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PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

FIXED INCOME ALLOCATIONS

TIGHT MARKET LIGHTENS UP

A cleverly constructed bonds portfolio can deliver returns in all market conditions

While an early resolution to the Iraq conflict has seen rising equity and bond markets, the investment outlook remains volatile due to uncertainty over the prospects for economic growth, inflation and even deflation.

This challenging investment environment, coupled with three years of negative stock market returns, has seen many investors re-appraise their asset allocation mix and risk/return objectives. Investors are realising that the generation of positive returns, rather than relative benchmark outperformance, will provide an integral part of future asset allocation strategies.

For the investor seeking a positive investment return, the current climate of relatively low fixed income and cash yields coupled with modest equity returns appear, on first analysis, to offer little room for manoeuvre. However, we believe that solutions exist.

'There has always been sufficient scope for fixed income asset managers to deliver positive returns'
Jana Benesova-Tuma, CSAM

STRATEGIES

Solutions are now available that offer investors the potential for a significant pick-up in yield during any given point of a market cycle. They work by taking full advantage of an expanding range of investment opportunities within the fixed income universe. An analysis of historical returns demonstrates that throughout both equity bull and bear markets over the last eight years, there has always been sufficient scope for fixed income asset managers to deliver positive returns. (See Chart 1.)

One innovative approach is to invest in diverse fixed

1

Asset class performance over time

Different asset classes perform well at different times; the key is to know which one to be in at what time

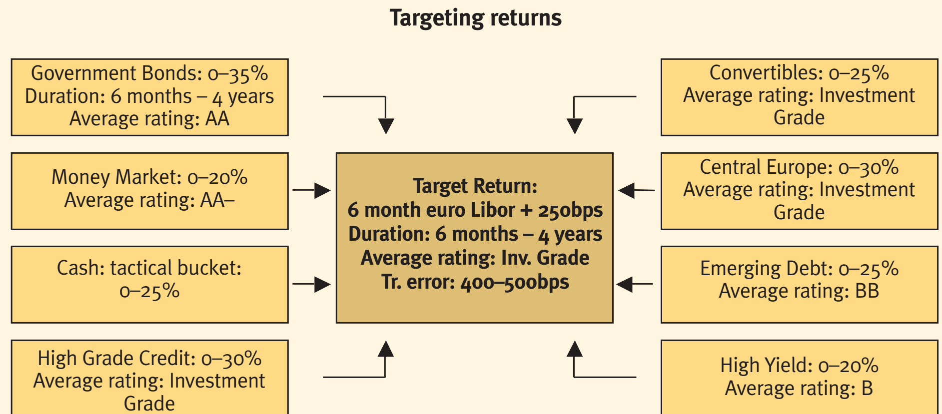
1995	1996	1997	1998	1999	2000	2001	2002
Equities 37.52%	Global Emerging Debt (USD) 39.21%	Euro Converts (Euro) 38.34%	Euro Converts (Euro) 27.84%	Global Emerging Debt (USD) 25.97%	Global Emerging Debt (USD) 15.66%	Central Europe FI (Euro) 29.90%	Global Emerging Debt (USD) 13.7%
Global Emerging Debt (USD) 26.77%	Euro Converts (Euro) 23.48%	Equities 33.35%	Equities 25.58%	Equities 21.04%	Corporates (A rated USD) 9.53%	Corporates (A rated USD) 10.98%	Corporates (A rated USD) 12.63%
Corporates (A rated USD) 20.94%	Equities 22.94%	US High Yield (USD) 13.26%	Central Europe FI (Euro) 24.11%	Euro Converts (Euro) 20.80%	Central Europe FI (Euro) 9.06%	Euro Govts (Euro) 5.90%	Euro Govts (Euro) 9.75%
US High Yield (USD) 20.46%	US High Yield (USD) 11.27%	Global Emerging Debt (USD) 13.02%	Euro Govts (Euro) 13.22%	Central Europe FI (Euro) 8.38%	Euro Govts (Euro) 7.17%	US High Yield (USD) 4.48%	Central Europe FI (Euro) 9.28%
Euro Govts (Euro) 19.41%	Euro Govts (Euro) 9.34%	Corporates (A rated USD) 9.50%	Corporates (A rated USD) 9.44%	US High Yield (USD) 2.51%	Euro Converts (Euro) 1.32%	Global Emerging Debt (USD) -0.79%	US High Yield (USD) -1.89%
Euro Converts (Euro) 12.31%	Corporates (A rated USD) 3.24%	Euro Govts (Euro) 5.93%	US High Yield (USD) 3.95%	Corporates (A rated USD) -2.38%	US High Yield (USD) -5.12%	Euro Converts (Euro) -1.60%	Euro Converts (Euro) -5.73
			Global Emerging Debt (USD) -14.35%	Euro Govts (Euro) -2.58%	Equities -6.12%	Equities -11.88%	Equities -22.09%

Source: Lipper Hindsight VII; data from 1995 to 2002. USD data used for illustrative purposes only, as Euro data has a short historic track record.

