Brandywine Global Investment Management, LLC
Topical Insight | October 31, 2017

Global Alternative Credit

An Unconstrained Approach to Overcoming Low Yields and Increased Volatility

INTRODUCTION

Finding value without incurring excessive risk has become increasingly difficult in the traditional fixed income space. Historically low interest rates, tight credit spreads, and unconventional monetary policy have paved the way for low return potential and increased volatility. In their search for yield, many investors have indiscriminately ventured down the credit quality spectrum and incurred higher levels of risk. Faced with these challenges, we think investors should consider unconstrained or alternative fixed income strategies, which may help to outperform historically low yields and returns without incurring excessive credit risk, volatility, or interest rate sensitivity, in our view. In doing so, investors may gain several potential benefits. By actively seeking differentiated sources of return, we believe an unconstrained fixed income approach may generate attractive total returns, diversify asset allocations, mitigate risk, and protect against various forms of market volatility.

THE BENEFITS OF AN UNCONSTRAINED APPROACH

An unconstrained or alternative approach to fixed income can help investors uncover value in unexpected places, whether it is within a particular region, country, sector, currency, or debt instrument. By not being limited to a particular country, sector, or benchmark, investors gain access to a more expansive universe that can offer greater opportunity as well as the flexibility to avoid unattractive segments of the market. Long/short strategies can provide further benefits through additional sources of return while the ability to short has the added benefit of being an important risk management tool in volatile environments. Lastly, an unconstrained global approach can exploit differences in exchange rates through active currency management to either enhance returns or help mitigate risk.

AN ALTERNATIVE APPROACH TO GLOBAL CREDIT

At Brandywine Global, we manage a Global Alternative Credit strategy that employs a "go anywhere," high-conviction approach to uncovering value in the global credit market (see **Figure 1**).

Figure 1 Global Alternative Credit

Description	A flexible high yield strategy that targets the best opportunities for total return, seeks to protect principal and generate a high income level, and uses active macroeconomic themes as a guide for its beta-hedging program and top-down valuation framework. The strategy looks to achieve these goals by tactically allocating across higher-yielding fixed income global sectors that offer the most attractive combination of value and fundamentals.
Inception Date	8/31/2010
Objective	U.S. dollar LIBOR + 600 bps over 3-year cycle
Key Differentiators	• Global flexibility informed by macro themes • Tactical concentration • Low correlation to other asset classes • Emphasis on risk management

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For Institutional Investors Only

We invest across regions, countries, sectors, and currencies with an emphasis on risk management and downside protection. We believe this highly flexible approach to the global credit market has the potential to deliver both attractive total returns and risk-adjusted performance, minimize downside volatility, and provide strong diversification benefits to an overall asset allocation. **Figure 2** and **Figure 3** demonstrate the risk/return profile of our Global Alternative Credit strategy since its inception in 2010 and how it compares to key benchmarks.

