Comparing the investment cases for European and US leveraged loans

May 2018
Executive summary

Leveraged loans, often referred to as bank loans, offer investors a broad and relatively liquid market of private, sub-investment grade loans that can deliver attractive returns with lower volatility when compared with similarly-rated, unsecured corporate bonds.

The investment opportunity set is global, but it is important that investors understand the differences between the two loan markets of the US and Europe, and what it takes to invest successfully in each. While the US loan market is public, larger and more liquid, being well-established over several decades with non-bank investors, institutional investors have steadily recognised the compelling benefits of allocating to European leveraged loans too, as part of a wider fixed income portfolio. Furthermore, there remains significant scope for increased institutional investment in European loans.

This paper looks at the investment benefits of the loan asset class as a whole, the key characteristics of the markets in Europe and the US, and why it may make sense for institutional investors to consider European loans as part of a diverse investment portfolio.

M&G and European leveraged loans

M&G was one of the first non-bank investors in European leveraged loans, in 1999, and is one of the largest loan managers in Europe today. Approximately $11.6 billion is managed on behalf of institutional investors across a range of funds in both segregated and pooled form, with the vast majority being for pension funds and insurance companies from Europe and Asia.

Source: M&G Investments, as at 31 March 2018
Introduction to European leveraged loans

Rising demand from non-bank, institutional investors

Over the past two decades, non-bank, institutional investors have expanded their participation in corners of Europe’s corporate financing market traditionally dominated by banks. Attracted by the significantly higher returns on offer, institutional investors have taken advantage of the financing opportunities in Europe as banks have pulled back to meet stringent capital requirements imposed by regulators, following the global financial crisis. This has resulted in bumper issuance volumes in high yield bonds from 2011 onwards and a revival of the European leveraged loans market after a hiatus in the immediate aftermath of the crisis. Currently, institutional investors accounted for over two-thirds of primary loan issuance in Europe, a share that has steadily increased over time, as illustrated in Figure 1.

Figure 1: European primary loan issuance by investor type (% of total), 2010 to 2018

Source: Standard & Poor’s (S&P) Capital IQ Leveraged Commentary and Data (LCD), as at 31 March 2018

In Europe, about two-thirds of leveraged loan issuance derives from private equity buyout activity, often following large mergers where companies divest non-core divisions, perhaps for regulatory reasons. Private equity houses step in to buy these divested entities and come to the leveraged loan market for debt funding. An arranging or lead bank will typically sell the loans, through a syndication process, to institutional investors alongside other banks.

The low interest rate environment has posed a number of challenges for institutional investors, such as pension funds and insurers who can, as a result, find themselves struggling to generate the investment returns needed to meet funding commitments or drive profitability.

The search for yield has undeniably been one of the main drivers of increased interest in the asset class, while institutional investors have recognised the benefits of making a strategic allocation to leveraged loans as part of a wider fixed income portfolio. This can be achieved through a shift of allocation from high yield bonds to loans (both are sources of sub-investment grade corporate debt), or from traditional investment-grade fixed income investments.

Key features of leveraged loans

The term ‘leveraged loans’, or ‘bank loans’, describes floating-rate debt issued – on a secured basis – by sub-investment grade companies, typically to finance mergers and acquisitions (M&A) or leveraged buyouts (LBOs) by private equity sponsor companies.

Strong relative value

When looking at the relative value of loans compared to other asset classes, there appears to be a lot of opportunity. The spread premium of European leveraged loans versus corporate high yield bonds has exceeded 1% for the two years to March 2018 – helping to underscore the case for an allocation to loans (see Figure 2).
The reason for the recent spread contraction of bonds is largely owing to market interventions conducted by the European Central Bank (ECB) through its corporate sector purchase programme (CSPP). As investment grade bond spreads have tightened, as a result of the CSPP, high yield securities’ spreads have contracted in sympathy as investors look for yield. European loans are not within the repurchasing remit of the ECB and thus their spreads have remained relatively unaffected.

