

## WHAT YOU NEED TO KNOW ABOUT THE CHANGE IN “EXPECTED LEVEL OF LEVERAGE” OF CARMIGNAC PATRIMOINE

Carmignac recently updated the prospectuses of its funds. One of the changes concerns the expected level of leverage that will be increased for Carmignac Patrimoine from 200% to 500%, taking effect on **February 26<sup>th</sup> 2018**.

This measure is often misunderstood and leads to confusion. This document intends to:

- explain what this leverage is,
- explain why we have done this.

In terms of risk profile of our funds:

- **There is no change for the funds' risk profile**
- The reason is that, as explained below, **the expected level of leverage (gross leverage) does not assess the riskiness of a fund**

Let it also be noted that this increase of “expected level of leverage”:

- **Does not change the philosophy nor the investment process of the fund**
- Does not change the performance drivers of the fund

## What are we talking about when we mention “expected leverage”?

There are many different terminologies referring to leverage and they can have different meanings:

1. **Expected level of leverage also known as gross leverage:** (Changing in the new prospectus)

The **expected level of leverage** is a regulatory measure aiming to provide an indicative volume of derivatives used in a portfolio.

Technically, it is the sum of the absolute values of the nominal of any derivative in the portfolio.

- Whenever a derivative instrument is added to the portfolio (on the long or on the short side), and whatever the asset class (Equity, Fixed Income, FX), the level of leverage increases.
- **Expected level of leverage does not reflect the actual “riskiness” of the portfolio** as it is simply an addition of the nominal amount of all the derivative positions of the portfolio whatever the asset class. Equity, fixed income and foreign exchange derivatives are summed all together without any distinction. Expected level of leverage does not take into account derivative positions that offset each other or mitigate risks in the physical portfolio.

2. **Net or economic leverage also known as commitment:** (Not changing in the concerned prospectus)

Net leverage accounts for the netting and hedging effects of the derivatives within the portfolio (netting of exposures, cash compensation, duration adjustments etc.).

**These methods are a better starting point to measure economic risk compared to the expected level of leverage.**

3. **Value at Risk:** (Not changing)

Value at Risk (or VaR) offers an estimation of the maximum loss to be expected within a specific period of time and with a defined level of confidence and is one of the **more relevant measures of a fund’s aggregate risk**.

VaR is a measure of the market risk of a portfolio and can be absolute or relative to a reference indicator.

**The VaR ratio allowed by regulatory authorities is 2 maximum**, i.e. fund’s VaR cannot be more than twice that of its reference indicator.

## What does it change for the funds risk profiles?

**There is no change for the funds risk profiles.**

As mentioned above, **expected level of leverage (gross leverage) does not assess the riskiness of a fund. VaR and commitment methods do assess this, and they are not being changed.**

These changes have been implemented without altering the risk profiles of the concerned fund

## Why did we increase it?

We expect the monetary policies introduced by central banks after the financial crisis of 2008 to normalise progressively. **As active fund managers, it is our role to anticipate this and equip ourselves with the right tools to deal more effectively with this new challenging environment.** We anticipate a more extensive use of interest rate and foreign exchange derivatives for risk management purposes. **These derivative instruments happen to have high gross nominal amounts, explaining why we have decided to increase the expected level of leverage.**

### Let's illustrate this with two examples:

#### 1. Protection against rising rates via interest rate derivatives:

One way to protect a portfolio from rising rates is to reduce modified duration by shorting interest rate derivatives. Several types of derivatives with different maturities, durations and nominals can be used.

**The smaller the duration of the derivatives you use, the more contracts you have to sell**, hence the greater the “expected level of leverage” (the sum of the **notional** of all derivatives).

All below examples illustrate the number of contract you need to sell to decrease the duration of a portfolio by 2. While they all have the same impact on the interest rate risk of the portfolio (i.e. the same change in duration), they have a different notional and a different impact on the “**expected level of leverage**”.

	Instrument Duration	Necessary # of contracts to buy/sell	Gross Leverage
<b>1 year EURIBOR</b>	1	2	200%
<b>Schatz</b>	2	1	100%
<b>Bobl</b>	5	0.4*	40%**
<b>Bund</b>	9	0.22	22%

*How to read the table? 1<sup>st</sup> column: instrument duration, 2<sup>nd</sup> column: number of contracts needed to reach duration target, 3<sup>rd</sup> column: gross leverage needed to reach duration target.*

*\*0.4 = Bobl has a duration of 5, and we wish to reduce duration by 2 so we need  $2/5=0.4$  contracts*

*\*\*40%= 100% \* 0.4*

In the above example, the gross leverage reflects the tools you use, rather than the risk you hedge.

#### 2. Neutralising a foreign currency trade via FX derivatives:

When a portfolio manager decides to buy a foreign currency-denominated equity/fixed income instrument, he has the possibility to hedge the currency risk (via an FX forward or futures contract) in order to keep the performance of the underlying security without the exposure to the currency.

In case he changes his mind and finally decides to keep the FX exposure, he cannot “just sell back” the derivatives position. He has to purchase the opposite position to offset the effect until the expiration of the future/forward contract.

Indeed, standard practice in the FX market imposes to trade a new contract to offset an existing one, i.e. “stacking” the derivatives until they mature. By doing this, there is an arithmetic increase in the “expected level of leverage”.

Let’s take the example of a PM investing 5% of his portfolio in Apple stock (denominated in USD) and decides to hedge the USD risk when buying the stock @ T0. But, in T+1, he decides to keep the USD exposure.

			<b>Gross Leverage</b>	<b>Net Leverage / Commitment</b>
<b>T0</b> <b>PM decides to hedge the currency risk</b>	<b>Initial contract</b>	Long FX Forward EUR/USD for 5% of the fund’s AUM	<b>5%</b>	<b>5%</b>
<b>T+1</b> <b>PM decides to finally keep currency risk</b>	<b>+ New contract</b>	+ Short FX Forward EUR/USD for same amount	<b>+5%</b>	<b>-5%</b>
<b>TOTAL</b>			<b>10%</b>	<b>0%</b>

In the example above, cancelling the initial position and offsetting the FX risk with a new contract increases the gross leverage (from 0 to 10%) while neutralizing commitment.

**Both these examples illustrate that the “expected level of leverage” of the fund is not a reflection of the riskiness of the fund. It is only an indicative figure measuring the “volume” of derivatives used in the fund.**

**Key take aways:**

- The change in expected level of leverage does not change the philosophy nor the investment process of any of the impacted funds
- Furthermore, it does not change for the funds’ risk profile.
- The expected level of leverage does not asses the riskiness of a fund, it is an indicative measure of the volume of derivatives used in the fund

## Glossary

**Bobl:** 3-5 year maturity German government bond

**Bund:** 10-30 year maturity German government bond

**Duration** (or modified duration): measure of the sensitivity of the price of fixed income instrument to a change in interest rates.

**EURIBOR:** Euro Interbank Offer rate, reference rate expressing the average interest rate at which Eurozone banks offers unsecured loans.

**Forward contract:** customised contract between two parties to buy or to sell an asset at a specified time in the future and at a price agreed upon today.

**Future contract:** standardised forward contract

**FX:** foreign exchange

**Schatz:** 2 year maturity German government bond

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