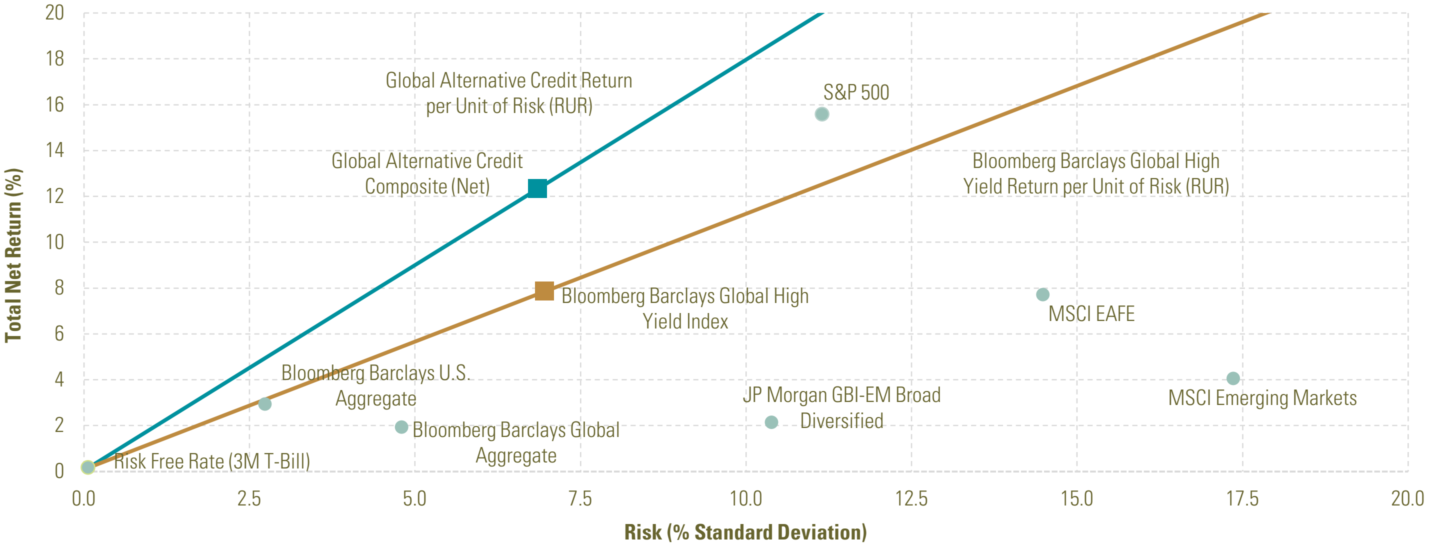
Figure 2 Comparative Risk/Return Statistics

Comparative Statistics - Since Inception, As of 9/30/2017

	Annualized Returns (%)	Annualized Standard Deviation (%)	Sharpe Ratio	Correlation
Global Alternative Credit Composite (Net)[1]	12.33	6.85	1.77	
Bloomberg Barclays Global High Yield Index	7.86	6.96	1.10	0.30
Bloomberg Barclays U.S. Aggregate	2.93	2.74	1.01	0.10
Bloomberg Barclays Global Aggregate	1.94	4.80	0.37	0.15
JP Morgan GBI-EM Broad Diversified	2.14	10.39	0.19	0.24
MSCI EAFE	7.72	14.49	0.52	0.28
MSCI Emerging Markets	4.05	17.37	0.22	0.27
S&P 500	15.58	11.15	1.38	0.27

Source: Bloomberg, Brandywine Global

Figure 3 Global Alternative Credit Risk Versus Return[1]
Since Inception, As of 9/30/2017



Source: Bloomberg, Brandywine Global

KEY DIFFERENTIATORS OF GLOBAL ALTERNATIVE CREDIT

Our Global Alternative Credit strategy is designed to generate attractive nominal and inflation-adjusted total return while striving to maintain low correlations to traditional asset classes—both equities and fixed income—measured over a full market cycle (see **Figure 2** on previous page). Because of its low correlations to other asset classes, an allocation to Global Alternative Credit may add diversification benefits and potentially improve the risk/return characteristics of U.S. equity and bond portfolios (see **Figure 4** and **Figure 5**). We believe that the combination of our proven, comprehensive process, global flexibility, tactical concentration, and emphasis on risk management affords us the latitude to construct a portfolio with differentiated sources of return that can better navigate an increasingly complex market environment.

