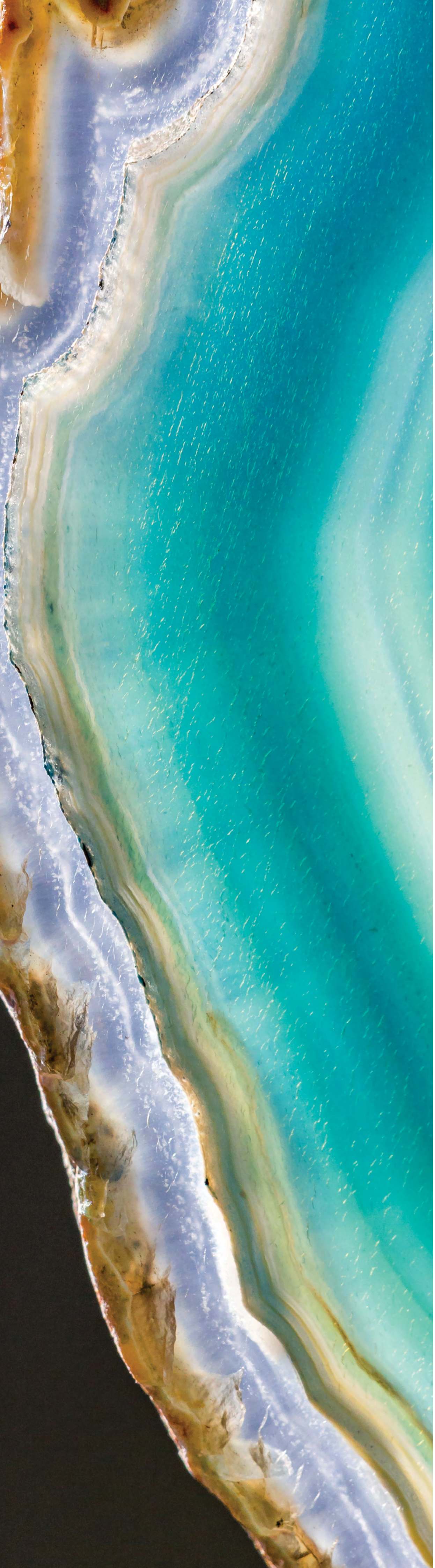


Manulife Investment Management

Portfolio Insight

Asia Total Return Bond Strategy: celebrating 10 years of delivering compelling returns

Overview

Manulife Investment Management's flagship Asia Total Return Bond Strategy recently marked its 10th anniversary. The strategy adopts a flexible and dynamic approach to the rapidly growing asset class, allocating across a wide range of currencies and credits in the Asia Pacific (ex-Japan) region. Since its inception in September 2009, the strategy's unique approach has created value for investors through a diverse range of market environments.

As we celebrate the strategy's 10th anniversary, we recap its achievements and innovations over the past decade. We also examine how the Asian fixed-income universe has evolved into a highly diversified, high-quality stand-alone asset class that, in our view, deserves investors' attention.

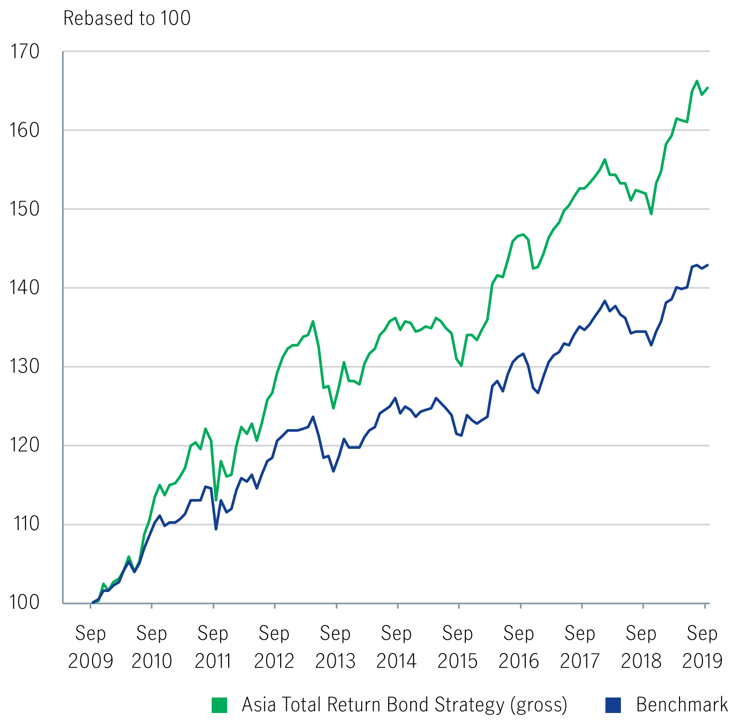
The strategy's performance over the past 10 years