Figure 2: Spread premium of European loans to high yield corporate bonds

Source: M&G Investments, Credit Suisse (CS WELL four-year discount margin), Bloomberg (BofAML European HPIC high yield index asset swap spread), as 31 March 2018

Low duration and floating-rate returns

Investors may also view loans as a means of capturing high yields while reducing overall duration in a blended credit portfolio. This is owing to their floating-rate structure. While loan markets are arguably not ones to ‘time’, it is important to understand how leveraged loans can behave in different interest rate regimes. Leveraged loans can offer a compelling investment opportunity in an environment of low and flat yields due to their high running income, low duration and less correlated, sustainable returns. Equally, as floating-rate investments offering a determinable spread over a short-term reference rate (e.g. Libor or Euribor, depending on the currency), leveraged loans can serve as a natural ‘hedge’ against rising interest rates. This is because loan coupons have the ability to adjust higher or lower based on underlying changes in Libor, typically every three months (90 days). Loans therefore pose minimal interest rate risk to a portfolio and are designed to benefit in a scenario of rising interest rates – particularly after Libor has increased beyond the level of the average floor1. High yield corporate bonds, in comparison, typically pay a fixed-rate cash coupon so income and returns will be susceptible to interest rate changes.

Other defensive characteristics

As leveraged loans can play a number of different roles in a portfolio, there will be different structural and market features that appeal to long-term investors dependent on their investment objectives. Importantly, leveraged loans benefit from security over assets and / or equity of the issuing companies, as well as seniority in the capital structure. This means that if an investment does not perform as expected, then the owners of these loans are first in line to be repaid, ahead of unsecured debt holders, thereby affording more downside protection compared to other similarly-rated fixed income instruments. This contributes to the relative stability of loan pricing in the secondary market. Historically, senior secured leveraged loans have had much higher recoveries than unsecured high yield bonds in the event of default or restructuring, limiting their downside risk. According to data from Moody’s Investors Service2 (measured using post-default trading prices), annual recovery

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1 When a loan has a floor, the loan’s coupon will reset to the higher of the floor or Libor / Euribor, typically every 30, 60 or 90 days.
rates for senior secured (first lien) loans have been consistently above unsecured global corporate high yield bonds, and have averaged at 80% versus 48% over the period from 1987 to 2017. Loan documentation for leveraged loan transactions includes contractually-agreed financial covenants, sometimes on an incurrence basis (to govern the addition of new debt) and sometimes on a maintenance basis (where pro-active demonstration of compliance is imposed on the borrower at regular intervals through the loan’s life). Together with seniority and security, loans tend to incorporate additional features that can provide comprehensive credit risk protection for an investor.

As things stand today, lenders do not need to take on undue risk, on behalf of underlying investors, to get well rewarded. European corporate default rates, for example, are low in absolute and relative terms, although careful lending practices, rigorous due diligence and ongoing investment monitoring can further reduce a portfolio’s default rate.

Explained: Prepayment feature

Unlike high yield bonds, leveraged loans do not typically have the potential for significant capital appreciation as loans are repayable at par (or face value), so do not tend to trade significantly above this level. This feature gives the borrower the option of early repayment (or the obligation to repay should ownership of the company change), provided it can generate the cash to repay the principal. By contrast, while the majority of high yield bonds are callable, borrowers must observe a non-callable period of several years. Also, for investors particularly concerned about liquidity, there is considerable inherent cash generation in a loan portfolio from this prepayment feature in addition to the presence of a functioning secondary market.

In 2017, the prepayment rate for European loans stood at 40% (representing €55 billion of the ELLI) – much higher than 2016 in volume and percentage terms – as a result of wholesale refinancing of supernormal coupons on loans, issued in 2016, following the Q1 general sell-off.