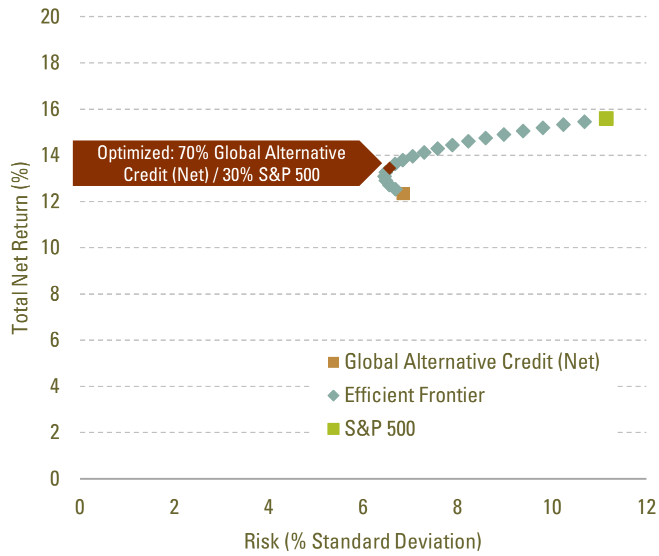
GLOBAL FLEXIBILITY ENHANCED BY LONG/SHORT CAPABILITIES

The breadth of our macro and fundamental research gives us a keen understanding of the global fixed income market, and the flexibility inherent in the Global Alternative Credit strategy allows us to take advantage of value we have identified across global sovereign and corporate bond markets as well as alternative credit markets. The Global Alternative Credit strategy is most extensively allocated to multi-currency global investment grade and high yield bonds, structured credit, and leveraged loans; high-quality sovereign bonds are typically used to mitigate portfolio volatility. Investments have been made predominately in developed markets as well as highly liquid emerging markets, although we may occasionally invest in a frontier market if a unique opportunity presents itself. Lastly, we are able to hold synthetic long and/or short positions in individual securities, indices, currencies, and interest rates. **Figure 6** (on the next page) demonstrates the historical allocations within the strategy.

HIGH CONVICTION AND MACRO THEMES EXPRESSED THROUGH TACTICAL CONCENTRATION

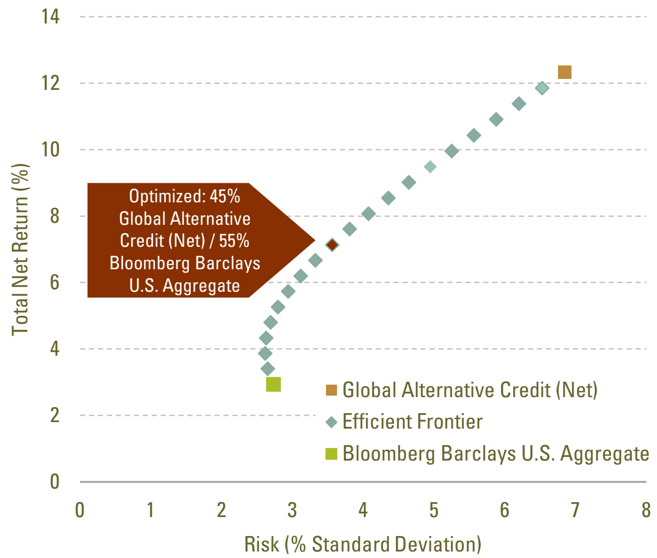
While the strategy has a broad investable universe, we have historically taken high-conviction positions where value is believed to be greatest. The portfolio is predominately comprised of cash bonds and enhanced by synthetic long and/or short positions that may be used to amplify returns or, more frequently, reduce volatility. We are generally invested in 50-100 positions, inclusive of both cash bonds and derivative positions. At times, this strategy has been positioned defensively, e.g., weighted toward issues with higher ratings or shorter durations. When macro conditions warrant, the strategy will be oriented more aggressively, e.g., toward higher-risk issues that potentially carry greater return potential. We may even use a significant cash position in certain market environments to protect assets.