The strategy has delivered consistently attractive risk-adjusted returns. As of September 30, 2019, cumulative gross return over 10 years[1] totaled 65.40%, which is equivalent to annualized returns of 5.16% and a risk-adjusted return of 1.00% per year since inception.[2] Assets under management have grown over 20-fold in the same time period, from US$20 million to US$463 million, bringing the total amount managed by the portfolio management team to more than US$12 billion.

The strategy derives its return from three key sources: interest rates, credit, and currency. In the past 10 years, the portfolio's total duration has ranged between 2.5 years and 5.3 years, exemplifying the strategy's dynamic approach to capturing interest-rate opportunities across different interest-rate cycles.

In addition, the strategy has pursued a flexible investment approach over the years, capturing the diverse opportunity set in the Asian fixed income universe. Our active blended approach can be observed by the portfolio's changes in exposure to the U.S. dollar and Asian currencies since inception.

Cumulative return and returns at different time intervals, 2009–2019



Performance (%)/timeframe	Quarter to date (2019)	Year to date (2019)	1 year	3 year	5 year	7 year	Since inception
Strategy	0.24	6.84	8.91	4.07	4.19	3.59	5.16
Benchmark	0.27	5.28	6.4	2.79	2.87	2.47	3.64

Source: Manulife Investment Management, September 2019. To calculate risk-adjusted return, we divide the strategy's annualized return by its standard deviation. The strategy has a blended benchmark, comprising—in equal weightage—the J.P. Morgan Asia Credit Index (USD) and the J.P. Morgan Emerging Local Market Plus Asia Index. Performance shown relates to the Asia Total Return Bond Strategy in U.S. dollars, at the composite level, gross of fees. Composite gross return calculates the average value of the performance of all the investment. Past performance does not guarantee of future results.

Contribution to performance

Interest rates

Over the past decade, interest rates were the largest contributor (45%) to cumulative returns. This can be attributed to the portfolio management team's active positioning efforts amid accommodative monetary policy from global central banks. The team benefited greatly from the firm's extensive footprint in Asia; for example, our local fixed-income team in Jakarta helped to position us for the downward move in interest rates in Indonesia[2] when the portfolio was overweight duration, boosting performance significantly. Active management of the portfolio's U.S. dollar duration also contributed to returns, although to a lesser extent.

Credit

Active credit management was the second-largest contributor (39%) to the strategy's cumulative return since inception. Credit selection is critical when investing in the large and diverse Asian fixed-income universe, where the ability to correctly identify investment opportunities can have a sizable impact on returns. Notably, the strategy has recorded zero credit defaults since its inception[4]—a reflection of the strong collaboration between the portfolio managers and the Asian credit research team.

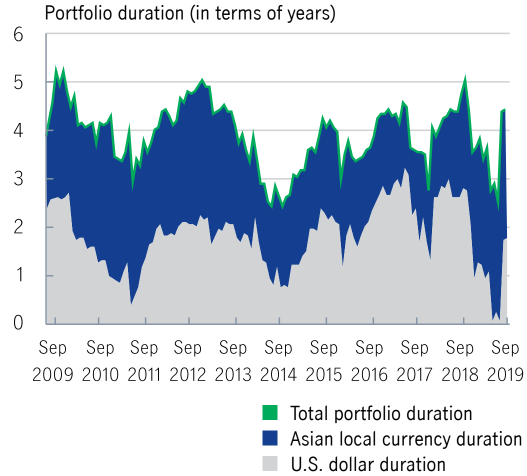
It's worth noting that the strategy's credit profile has evolved along with structural changes in the asset class. Overall, the strategy has maintained an average weighting of 15% in the high-yield segment, enabling investors to take part in the compelling upside of this market, while actively managing portfolio risk by maintaining an average investment-grade rating for the portfolio.[3] Over time, the portfolio management team strategically increased exposure to the "BBB"-rated corporate space,[5] as more quality Asian corporates turned to the debt market to raise funds—where the team is concerned, the yield to quality in this credit segment represented a sweet spot.