Figure 3: European loan market repayment volume (€ billion) and repayment rate (% of total) per annum, 2008 to 2018

Source: S&P Capital IQ LCD European Leveraged Loan Index (ELLI), as at 30 April 2018
The European and US leveraged loan markets compared

The global loan market is made up of two distinct main markets: Europe and the US. Institutional investor participation in the US predates that of Europe. Furthermore, retail investor presence, while lacking from the European market, has been a long-standing feature across the Atlantic. The US market is also overseen by the Securities and Exchange Commission (SEC), while the European loan market is an unregulated one, making it relatively inaccessible to retail investors.

Figure 4: The composition of the European and US primary loan markets by broad investor type

The pace and extent of regulatory change has helped to shape the development of both loan markets in the years following the global financial crisis. The investment opportunity set is global, but there are significant regional differences, which we will explore in more depth in the next sections.

Long-term performance

Although annual returns from the European and US loan markets look broadly similar over the long term, as shown in Figure 5, European loan returns have traditionally exceeded those of the US, having delivered a premium over the past three, five and ten-year (not shown in the chart) horizons (on an annualised basis).

The European loan market’s 2017 total return looks impressive compared to the return generated by the US loan market, however in relative terms, 2015 was a standout year for the European market compared to the US – although this was largely down to a wave of defaults in the US market, linked to that market’s greater oil and gas exposures. Europe, by contrast, has little representation from these cyclical sectors, being a market more commonly populated by private equity-owned companies.
Figure 5: European loan returns traditionally exceed those of US

European and US loan market annual returns, 2010 to 2018

<table>
<thead>
<tr>
<th></th>
<th>European loan index*</th>
<th>US loan index</th>
<th>Differential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last 3 years total</td>
<td>5.39%</td>
<td>4.33%</td>
<td>106 bps</td>
</tr>
<tr>
<td>return (annualised)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Last 5 years total</td>
<td>5.33%</td>
<td>4.17%</td>
<td>116 bps</td>
</tr>
<tr>
<td>return (annualised)</td>
<td></td>
<td></td>
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</tr>
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Source: Credit Suisse, as at 31 March 2018. * hedged to US dollar

Relative stability of returns

The sectoral distribution of the European loan market, which is biased towards companies with solid operating performance and stable cashflows as befits, could also help to explain the relative stability of returns compared to US loans, and equally to US (and European) high yield bonds.

Loan market returns for 2017, while respectable, were overshadowed by bonds, call-protected as those instruments are, allowing them to benefit in price increases from contracting spreads. 2017 was also a period of historically low volatility, which quickly returned to credit markets in February 2018, albeit briefly, but loans held firm amid the disruption in financial markets.

The most significant period of intervening volatility was in 2011 – at the height of the European sovereign debt fears – when loan prices fell five points. More recently, the September 2015 wobble in European high yield was not seen in loans and, when fears of Chinese growth contraction and falling oil prices unsettled comparable credit markets at the start of 2016, the European leveraged loan market was relatively resilient. Even the unexpected ‘Brexit’ vote in June 2016 and the subsequent political ‘shock’ after Donald Trump’s US Presidential election win later that year, had little impact on cumulative European loan returns, as may be seen in Figure 6.

Figure 6: European loan market has remained resilient during periods of market turbulence

European and US loan, European and US high yield bond cumulative returns, 31 December 2014 to 31 March 2018

Source: Credit Suisse European, US Loan and European High Yield bond indices (HPIC), US HY (H0A0), hedged to US dollar (USD) cumulative returns, as at 31 March 2018.
In the periods of macro volatility since the crisis, the loan market has responded but in relatively muted fashion thanks to the characteristics of the asset class as previously described (floating-rate returns, senior secured status), with the protective structural market barriers, specific to the European market, insulating it still further.

**Risk-return profile**

European loans, in particular, should be noted for their high running income and relatively stable returns. As Figure 7 shows, European loans have exhibited a better risk-return trade-off compared to US loans (and high yield bonds) over a longer time horizon.