Figure 4 Efficient Frontier Model Portfolio – Global Alternative Credit and S&P 500 Index[1] As of 9/30/2017



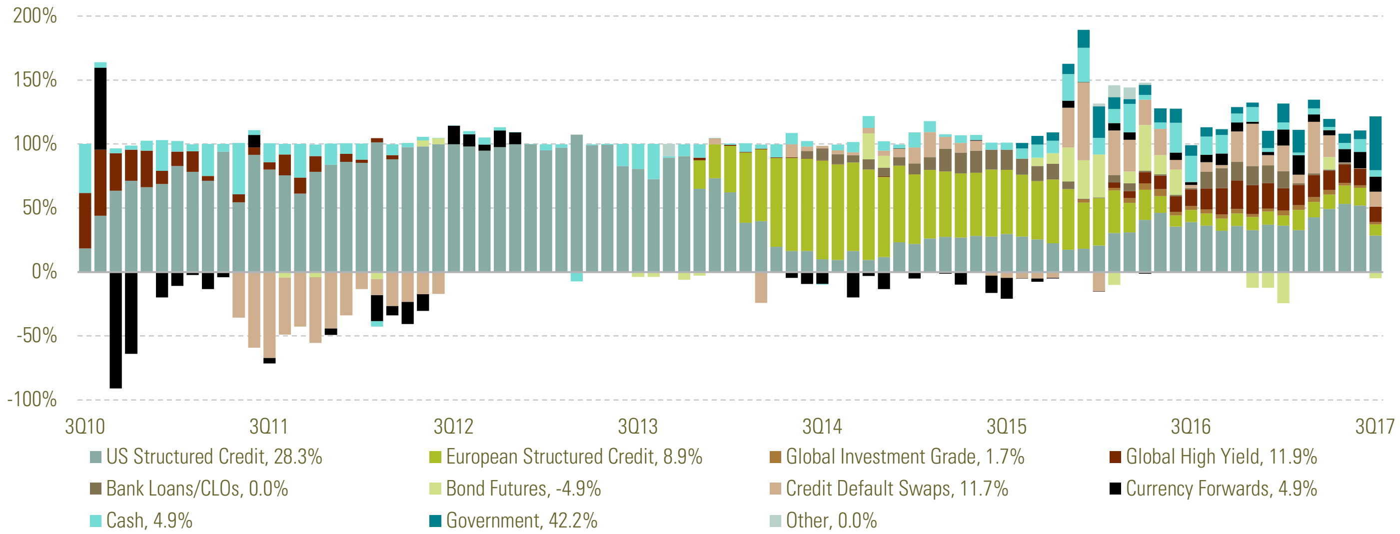
Source: Brandywine Global, RIMES

Figure 5 Efficient Frontier Model Portfolio – Global Alternative Credit and Bloomberg Barclays U.S. Aggregate Index[1] As of 9/30/2017