Currency

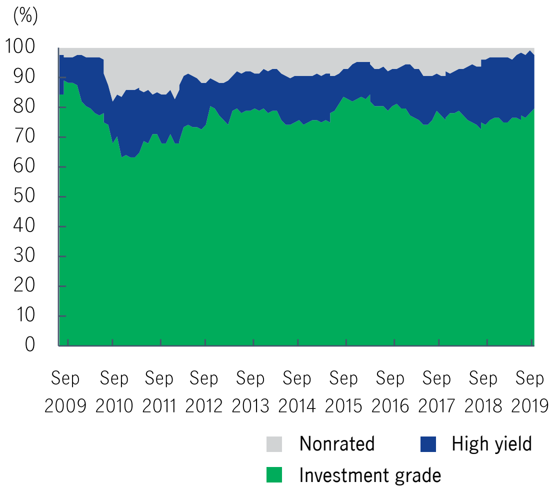
Finally, currency positioning added a smaller, but steady, contribution (16%) to the strategy's return. The strategy's blended[6] approach allows the portfolio management team to take both U.S. dollar and local currency positions in the region's debt market. The flexible nature of the strategy, which allows for exposure to key Asian currencies such as the Indonesia rupiah and Chinese renminbi, also contributes to positive returns from a currency perspective during periods of U.S. dollar weakness.

Evolution of the strategy's positioning over the past 10 years

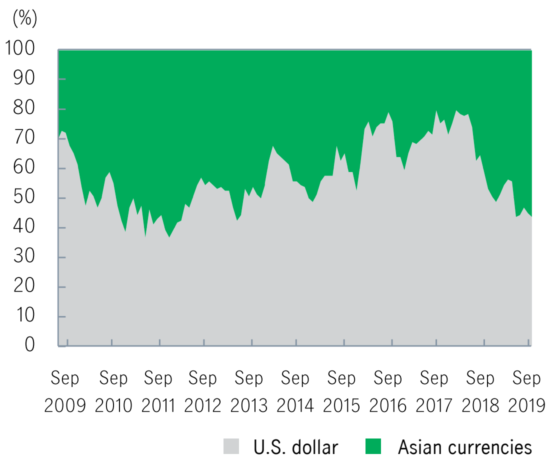
Historical portfolio changes: duration changes



Historical portfolio changes: rating changes



Historical portfolio changes: currency changes



Source: Manulife Investment Management, as of September 30, 2019.

The strategy's competitive edge

The strategy's strong performance over the past decade can be attributed to several key factors: its flexible approach, a stable portfolio management team with an extensive regional footprint, and our dedication to innovation.

A strategy that prioritizes flexibility

Manulife Investment Management's Asia Total Return Bond Strategy adopts a "go anywhere" approach that seeks opportunities in both hard currency and local currency bond markets across the region with the objective of maximizing return potential. In other words, the strategy enables the portfolio management team to invest flexibly across the entire US$18 trillion Asian fixed-income spectrum.[7] This blended strategy differs from its more rigid peers that focus exclusively on either U.S. dollar-denominated or local currency credits in the region. This allows the portfolio to be more diversified than pure U.S. dollar Asian bond portfolios, and therefore, less volatile than pure local currency strategies.

Strength of the pan-Asian fixed-income team

The strategy is managed by our pan-Asian fixed-income team, which is supported by more than 50 investment professionals located in 10 offices across Asia. Besides the team's notable size, two other factors set them apart from their peers:

Team stability and continuity

Endre Pedersen, Asia fixed-income chief investment officer, and Portfolio Manager Neal Capecci have been managing the strategy since its inception 10 years ago. They were later joined by seasoned portfolio managers Jimond Wong and Murray Collis, creating a team with complementary strengths, bringing synergy and stability to the table. This is a key factor that distinguishes our strategy from industry peers.

Extensive regional footprint

Importantly, our pan-Asian fixed-income team has analysts located across the region, including important emerging markets (EM) such as Indonesia and China. Our extensive regional footprint serves as a key competitive advantage, enabling us to gather proprietary intelligence and trade ideas on the ground across Asia.