**Figure 7: European loans offer high risk-adjusted and stable returns over time**

### Reward for risk (3 years annualised)

<table>
<thead>
<tr>
<th></th>
<th>European loans</th>
<th>US loans</th>
<th>European high yield</th>
<th>US high yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sharpe ratio</td>
<td>2.16</td>
<td>1.30</td>
<td>1.06</td>
<td>0.75</td>
</tr>
</tbody>
</table>

Source: Bloomberg, HPIC, EG00, HOA0, Credit Suisse hedged to US dollar and Credit Suisse US Index returns, as at 31 March 2018

### Reward for risk (5 years annualised)

<table>
<thead>
<tr>
<th></th>
<th>European loans</th>
<th>US loans</th>
<th>European high yield</th>
<th>US high yield</th>
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<tbody>
<tr>
<td>Sharpe ratio</td>
<td>2.47</td>
<td>1.52</td>
<td>1.43</td>
<td>0.82</td>
</tr>
</tbody>
</table>

**Market size**

The Credit Suisse Western European Leveraged Loan Index (CS WELLI), which represents some of the institutional subset, puts the size of the market at €230 billion. For the US, the Credit Suisse Leveraged Loan Index (CS LLI) is approximately $1.1 trillion in size. However, not everything is captured by the indices, this being a private market, with both markets at least 30% larger.

Annual issuance of both loan markets since the global financial crisis – set against high yield bond issuance volumes for comparison — can be seen in Figures 8 and 9, respectively.
Figure 8: Annual US loan issuance has consistently exceeded US high yield bond issuance since 2011

US loan and high yield bond issuance ($ billion), 2008 to 2018

Source: S&P Capital IQ LCD, Credit Suisse, as at 31 March 2018

Figure 9: Annual European loan issuance has been comparable to European high yield bond issuance post-crisis

European loan and high yield bond issuance (€ billion), 2008 to 2018

Source: S&P Capital IQ LCD, Credit Suisse, as at 31 March 2018

In M&G’s estimation, the addressable loan market in Europe for an established manager is approximately €300 billion, roughly the same size as the European corporate high yield bond market.

We have summarised the key data characteristics of the two loan markets in Table 1.

Table 1: European and US loan market comparison — key characteristics at a glance

<table>
<thead>
<tr>
<th></th>
<th>European loan index</th>
<th>US loan index</th>
</tr>
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<tbody>
<tr>
<td>Institutional loan market size</td>
<td>€300 billion</td>
<td>$1,000 billion</td>
</tr>
<tr>
<td>New issue volume 2017</td>
<td>€120 billion</td>
<td>$649 billion</td>
</tr>
<tr>
<td>Normal spread</td>
<td>342 bps</td>
<td>352 bps</td>
</tr>
<tr>
<td>4-year discount margin</td>
<td>372 bps</td>
<td>386 bps</td>
</tr>
<tr>
<td>Volatility (5 years)</td>
<td>1.96%</td>
<td>2.41%</td>
</tr>
<tr>
<td>Loan issues with public ratings</td>
<td>c.75%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Market estimates, S&P Capital IQ LCD, Credit Suisse, as at 31 March 2018
Investor base and demand for loans

As Table 1 shows, the historical volatility of the two loan markets over the past five years has been broadly similar, although the notable (circa 25%) daily-dealing, retail investor presence in the US market could help to explain the higher standard deviation of returns. In Europe, there is no retail fund community as loans are not classed as UCITS-eligible assets. This could put the European market in sharp contrast to the US, where fund inflows may pressurise spreads to a greater degree if not matched by issuance.

Open-ended funds are now relatively common in Europe albeit that dealing frequencies will typically be monthly, rather than daily, given their institutional nature and the non-standard – and sometimes lengthy – periods for loans to settle. Closed-ended, structured funds, primarily collateralised loan obligations (CLOs), account for a sizeable market share in Europe too. This indiscriminate, captive European loan investor has continued to support the market, with €21 billion in issuance raised in 2017.

Secondary market volumes

We believe European loans offer decent liquidity to investors despite the lack of retail investor participation in the market, thanks to the number of active institutional investors and banks. However, the market is less liquid than that of the US, as shown in Figure 10. The turnover ratio in the European secondary market has been around 35% over the past two years, having fluctuated between 40-50% in the preceding three years.