Source: Brandywine Global, Bloomberg Barclays

Figure 6 Global Alternative Credit Historical Allocations
As of 9/30/2017



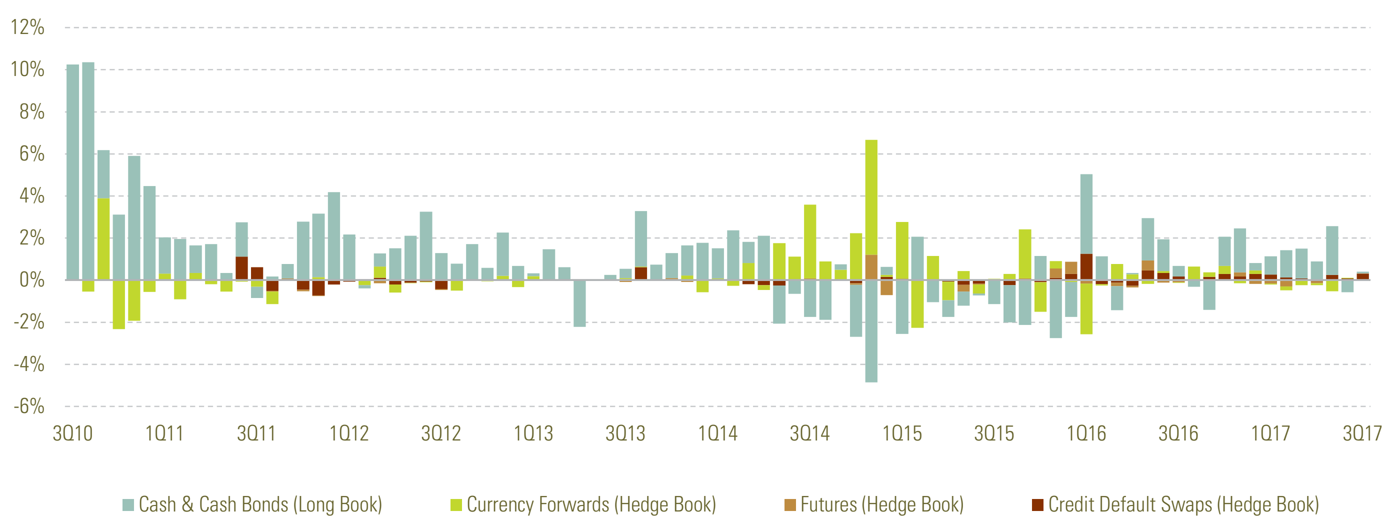
Source: Brandywine Global

MANAGING RISK USING A HIGH MARGIN OF SAFETY

Philosophically, we believe that our job is to intelligently and thoughtfully assume risk on behalf of our clients. We focus on identifying investment opportunities that offer a high margin of safety given the price of the security relative to the associated information risk uncovered in our top-down macro analysis and fundamental research. We believe that the strategy's management style, flexible investment process, and wide investment parameters help to actively limit credit risk and interest rate volatility, as we are not constrained to underperforming segments of the market or benchmark-relative allocations; the strategy has the flexibility to avoid risk where necessary. We incorporate proprietary modeling, scenarios analysis, and stress testing of the portfolio, which help us to better understand the behavior of existing or potential holdings in a range of environments.

We take a disciplined approach to valuation through security selection and our ongoing buy/sell discipline. Derivatives are also used to aid in risk management. We have the ability to overlay the portfolio with derivatives, such as credit default swaps (CDS), interest-rate futures, and currency forwards during periods of volatility—swaps are particularly important in this process. We use a mix of CDS in single securities and indices that cover the investment grade and high yield credit markets. Also, we use currency forwards and short-duration exposure to hedge systemic macro risk. **Figure 7** and **Figure 8** (on next page) demonstrate our effective use of hedges to provide protection in volatile markets.

Figure 7 Effective Use of Hedges Provides Protection in Down Markets
Global Alternative Credit Contribution to Return,[1] As of 9/30/2017



Source: Wilshire Axiom

We do not manage Global Alternative Credit to a specific risk level, although we maintain both a short- and long-term focus on minimizing drawdowns and reducing downside volatility in the strategy.

CONCLUSION

Nontraditional or alternative investment strategies with diverse sources of return and low correlations to traditional asset classes are likely going to become increasingly important for investors amid the challenging market environment and uncertain monetary policy outlook. We believe that our Global Alternative Credit strategy offers the potential for superior total return by looking outside of traditional fixed income sectors while the strategy's long/short ability can help deliver an attractive risk/return profile in challenging market environments.

Figure 8 Global Alternative Credit Upside/Downside Capture

While the Bloomberg Barclays Global High Yield Index, a risk proxy for the global credit market, has generated negative monthly returns 28 times since the launch of Global Alternative Credit, the strategy has generated, on average, 30 basis points of positive return gross contribution compared to the Index, which generated -160 basis points.