The pan-Asian fixed-income team

Pan-Asian fixed-income team

Endre Pedersen
Chief Investment Officer

Neal Capecci
Portfolio Manager

Murray Collis
Portfolio Manager

Jimond Wong
Portfolio Manager

Environmental

Social

Governance

Strategy innovation: incorporating environmental, social, and governance (ESG)

To augment our competitive edge, Manulife Investment Management's pan-Asian fixed-income team continually seeks to adopt innovative policies. In 2015, our firm became a signatory to the UN Principles for Responsible Investment (PRI) and since then, we've formally incorporated a robust ESG perspective into our investment analysis and decision-making processes.

Apart from conducting traditional research and financial analysis on every single issuer, our credit analysts work closely with our dedicated ESG research team to review ESG factors. In addition, a bespoke ESG taskforce for our Asian fixed-income portfolios has been set up to track the progress of our ESG integration.

Through our proprietary ESG framework, we examine the relevant ESG risks that issuers are exposed to, and then assign an appropriate risk intensity ranking to each factor. The rankings focus on risks that may affect the credit profile of a company and can take the form of reduced cash flow, weakened protection of creditors' interests, or other credit considerations that may influence default risk.

Each intensity ranking corresponds to an estimated impact to our proprietary internal risk rating. This forms the basis of our internal credit rating as we assess the relative merits of issuers and the fair value of their bonds before deciding if they represent appropriate investment opportunities for the team. Palm oil production in Asia, for example, is one instance where ESG factors affected our credit assessment. The industry is typically associated with poor labor conditions and the negative effects it can have on the environment, which includes deforestation, excessive water usage, and the loss of biodiversity. These are issues that could result in credit risks to companies in the sector, and importantly, influence the team's assessment of their credit profiles.

Why Asian fixed income now?

The Asian fixed-income universe has experienced significant transformation over the past decade. Indeed, investors have traditionally viewed the market as part of a broader asset allocation to EM fixed income. However, over time, Asia has distinguished itself as a quality, stand-alone market that's worthy of its own strategic asset allocation.

In our view, several compelling reasons underpin this palpable shift in investors' perception:

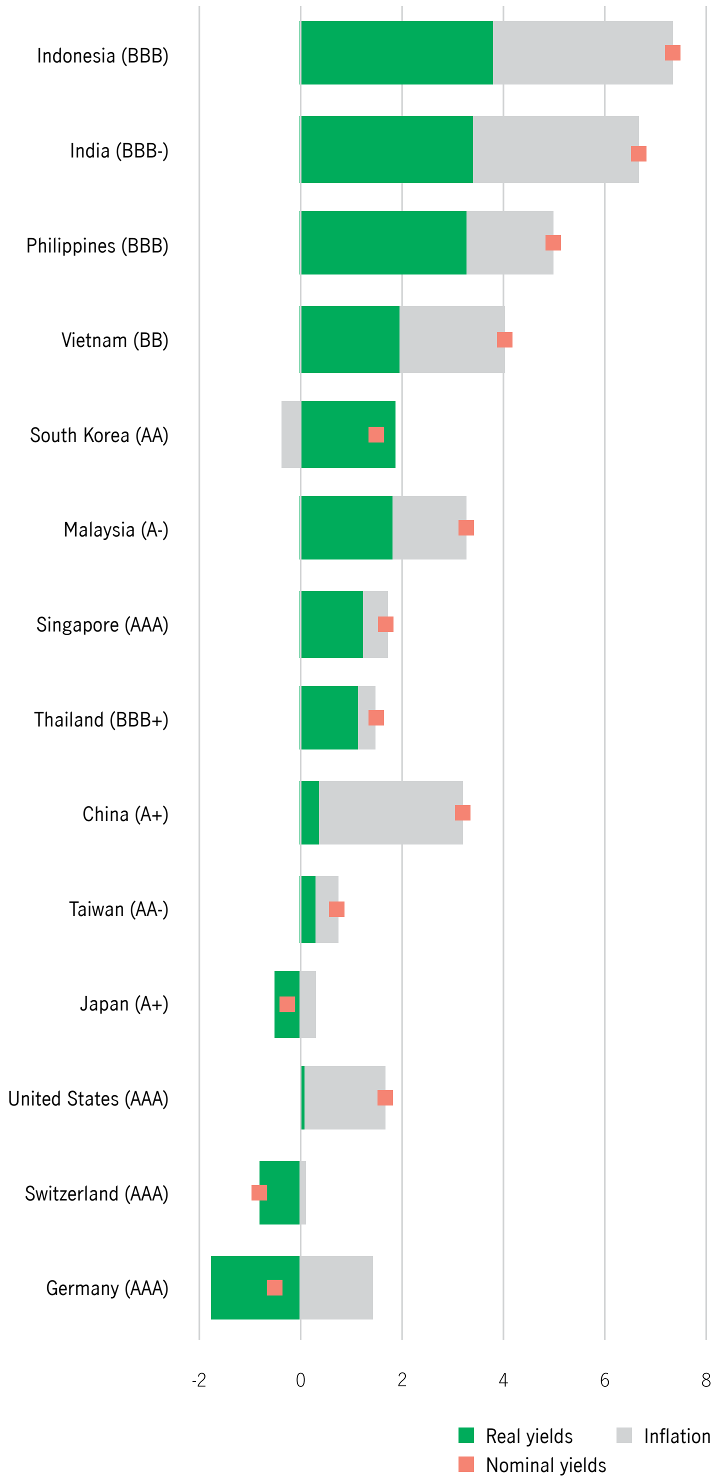
Asia offers strong economic fundamentals, attractive real yields, and an improved credit profile