European loans continue to offer steady liquidity nonetheless. Lower turnover typically translates into greater market stability, which can be attributed to the absence of daily-dealing retail funds in the market (that tend to have shorter investment horizons).

Figure 10: European and US secondary loan market liquidity

Source: S&P Capital IQ LCD, Thomson Reuters LPC, Loan Market Association, LSTA Trade Data Study, as at 31 December 2017
Bid-ask spreads in Europe have tended to be slightly wider than the US, but spreads have narrowed over recent years and the most liquid loans have continued to trade at bid-ask spreads closer to 50 bps since the start of 2013, as shown in Figure 11.

**Figure 11: European and US loan flow-name composite: bid-ask spreads**

**European loan flow-names composite: bid-ask spread (bps)**

**US loan flow-names composite: bid-ask spread (bps)**

Source: Thomson Reuters, S&P Capital IQ LCD, as at 31 March 2018

**Structural trends: the rise of ‘cov-lite’**

Investors’ search for yield has driven up demand, and this in turn, has given borrowers the upper hand to dictate loan terms, leading to the growth of so-called ‘cov-lite’ structures, i.e. loans that lack maintenance covenants. Europe has, to an extent, adopted this theme from the US to capitalise on borrower-friendly market conditions, and as a result of higher competition among European and US lenders. Supply and demand dynamics have helped to drive the cov-lite trend rather than changes in credit quality, as the post-crisis resurgence of the loan market saw companies pushing for similar terms they had been getting from issuing high yield bonds.

Covenant quality protection is not as weak in Europe as it is in the US, but in 2017, other important protections were often loosened. The ability to base financial tests on ‘pro forma’ rather than actual EBITDA became commonplace, requiring lenders to feel fully confident that outlined future synergies and cost-savings were credible and achievable within a reasonable timeframe. As Figure 12 shows, at the height of the credit expansion phase in 2007, institutional cov-lite loans accounted for just 5% of total loan issuance in Europe, disappearing again before steadily gaining in popularity over the past six years. In Q1-2018, cov-lite loans made up around 66% of total loan issuance in Europe compared to 78% of total loan issuance in the US.
Despite the dilution in investor protections, total new issue leverage was constrained in Q1 2018 – at 5.1x – in line with the US market, though the incidence of greater all-senior structures grew. Moreover, equity contributions in the typical leveraged buyout increased, helping to mitigate the cov-lite rise in Europe (see Figure 13).

Like the US, 2016 saw the announcement of the ECB’s intention to introduce its own (similar) guidelines on leverage in Europe – recommending that banks should not underwrite transactions presenting a ratio of total debt to EBITDA (a measure of operating performance) exceeding 6.0x, with justification and approval required for any exceptions. It should be acknowledged that there is mounting speculation about the lasting resilience of the US leveraged lending guidelines under the current administration, particularly in light of easing of regulation elsewhere (e.g. 2018 cessation of ‘skin-in-the-game’ rules for CLO managers).
Further considerations for investors

There are a number of additional factors that investors should consider before investment, including access to assets, the need for dedicated analysts and restructuring expertise.

Access to assets

Europe is a relationship-driven market and therefore requires extensive, dedicated resources for successful long-term investing. It is not uncommon for a loan syndication to be closed early, at the request of the borrower, as a club deal, without general syndication being pursued – which is where having existing relationships can be beneficial. Furthermore, an investor may benefit from remaining ‘private-side’, assuming its resources can be walled off from its public credit department. The US market, on the other hand, is arguably more public and ‘bond-like’ in nature with a primary syndication process similar to that for new public bond issues – where the borrower issues an open invitation to lenders to bid for securities.

In the US, managers would tend to benefit from having a larger presence in size (i.e. total assets) terms as the market comprises more large-cap issuers than Europe, and an ability to execute significant volumes of trades in the secondary market. As European loans involve a high degree of operational complexity, including multi-currency features, there are high barriers to entry to new participants. Managers that have established a firm foothold in the market are therefore at a distinct competitive advantage.