Monthly Performance[1] - Since Inception, As of 9/30/2017	Down Market*	Up market*
Global Alternative Credit (Net)	0.30%	1.36%
Long Book (Net)	-0.63%	1.53%
Hedge Book (Net)	0.91%	-0.17%
Bloomberg Barclays Global High Yield Index	-1.60%	1.76%

*Market defined as Bloomberg Barclays Global High Yield Index

Source: Wilshire Axiom

1. Supplemental information to the attached Global Alternative Credit GIPS-compliant composite presentation.

The Global Credit team offers special thanks to interns John Edelman, Jr. and Karli Visconto in helping to create this paper.

The views expressed herein represent the opinions of Brandywine Global Investment Management, LLC ("Brandywine Global") and are not intended as a forecast or guarantee of future results. This material is for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. All information obtained from sources believed to be accurate and reliable. Any forward-looking statements are based upon certain assumptions, some of which are described herein. Actual events are difficult to predict and may substantially differ from those assumed. Investing in the bond market is subject to certain risks, including market, interest rate, issuer, credit, and inflation risk. Mortgage-and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency, or private guarantor, there is no assurance that the guarantor will meet its obligations. The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The quality ratings of individual issues/issuers are provided to indicate the credit-worthiness of such issues/issuer.

The Bloomberg Barclays Global High Yield Index provides a broad-based measure of the global high-yield fixed income markets. The Global High-Yield Index represents the union of the U.S. High-Yield, Pan-European High-Yield, U.S. Emerging Markets High-Yield, and Pan-European Emerging Markets High-Yield Indices. Until January 1, 2011, it also included the CMBS High-Yield Index. The Global High-Yield Index is a component of the Multiverse Index, along with the Global Aggregate Index. The Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The Bloomberg Barclays Global Aggregate Index provides a broad-based measure of the global investment-grade fixed income markets by including agencies, corporates and asset backed issues. The JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Broad Diversified is a comprehensive emerging market debt benchmark that tracks local currency bonds issued by emerging market governments. The unique diversification scheme ensures that weights among the index countries are more evenly distributed by reducing the weight of large countries and redistributing the excess to the smaller weighted countries with a maximum weight per country of 10%. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The Morgan Stanley Capital International (MSCI) EAFE Index is an unmanaged index of equity securities from developed countries in Western Europe, the Far East, and Australasia. The Morgan Stanley Capital International (MSCI) Emerging Markets (EM) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. S&P® is a trademark of McGraw-Hill, Inc. The S&P 500® Index is a broad measure of the domestic large cap stocks. The 500 stocks in this capitalization-weighted index are chosen by the financial information firm Standard and Poor's based on industry representation, liquidity, and stability. Indices are unmanaged and not available for direct investment.

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Global Alternative Credit Composite | As of September 30, 2017 | Results shown in USD - Final

ANNUALIZED RETURNS

	COMPOSITE RETURN GROSS OF FEES (%)	COMPOSITE RETURN NET OF FEES (%)	US 3 MONTH LIBOR + 600BPS (%)
QTD	1.94	1.63	1.78
YTD	8.90	7.90	5.35
1 YEAR	10.37	9.01	7.13
3 YEAR	3.48	2.20	6.66
5 YEAR	6.82	5.32	6.50
7 YEAR	12.62	10.94	6.47
SINCE INCEPTION 9/2010	14.02	12.32	6.47

CALENDAR YEAR RETURNS

YEAR OR YTD	COMPOSITE RETURN GROSS OF FEES (%)	COMPOSITE RETURN NET OF FEES (%)	US 3 MONTH LIBOR + 600BPS (%)	NUMBER OF ACCOUNTS	MARKET VALUE (MILLIONS)	TOTAL FIRM ASSETS (MILLIONS)	COMPOSITE DISPERSION (%)	COMPOSITE ST. DEV. (% 3-YEAR ROLLING)	US3MLIBOR600 ST. DEV. (% 3-YEAR ROLLING)
2017	8.90	7.90	5.35	4	577	73,890	N/M	4.14	0.10
2016	6.94	5.62	6.74	4	501	65,498	N/M	4.30	0.07
2015	-4.01	-5.21	6.31	4	918	68,819	N/M	4.18	0.02
2014	11.35	9.71	6.23	3	837	63,375	N/M	4.21	0.03
2013	9.00	7.12	6.27	1	48	50,050	N/M	4.79	0.03
2012	20.23	18.17	6.44	1	34	42,894	N/M	N/M	N/M
2011	19.91	17.86	6.34	1	4	33,122	N/M	N/M	N/M
2010	29.56	28.85	2.06	1	3	31,996	N/M	N/M	N/M