Asia's increased influence in global fixed-income markets is primarily due to the region's dynamic economic performance, attractive real yields, and improved credit profile. Asia is one of the most diverse regions in the world, accounting for 60% of the world's GDP growth rate and is home to 40% of the world's population.[8]

Asia's robust growth rate, coupled with the diverse sources of economic growth, has translated into an improved credit profile for the region over time, enabling the continent to differentiate itself from other EM economies. Almost all major Asian markets enjoy investment-grade sovereign ratings (apart from Vietnam), and have more favorable ratings compared with other EM regions.[9] In contrast, other large EM countries such as Argentina, Brazil, Russia, Turkey, and South Africa have seen significant credit rating downgrades over the past decade.[10]

At the same time, Asian central banks' prudent approach to managing inflation has helped to keep real yields for the region's sovereign debt firmly in the positive territory. This is in stark contrast to the growing sea of negative yielding debt in developed fixed-income markets, which stands at around US$15 trillion.[11] Overall, Asian bonds stand out as a compelling solution for forward-thinking global investors seeking sustainable returns, higher real yields, and potential diversification benefits.

Nominal and real sovereign yields of 10-year bonds: Asia vs. developed markets



Source: Manulife Investment Management, Bloomberg. Sovereign ratings based on the median rating between S&P, Moody's and Fitch, as of September 30, 2019. Inflation rate is represented by year-on-year change of consumer price index.

The rise of China in global fixed-income markets

The emergence of China's onshore bond market is one of the key regional developments over the past 10 years. Despite being the world's second-largest economy (in nominal GDP terms), China is currently home to only the third-largest, but rapidly growing, bond market. The market grew at an annualized rate of 16.6% over the past five years, effectively doubling in size.[12]

However, China's fixed-income market remains relatively closed with a low level of foreign ownership: as of January 2019, foreign holdings of Chinese domestic bonds stood at less than 3.0% of the market.[13] Nevertheless, this is changing as investors globally show increasing interest in the market and the diversification benefits it can offer, particularly after its inclusion in major global bond indexes in April. We believe recent decisions by Bloomberg Barclays and JP Morgan to include Chinese bonds in global bond indexes could send up to US$600 billion of "passive money" into the Chinese onshore bond market.[14]

Manulife Investment Management is uniquely positioned to help investors tap opportunities in the rapidly expanding China market. We've been investing in Chinese bonds (both onshore local currency and offshore U.S. dollar-denominated debt instruments) since the inception of the strategy in September 2009. Our portfolio managers have also been actively investing in Chinese local bonds through the offshore "dim sum" bond market, as well as the onshore market through the China Bond Connect arrangement.

Structural changes in Asia's fixed-income investment universe

We believe that investors will benefit from structural changes in the Asian fixed-income universe over the medium term. Over the past 10 years, the Asian fixed-income universe has both deepened and widened. The number and types of issuers have increased, boosting the market's overall liquidity, providing compelling new investment opportunities.

