ROBECO QUANT HIGH YIELD FUND

Quant investing in liquid high yield

- Liquid access to the global high yield market
- Quant market-timing model for alpha generation
- Suitable for tactical positions in the portfolio

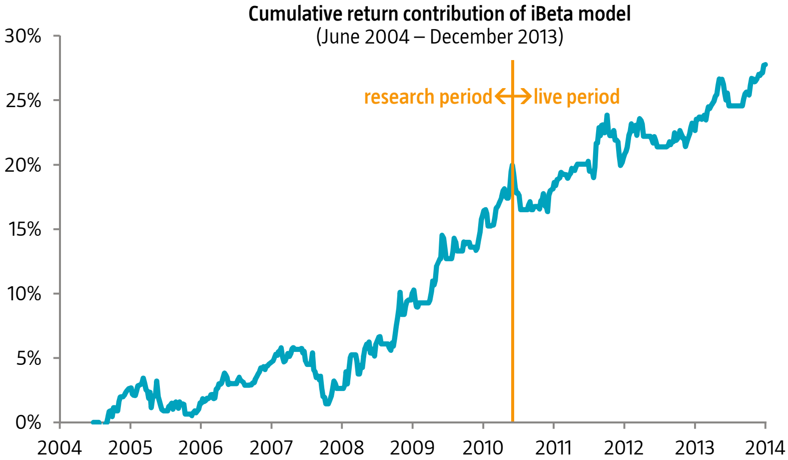
Robeco introduced Robeco Quant High Yield Fund on March 28, 2014. By investing in credit default swap (CDS) indices, this fund offers liquid exposure to global high yield, allowing investors to tactically trade in and out of this asset category at low costs. Performance is driven by a proprietary quantitative market-timing model with a solid track record of over ten years.

For which investors?

The fund's high liquidity makes it suitable for tactical investors, such as allocation teams with higher demands on transaction costs and liquidity, and for strategic investors, like pension funds and sovereign wealth funds, who want to take additional tactical positions. Also, investors who are concerned about the decreasing liquidity of the high yield bond market will be served with this solution. Finally, investors looking for a quant investment style in high yield should find this product appealing. The fund aims to offer a higher return than the Barclays Global High Yield Corporates Ex Financials index.

Liquidity in high yield?

The fund implements its high yield exposure by investing in liquid CDS index derivatives, which allow investors to implement their view on the high yield market in a single trade. Twice a year Markit determines the index constituents according to a rules-based process. It adds the issuers with the highest liquidity to these indices and excludes distressed issuers. CDX High Yield consists of 100 US high yield companies, while iTraxx CrossOver comprises 60 European high yield companies. By investing



Source: Robeco Quantitative Research

in both instruments, Robeco Quant High Yield Fund thus offers well diversified exposure to 160 high yield companies. The CDS indices are much more liquid than direct investments in high yield bonds, resulting in much lower transaction costs. In market environments with liquidity stress, the benefits of these instruments become especially clear: high yield bond returns could be severely hurt, whereas liquidity stress has a much more muted impact on the liquid instruments used in the Robeco Quant High Yield Fund.

Quant model drives alpha

The alpha of the fund is driven by Robeco's quantitative market-timing model. This proprietary model has a track record of over 10 years: both in the research period and the live period of the model (since May 2010), it has delivered stable outperformance.[i] The model is based on academic research and uses various factors to forecast credit returns. For example, both empirically and theoretically a positive equity market return can be expected to result in a positive credit market return. The same holds for a decline in equity market volatility. Also, our research shows that trends in credit markets can be expected to continue. Finally, the model uses various indicators to measure risk appetite in credit markets. Based on the model's return forecast, the fund's exposure (beta) to the high yield market will be reduced or increased. As a result, the portfolio beta varies between 0.5 and 1.5, reducing risk in declining credit markets and benefiting more in rising credit markets.

Alternative to ETFs

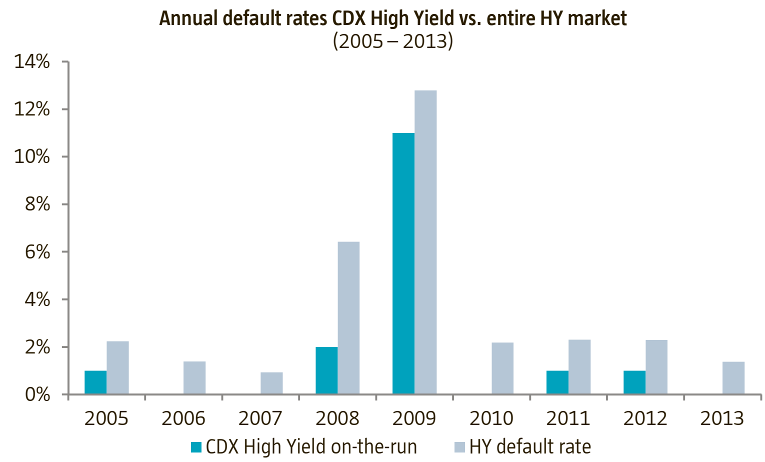
Robeco Quant High Yield Fund offers an alternative to ETFs. Even leaving aside the obvious argument that the fund is actively managed and aims to deliver alpha, there are more fundamental considerations. First of all, our research[ii] shows that ETFs substantially underperform their benchmarks. Second, ETF prices often deviate substantially from their net asset value (NAV): in quickly declining markets, investors often sell substantially below the NAV and in rising markets, they often buy substantially above the NAV. Due to the very high liquidity of the instruments in the Robeco Quant High Yield Fund, investors can get in and out close to the NAV.