Organization
Brandywine Global Investment Management, LLC (the "Firm") is a wholly owned, independently operated, subsidiary of Legg Mason, Inc. The Firm has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS). For the periods July 1, 2000 through June 30, 2016, the Firm has been verified by Kreischer Miller. A verification includes assessing whether the Firm (1) complied with the composite construction requirements of the GIPS standards on a firm-wide basis, and (2) designed its processes and procedures to calculate and present performance results in compliance with the GIPS standards. A copy of the verification report is available upon request. Disclosed total firm assets represent the total market value of all discretionary and nondiscretionary, fee-paying and non-fee-paying assets under the Firm's management.

Composite Description
The Global Alternative Credit Composite (the "Composite") Inception date: September 1, 2010. Creation date: September 1, 2010. The Composite includes all fully discretionary, fee-paying, actively managed Global Alternative Credit accounts with no composite minimums. The investable universe is generally comprised of high yield corporate bonds rated below BBB- or Baa3 by at least one rating agency and non-agency mortgage-backed and other mortgage related securities that are trading at distressed prices The Strategy may also consider investment in unrated securities deemed to be of comparable quality, and may also take positions in bank loans, defaulted bonds and bank loans, investment grade corporate bonds, US Treasuries, credit default swaps, emerging market debt, equities (listed and unlisted), preferred stock, convertible securities, and currencies. In addition, the Strategy may also utilize futures, leverage, and take short positions in various investment instruments (including but not limited to equity index futures, equities, bonds, loans, CDS, etc.) to manage the beta and directionality of the portfolio. The portfolios are typically invested in 20-50 securities.

Benchmark
London-Interbank Offered Rate (LIBOR) - British Bankers Association Fixing for US Dollar. The rate is an average derived from the quotations provided by the banks determined by the British Bankers' Association. BBA USD LIBOR is calculated on an ACT/360 basis and for value for two business days after the fixing. An annual return of 6.00% is then added to the return.The Bloomberg Barclays Global High-Yield Index provides a broad-based measure of the global high-yield fixed income markets. The Global High-Yield Index represents that union of the U.S. High-Yield, Pan-European High-Yield, U.S. Emerging Markets High-Yield, CMBS High-Yield, and Pan-European Emerging Markets High-Yield Indices.

Performance Calculation
Preliminary data, if so noted, reflects unreconciled data for the most recent reporting period. Portfolios are valued daily on a trade date basis and include dividends and interest as well as all realized and unrealized capital gains and losses. Return calculations at the portfolio level are time-weighted to account for periodic contributions and withdrawals. Performance results are calculated on a before tax, total return basis. The Composite returns consist of size-weighted portfolio returns using beginning of period values to weight the portfolio returns. Monthly linking of interim performance results is used to calculate quarterly and annual returns. Composite's valuations and returns are computed in U.S. Dollars ("USD"). The results are presented in USD or in other currencies (to accommodate overseas investors), the latter by converting monthly USD returns into other currency returns using the appropriate currency exchange rate returns. Gross returns reflect the deduction of trading expenses. Net of fee returns reflect the deduction of trading expenses and the highest investment management fees charged within the composite membership as stated in the fee schedule below. Composite dispersion is calculated using the asset-weighted standard deviation method for all portfolios that were in the Composite for the entire year. Composite dispersion is not presented for periods with five or fewer portfolios. The number of accounts and market values are as of the end of the period. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period.