The J.P Morgan Asian Credit Index—which comprises U.S. dollar-denominated Asian bonds (100%)—for example,[15] has evolved significantly since 2009. Sovereign and quasisovereign issuers accounted for more than half of U.S. dollar credit issuance 10 years ago; they now represent 36.0% of the index. Similarly, financials and real estate now make up approximately 40.0% of the index—a world away from a decade ago, where the real estate segment barely registered on the index.

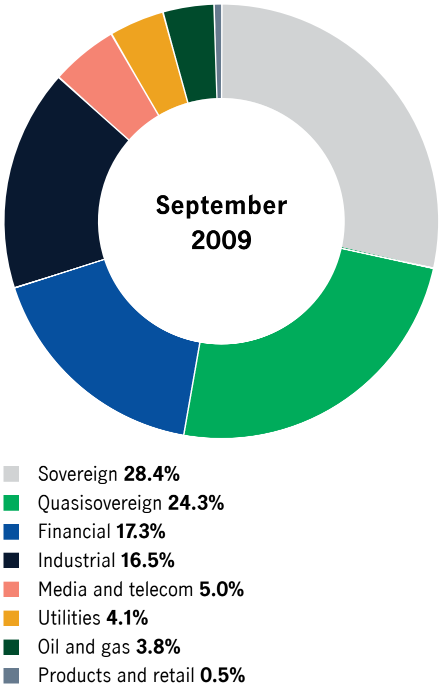
In terms of sovereign issuers, South Korea represented 28.0% of market capitalization, followed by Hong Kong (15.0%) and the Philippines (13.5%) back in 2009. Unsurprisingly, the picture has evolved significantly in just 10 years, with China now representing 51.0% (up from 6.4% in 2009) of total market capitalization, followed by Indonesia (11.1%) and South Korea (8.8%). This new norm demands the expertise of a well-resourced China-based credit team (such as ours) to navigate the constantly changing environment—something that requires a thorough screening of the issuers.

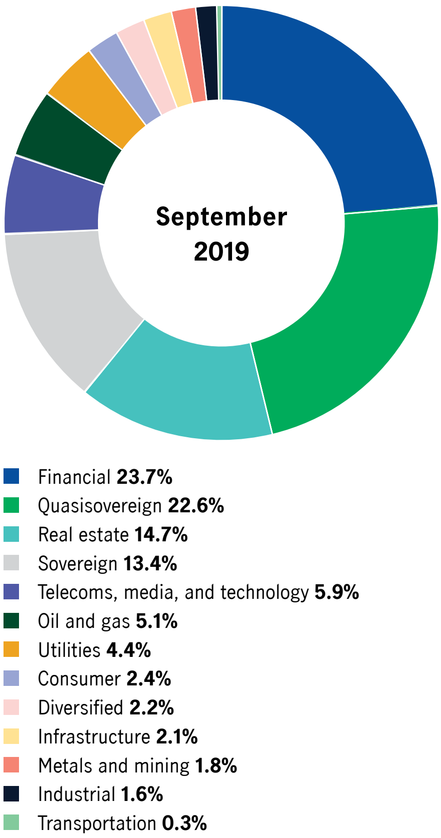
Finally, the quality of Asian debt, or credits, has improved: In 2009, 30.8% of credits were below investment grade; credits belonging in this category fell to 23.3% in 2019. This is a positive development that reflects numerous factors, including the credit-rating upgrade of key regional markets (such as Indonesia and the Philippines) to investment grade in this time period.

Furthermore, the "BBB"-rated credit segment has grown and deepened; its weight in the index rose from 12.7% in 2019 to 39.3% a decade later, while the number of bonds included in the index has also increased from 60 to 564. We're particularly interested in the corporate "BBB/A" space in Asia, which, in our view, offers an attractive risk/reward profile relative to global bond offerings inhabiting a similar credit spectrum.

On the demand side, the regional investor base for Asian credit has also evolved. Over the years, we've observed that the asset class has attracted a growing investor base from within Asia, taking the place of international investors from the United States and Europe. This is reflected by the fact that the portion of new U.S. dollar-denominated Asian bonds issued to investors based in the region has nearly doubled in the last 10 years, from 44.0% in 2009 to 80.0% this year.[16] The strengthened regional investor base enhances the stability of the asset class, particularly in times of increased volatility, helping to reduce the risk of capital flight.