2

Targeting returns

Achieving an optimal blend of fixed income assets to provide a targeted positive return, for a modest level of risk



Note: For non-euro based asset classes, the majority of the Forex exposure is hedged back to the fund's reference currency, the euro. ***Source: CSAM***

income products, while providing investors with a transparent, positive performance objective that remains within strict risk parameters.

The successful implementation of this strategy relies upon the expert knowledge of an ever-expanding range of fixed income instruments. These include core issues from "traditional" borrowers through to "enhanced" products such as emerging market debt, Central European debt, convertibles and high yield.

TARGET RETURN

An example of this strategy is the Credit Suisse Asset Management Target Return Fund, which aims to target a gross return of six month euro Libor + 250 basis points through optimising the portfolio's allocation across a diverse range of fixed income assets.

To implement such strategies successfully it is necessary to integrate a risk management tool into the process. A risk management and optimisation tool should be applied within the context of a tried and tested investment process, overlaying qualitative investment decisions to provide a value enhancing combination.

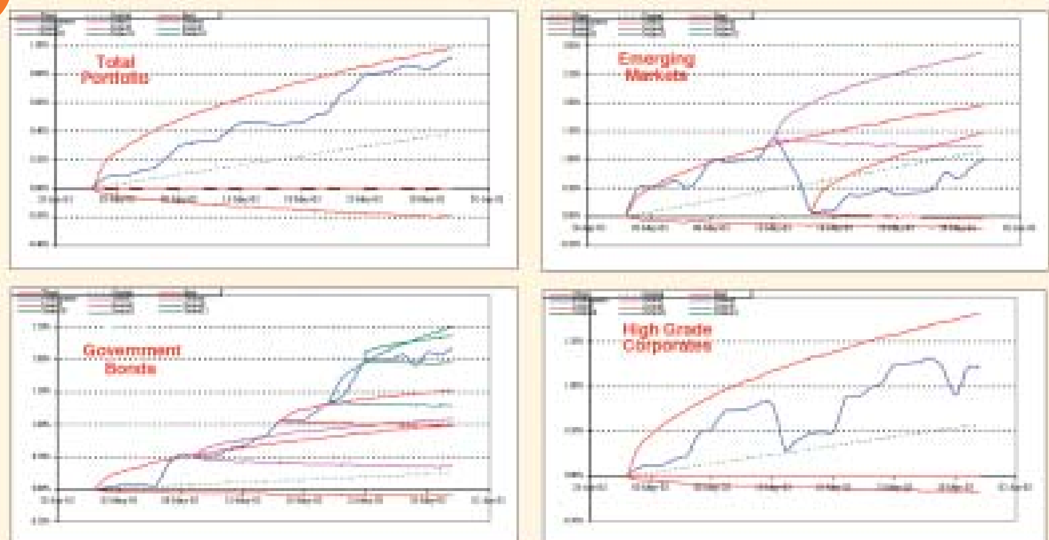
Each fixed income asset category can then be selected on the merits of prevailing market conditions, and weighted within specific investment ranges. (See Chart 2.) This ensures the overall portfolio is well diversified and makes full use of the low correlation between some of the respective underlying fixed income investments, to help minimise the fund's overall risk profile.

Within each fixed income asset category, performance is typically derived from four areas:

- Security selection within the corporate bond universe;
- Yield curve management of government bonds;
- Active management of convertibles, capable of capturing the upside benefits of equity markets, or enhancing credit value; and
- Active management of money market and cash positions.

3

A dedicated risk management tool helps ensure the portfolio maintains an optimal asset allocation



Source: CSAM Investment Outlook (Q2, 2003)

An allocation to fixed income should be undertaken using strict risk controls. Ideally, each asset class should have predetermined profit and loss taking levels set on a monthly basis. In this way, both upside and downside scenarios can be measured against the actual performance of the asset class on a daily basis. Triggers can be set should the upside "envelope" limit be broken where profit taking may occur. Similarly, if the downside envelope limit is broken, the position can be re-evaluated and re-allocation may occur. (See Chart 3.)

