsletter (USD)

Market review
Over the second quarter, emerging market external/USD debt was down 5.6%, with investment grade countries some of the worst hit given closer correlations with US Treasuries in the face of rapidly rising yields, particularly following the US Federal Reserve's comments on quantitative easing. Some of the worst returns in higher-grade countries were seen in Brazil, Mexico, China, Malaysia and Kazakhstan, all down between 5% and 8%. Below investment-grade countries, where underlying fundamentals have a greater influence, were down 4.7% overall. One of the few bright spots was Hungary, which registered a positive return of 3% and growth was much better than expected. In terms of the highest beta countries, the worst hit were Morocco, Venezuela, Ivory Coast and El Salvador, which were all down 10% or more. Argentina was up almost 7%, but this is based more on speculative investors rather than fundamentals as the court case continues. Turkey was upgraded to investment-grade status by Moody's, and industrial production was better than expected. However the bonds saw a negative return of close to 5%, with simmering political discontent at the end of May developing into full-on demonstrations and a call for Prime Minister Erdogan to step down. In terms of credit-rating actions, Venezuela was downgraded one notch to B by S&P while Latvia was upgraded to BBB+ by S&P and Turkey to Baa3 by Moody's.

Performance analysis
The strategy outperformed the benchmark over the quarter resulting from our more defensive bias such as being underweight duration particularly in countries with a higher sensitivity to US Treasury yield movements. An underweight to the Philippines was one of the biggest contributors to performance as the bond rally earlier in the spring following a credit rating upgrade to investment-grade status turned to negative returns as investors started to take profits, particularly as exports surprised on the downside. An underweight to Brazil was also strongly positive as this was one of the worst hit markets, with bonds down 10%. Underweights in Mexico and China were also key outperformers. There were no major single detractors, but our defensive positioning in Argentina from security selection detracted as positive returns were driven by speculative investors. Lastly, an off-benchmark defensive position to emerging currencies contributed, in particular the South African rand and the Russian rouble, which were some of the worst hit over the quarter.

Performance[1]

Annualised %		Q2	YTD	1yr	3yr	5yr	Since inception[2]
Pictet Emerging Debt Composite		-5.24	-6.61	2.61	7.80	10.35	13.83
JP Morgan EMBI Global Diversified (TRI)		-5.64	-7.77	1.11	7.33	8.37	9.69
Relative performance		0.40	1.16	1.50	0.47	1.98	4.14

Calendar years %	2012	2011	2010	2009	2008	2007	2006
Pictet Emerging Debt Composite	17.83	8.63	9.77	30.4	-4.33	7.35	12.31
JP Morgan EMBI Global Diversified (TRI)	17.44	9.77	12.24	29.82	-12.03	6.16	9.86
Relative performance	0.39	-1.14	-2.47	0.58	7.70	1.19	2.45

[1]Pictet Emerging Debt Composite for pooled portfolios, gross of fees in USD, 30.06.2013. [2]Inception date 30.11.1998. Benchmark 50% ELMI+ & 50% EMBI+ (TR) Index to 31.01.2002.

Risk statistics 5yr annualised in %

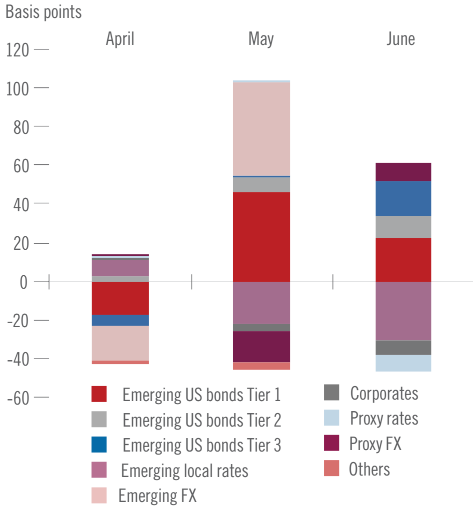
	Pictet Emerging Debt Composite	JP Morgan EMBI Global Diversified (TRI)
Standard deviation	10.45	11.84
Ex-post Tracking Error	2.53	—
Information ratio	0.71	—
Beta	0.87	—

Top 10 country exposures for USD Bonds in %

	Rep A/C	JP Morgan EMBI Global Diversified (TRI)
Indonesia	6.9	4.9
Russia	5.6	5.4
Philippines	5.3	5.2
Turkey	4.3	5.3
Venezuela	4.1	4.0
Mexico	3.6	5.1
Lebanon	3.4	3.3
Colombia	3.1	4.0
Ukraine	3.1	3.6
South Africa	3.0	3.0
Off benchmark currency exposure	13.5	

Country positions are taken from the Pictet-Global Emerging Debt fund, which is included in the composite.