Asia credit now and then (by sector)





Source: Bloomberg, as of September 2019.

Conclusion

The strategy's evolution, which took place in tandem with the development of the Asian fixed-income universe, underscores several key trends that are set to continue.

Improving market quality

The overall quality of Asian bonds is high and will continue to strengthen. This is evident from the region's improving sovereign credit ratings and evolving bond index composition, as the Asian fixed-income market transitions from comprising primarily high-yield issuers to investment-grade issuers such as the Philippines and Indonesia.

Increasing diversification opportunities

We expect the Asian fixed-income universe to continue to expand. Emerging Asian economies such as Vietnam will continue to diversify their financing needs away from traditional sources such as banks and increasingly tap into the region's rapidly developing capital markets. This is a development that's likely to be aided by the growth of new industries, such as social media and mobile-taxi network providers, which didn't exist 10 years ago. It's also likely that we'll see tremendous fixed-income opportunities emerge in relatively new markets such as India, where we're establishing a local presence.

Opening of China's bond market

China is opening its onshore bond market to foreign investors and attracting more companies to issue renminbi-denominated debt onshore. This process will continue over the next decade, making it one of the most important fixed-income markets globally. Once again, it's a development that will create new opportunities for investors and enhance the overall appeal of the region's fixed-income market.

The Asia Total Return Bond Strategy has offered investors 10 years of compelling returns. The flexible, nimble, and dynamic nature of the strategy has navigated through diverse market conditions over the past decade—its proven track record speak for itself. As we look forward, we believe the strategy will continue to perform strongly on the back of positive developments in the Asian fixed-income market.

Endnotes

1 Data shown represents performance captured between September 2009 and September 2019, in U.S. dollars gross of fees and does not include advisory fees and other expenses an investor may incur, which when deducted will reduce returns. For periods lasting more than one year, return figures will be annualized. Past performance does not guarantee future results. Changes in exchange rates may have an adverse effect. **2** In 2016, Bank Indonesia surprised markets with its aggressive monetary policy easing—the central bank cut key interest rate six times during the year to boost its economy amid muted inflation. **3** The strategy has maintained a 40% limit on high-yield debt since inception, with a 25% limit on corporate high-yield debt holdings. **4** Source: Manulife Investment Management, November 2019. **5** "BBB" refers to the Standard and Poor's rating of investment-grade bonds. The strategy increased its exposure to this credit segment from 10% in September 2009 to roughly 44% as of August 2019. **6** "Blended" in this context refers to the ability to invest in either U.S. dollar-denominated Asian credits or local currency credits. Other Asian total return strategies either exclusively invest in U.S.-dollar denominated Asian credits or local currency credits. **7** Asia Development Bank, Manulife Investment Management, June 2019. **8** International Monetary Fund, October 2019. **9** Bloomberg, June 30, 2019. **10** Bloomberg, September 2019. **11** *Financial Times*, October 1, 2019. **12** Asia Development Bank, as of September 2019. **13** "China's $13 trillion on shore bond market makes global index debut," *China Daily*, April 2, 2019. **14** JP Morgan in September 2019 that it will gradually add Chinese sovereign debt into its GBI-EM global bond indexes. The inclusion will commence on February 28, 2020, and roughly 1% of Chinese sovereign debt (as part of the total index) will be added monthly for a period of 10 months to its GBI-EM global diversified and narrow diversified indexes. Bloomberg Barclays announced that it will add Chinese RMB-denominated government and policy bank securities to the Bloomberg Barclays Global Aggregate Bond Index; this will be phased in over a 20-month period starting April 2019. When fully accounted for in the Global Aggregate Index, local currency Chinese bonds will be the fourth-largest currency component following U.S. dollar, euro, and Japanese yen. Using January 2018 data, the index would include 386 Chinese securities and represent 5.49% of the index. **15** The J.P. Morgan Asia Credit Index (JACI) is a broad liquid U.S.-dollar denominated Asia debt benchmark. It tracks total returns for actively traded U.S.-dollar denominated debt instruments in the Asia ex-Japan region. It is not possible to invest directly in an index. **16** Manulife Investment Management, UBS, March 31, 2019.

Investment considerations

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Source for information shown is Manulife Investment Management, unless otherwise noted.

Important information

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