Within the fixed income portfolio an allocation to government bonds of around 20 per cent is advisable in current market conditions. This is based on our belief that interest rates in G7 countries will remain low for the foreseeable future, supported by low inflation and a weak economic outlook. This is particularly true of Europe, due to poorer than expected growth and a strengthening euro, which is undoing some of the previous easing from the European Central Bank. On this basis, we are positive on government bond valuations, and particularly peripheral markets such as Canada and Australia due to their significant spread premium over US and European government bond markets.

We recommend a credit allocation of approximately 55 per cent of the fixed income portfolio. We believe that credit allocation will be key for 2003. Irrespective of the uncertain outlook for the global economy, default rates continue to ease and company balance sheets are deleveraging. So whilst we remain cautious about overarching risks to the corporate sector such as diminishing pricing power, we are focusing on industries with strong cash flows, controlled costs and high asset recoveries.

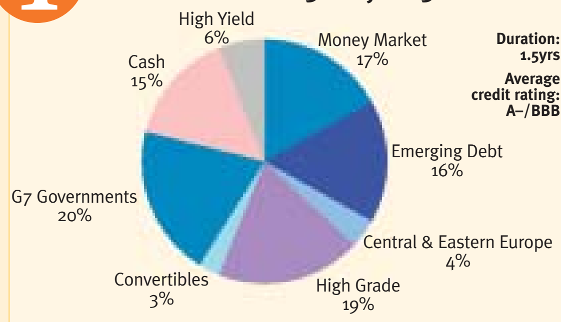
With Libor rates at historically low levels (six month euro Libor is around 2.38 per cent as at 31 May 2003), the risk/return profile of owning defensive high grade, high-yield corporate names, as well as emerging debt bonds and Central European debt, is crucial. On this basis, we believe that a barbell strategy between high-grade names and sub-investment grade names should still add value, irrespective of the recent strong rally.

With regard to high yield corporate names, we remain even more selective. While the risk/return profile is attractive, liquidity remains low, and we are holding back on a sizeable allocation, subject to an improvement in relative value and technicals.

On the convertible side, we believe that we can add value via bond floors as well as delta strategy (sensitivity to the equity market). We are conservative, but we are starting from a modest allocation and lower delta stance and will re-evaluate during the course of the year.

As regards emerging market debt, we retain our current modest allocation, with additions to Central European debt, since we are more positive on this region.

4 Asset allocation of the CSAM Target Return Fund as at 31 May 2003



While capital preservation and positive value creation are key drivers for fixed income funds, cash also represents an important asset class for the successful management of such products. Its benefits are highlighted when bond valuations are unattractive and a safe haven is required. It can also help to re-balance risks taken elsewhere in the portfolio.

The CSAM Target Return Fund, for example, currently has a low annualised volatility of approximately 1 per cent, compared with equity and government bond market volatility of around 30 per cent and 6 per cent respectively.

It is important that a fixed income portfolio is well-diversified across various asset classes including government bonds, high-grade corporates and cash, as well as more equity sensitive products such as high-yield and convertibles. (See Chart 4.)

Jana Benesova-Tuma, fixed income portfolio manager, Credit Suisse Asset Management

Benefits of strength

Key benefits of a Target Return portfolio:

- **Directly addressing growing investor demand for a product that targets a certain level of positive return within a strict risk control framework;**
- **Meeting this need by aiming for targeted returns above six month euro Libor +250bps, year in, year out, whatever the market environment;**
- **Fully leveraging the value enhancing combination of a tried and tested investment process, with a dedicated risk management tool, to achieve an optimal asset allocation mix; and**
- **Optimising the portfolio's allocation process across a diverse range of fixed income instruments so that the low correlation aspects of underlying asset classes help minimise the fund's overall risk profile.**

CORPORATE STATEMENT

Credit Suisse Asset Management (CSAM) is one of the world's largest asset managers and one of the few with a truly global platform. CSAM has 2079 employees in 22 offices across three regions worldwide, clients in more than 50 countries and total assets under management of US$292.3bn as at 31 March 2003. We offer a full range of financial investment products and services to institutional, retail and private clients.

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