Alternative to HY bond funds

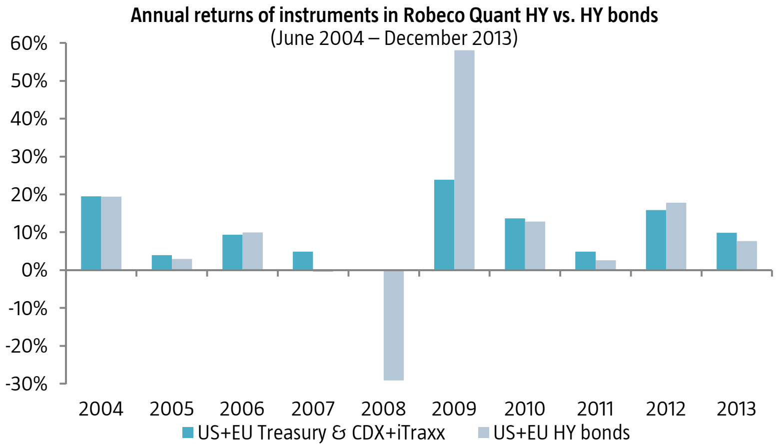
As high yield bond funds - including Robeco High Yield Bonds Fund - have the advantage of offering various performance drivers, including issuer selection, they are highly suitable for strategic investors in high yield. However, as Robeco Quant High Yield Fund offers higher liquidity and lower transaction costs, it can be a good alternative for tactical investors. Furthermore, most high yield bond funds use a fundamental investment style, whereas Robeco Quant High Yield Fund applies a quantitative model for alpha generation. This offers style diversification for high yield investors.

CDS less risky

Although some perceive investments in CDS indices as risky, our research actually shows the opposite. Their default rate is lower than that of the high yield bond market: the average default rate of



Source: Markit, Bank of America Merrill Lynch



Source: Barclays

the on-the-run CDX High Yield is 1.8% against 3.6% for the US high yield bond market.[iii] Also, in 2008 CDS indices suffered much smaller losses than physical high yield bonds, because they do not contain an illiquidity premium. The return on global high yield bonds was -29.1% in 2008, while the instruments in Robeco Quant High Yield Fund returned -0.3% (even without the alpha of the model).

Mitigating counterparty risk

Still, as the investment exposure of the fund is obtained to a material degree through derivatives, and transactions are done over-the-counter, it is important to manage counterparty risk. Robeco has extensive experience in mitigating counterparty risk, i.e. by daily collateral management, netting exposures, monitoring the credit quality of counterparties, proper legal documentation, etc.[iv] The credit quality of the counterparties is therefore monitored and collateral is exchanged on a daily basis to reflect market movements in the value of the instruments. Predefined guidelines also restrict the leverage exposure of derivatives on a fund level.

Strong correlation with bonds

Our research shows that in most years the iTraxx and CDX instruments earn approximately the same returns as bonds. After all, they both relate to the credit-worthiness of high yield corporates. However, over shorter investment horizons returns may differ due to differences in ratings, sectors, and names. For example, in 2013 returns of high yield bonds and iTraxx/CDX had identical signs in about 60% of the days, but about 80% of the months. The most important return divergences between CDS and bonds occurred in 2008 and 2009 due to variation in the bond liquidity premium.

Conclusion

Robeco Quant High Yield Fund offers investors the opportunity to gain easy and quick access to high yield returns at low transaction costs. A proven quantitative beta timing model is used to generate alpha. Depending on clients' needs, the fund therefore offers an attractive alternative to ETFs and to direct high yield investments.

Patrick Houweling
Fund manager Robeco Quant High Yield Fund

Key characteristics Robeco Quant High Yield Fund

Feature	*Description*
Investment strategy	CDX HY + iTraxx Crossover, equally exposed to 160 companies Portfolio beta between 0.5 and 1.5 based on quant model 3% target tracking error using integrated risk management Refreshed credit quality due to semi-annual update of constituents
Cash invested in	US Treasuries + German Bunds, 4 year duration*
Currency risk	Fully hedged to share class currency
Liquidity	Daily liquidity
Swing price	11 bps
Fee	50 bps for institutional share classes

*Zero-duration share class is also possible. Source: Robeco, as of April 15, 2014

[i] The research period starts in July 2004, the month in which iTraxx CrossOver and CDX High Yield started trading in their current form.
[ii] Houweling, P., 2012, "On the Performance of Fixed Income ETFs", Journal of Index Investing.
[iii] Source: Markit, Bank of America Merrill Lynch. Period: 2005-2013
[iv] For more information about counterparty risk management, please read the Robeco white paper: "Counterparty risk. Minimizing the counterparty risk of OTC derivatives while reaping the benefits". This paper is available on request.

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