Need for dedicated analysts and restructuring expertise

Having long-standing and stable relationships with key market stakeholders (such as private equity sponsors, issuers and banks) can give managers unrivalled access to assets and create an ability to be selective. The onus is on lenders to perform the necessary due diligence as part of a robust – often private-side - credit process to help insulate returns for investors and minimise the risk of default.

In Europe, the crossover between the loan and bond markets is limited. The European market is dominated by private equity-owned issuers, meaning companies that offer no other investment opportunities in any public forum (bonds, equity).

Not only does this arguably mean scope for diversification, but Europe more commonly offers an investor the option to be ‘private’ rather than ‘public’, requiring lenders to undertake their own credit analysis. This private-side status affords a lender with valuable information that is not otherwise available in the public domain, permitting fuller credit monitoring.

The need for dedicated analysts and specialists is as integral to the management of distressed situations as it is for day-to-day investment in Europe. Restructurings are usually privately negotiated in Europe, unlike the Chapter 11 route in the US, and can often be complicated and lengthy albeit with similar (high) recovery rates. This feature of European restructurings may become particularly important in the era of cov-lite defaults. In our view, the variability of restructuring outcomes will widen, making the dedication of resources ever more crucial to performance.
Portfolio diversification benefits for loan investors

While investment in European and US loans can offer compelling returns and greater downside protection to an investor, we believe diversification and stock (issuer) selection in a leveraged loan portfolio are essential attributes as leveraged loans present asymmetric risk-return characteristics. It is therefore important that each manager is selective in the investments made to protect a portfolio from default risk, enabled by significant scale and flexibility and having good access to assets.

M&G is a large European fund manager that employs a European loan strategy albeit incorporating US company investment when lending to global companies with a significant European presence. At M&G, it is our aim to provide an investor with exposure to large, stable businesses, including those of truly global presence, while also bringing diversification and liquidity benefits.

Conclusions

Structural shifts in the way companies obtain longer-term capital have created an attractive opportunity for large-scale institutional investment in the asset class. There remains significant scope for increased institutional investment in European loans and we believe that it is an attractive time to invest.

The spread premium between the European and US leveraged loan markets has converged over the course of 2017, with a mere eight bps differential at the end of April 2018 (see Figure 14). In our view, there is unlikely to be much reallocation of investor capital from European to US loans, such are the sizeable hedging costs. Furthermore, the performance of European loans typically offers a premium over time and, while liquidity is more limited, it is tolerable by the pension funds and insurance companies that commonly allocate to the market over a cycle.

Figure 14: European and US loan discount margins, 2013 to 2018

Source: Credit Suisse (CS), as at 30 April 2018

In Europe, defaults are not expected to be a key factor in performance terms in 2018, as the loan market has limited exposure to troubled sectors. Based on historical data on default rates for the Credit Suisse Western European Leveraged Loan Index, the average default rate (by value) was 4.1% in the period from 2008 to 2018, as shown in Figure 15.
Together with a low default outlook, European loans have low refinancing risk in the near term, as can be seen in Figure 16, following the wave of refinancing activity in 2017.

**Figure 16: Europe faces minimal refinancing pressure in the near term**

**European loan market maturity profile, 2019 to 2027**

Europe and the US are at differing stages of their economic cycles; have divergent attitudes to monetary stimulus and fiscal expansion; and both display potential vulnerability to populist politics. As credit markets are likely to continue to take their cue from global monetary policy, macroeconomic and political events, including Brexit negotiations and the actions of the ECB and the US Federal Reserve, investors will be looking for continued stability of returns in an uncertain climate.

While episodes of market volatility cannot be avoided completely, we expect loans to continue to exhibit far greater stability than wider debt markets. M&G’s view is that a conservative, senior-based European leveraged loan strategy will outperform the market over a cycle.
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