Attribution



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All data presented as at 30.06.2013 in USD — Source: Pictet

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Portfolio activity

Over the quarter, we actively managed the strategy's duration, but within an overall bias to be underweight duration given the overall trajectory of spread widening. In the higher-grade countries, such as Mexico and the Philippines, we slightly reduced our underweights towards the end of the quarter when US Treasury yields started to stabilise. In mid-grade countries, where we had some small and selective overweights, such as Namibia and Turkey, we have turned more neutral to get closer to the benchmark. Higher-yielding countries were not hit as badly earlier in the quarter, but began to slip during the worst of the sell-off in June. Here we generally maintained a neutral position. We kept the underweight to Argentina despite some positive returns by very speculative investors as the current court case with 'hold out' creditors is ongoing and a positive outcome remains uncertain. One of our few recent overweights has been in the Dominican Republic, where we decided to go underweight as we saw selling pressure extending to some of these higher beta names. In off-benchmark corporate bond exposure, we cut the 3% position to close to zero by the end of the quarter as we started to see liquidity become an issue and this was clearly the right decision. We also employed tools to protect the strategy, in particular hedging the strategy against the impact of rising US Treasury yields.

Market outlook

The 10-year US Treasury bond yield rose to 2.6% at its peak during the quarter and spread on the benchmark now stands at 325bps. It remains uncertain how quickly yields may rise further, if we see stabilisation and whether this is the first real sign of the so-called 'great rotation'. Currently, the short-term outlook is challenging, and we cannot rule out more rapid outflows from the asset class. However, it remains well supported by long-term institutional investors, and we have seen some further allocations by investors who may be viewing this as a buying opportunity with the yield now at 5.8%, although this has been small. Lower-beta countries have an element of correlation with movements in US Treasuries, while higher-yielding and less correlated countries may continue to provide interesting opportunities, but these are likely to see some pressure as well. In addition, it is not a static opportunity-set as new bonds are issued along the curve, and new countries are potentially issuing for the first time, mostly sub-Saharan Africa.

Portfolio strategy

We continue to emphasise an overall underweight duration while being very active and selective in our tier 1 and 2 countries. Some of the highest-grade countries, such as Brazil and Russia, are seeing position unwinding and this does not look as though it will stop soon, given rising yields across global fixed-income markets. As a result, we are likely to continue our defensive bias, which has served the strategy well year to date and during other periods of market pressure over the years. We may look for opportunities in higher-beta countries such as Vietnam and the Dominican Republic as well as quasi-sovereigns and even investment-grade countries which may have been oversold. However, we do see current market pressure continuing in the short term. In terms of off-benchmark positioning, our bias is to be long USD given the stronger dollar theme. This means we are unlikely to put on any meaningful long exposure to emerging currencies. In emerging rates, we are looking at highly selective positions to take advantage of specific trends and events. For example, the growth slowdown in Russia had been pointed to the possibility of an easing cycle by the central bank, but given rouble weakness, this may be off the table for now. Of course, markets remain highly sensitive to global data and policy actions, as we are clearly seeing now, and this means we need to have the flexibility to make changes in the strategy quickly.

USD Bond duration in years

	Rep A/C	JP Morgan EMBI Global Diversified (TRI)
Mexico	0.48	0.42
Indonesia	0.45	0.38
Turkey	0.42	0.39
Russia	0.38	0.30
Philippines	0.38	0.43
Peru	0.34	0.31
Colombia	0.32	0.29
Brazil	0.26	0.42
Kazakhstan	0.25	0.23
Chile	0.24	0.23
Venezuela	0.24	0.21
Panama	0.23	0.23
Lebanon	0.21	0.16
South Africa	0.21	0.19
Poland	0.21	0.19
Uruguay	0.19	0.17
Hungary	0.18	0.18
Argentina	0.14	0.10
Croatia	0.12	0.12
Lithuania	0.11	0.12
Ukraine	0.11	0.13
El Salvador	0.10	0.12

Weighted modified duration positions are taken from Pictet-Global Emerging Debt fund, which is included in the composite. Duration breakdown >0.10.

Strategy information

Strategy inception	30.11.1998
Strategy assets	USD 7.5 bn
Investment objective	To outperform the JP Morgan EMBI Global Diversified index by 1-3%per annum, gross of fees
Investment team	Simon Lue-Fong Orlena Yee Mary-Thérèse Barton Wee-Ming Ting Philippe Petit

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