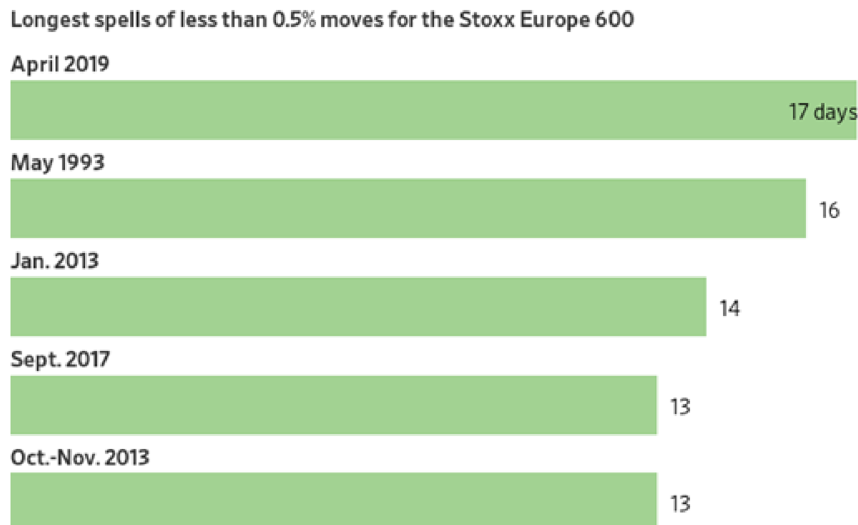
Ayaltis Funds – April 2019 Commentary

Market Commentary

Our flagship fund Areca Value Discovery is down -0.23% in April for Class B USD as markets entered the last stretch capping the rebound from Q4 last year. Once again, the S&P did not experience a single day down by more than 1%. The reversal of stance from the Fed returned markets fully to a state of bullishness. As markets reached an equilibrium, internal Relative Value reversion temporarily subsided as expected as volatility decreased, contributing to our result. Nevertheless, when markets become placid, investors should be more nervous than complacent. On the back of the big bounced-back rally in US stocks this year, non-commercial traders – hedge funds among them – are now betting on the US stock market remaining tranquil by the greatest ratio on record. May is so far proving how wrong they were and how political and economic issues can turn-around dramatically these days. In April, investors had high expectations on China and the US reaching an agreement to defuse a trade war. Theresa May was granted a delay of the Brexit deadline to October 2019, giving her (or someone else) breathing room to find an agreement. In light of the equity sell-off happening in May with credit spreads widening, one can understand how complacency can be dangerous with current lofty valuations; market direction changes have no early warning!

Graph 1: Quiet European Stock Market



Source: Dow Jones Markets April 2019

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Portfolio Commentary – Areca Value Discovery

We remain focused on decorrelated opportunity sets while more prudent than the average hedge fund allocator on market beta direction. We increased our exposures to events and aim to drip every last drop of performance from beta-insensitive investment opportunities. As expected, the positions most reliant on reversion in our portfolio, in equity and credit, had muted performance as the fragile extension of an anomalously strong market bounce-rally ended into a volatility devoid period. This is what happens in all passive ends of rallies.

We continue to increase our allocation to funds in opportunity sets with increasing alpha sources. One is a specialised volatility Relative Value trader, with engines that trade across the whole surface on the basis of volatility forecast models. Having previously successfully managed equity portfolios with forecast engines based on machine learning technics, he decided to go one step further to apply the same methodology to the options space. The fund has successfully navigated the current markets and is only open to a few select investors. The second addition is an Event Driven biased equity manager specialised in the healthcare sector. The main risk in the space is the idiosyncratic jump of a security. This is why this manager is diversified over 50 companies with a maximum allocation of 3% on any given security.

We have reduced our overall correlation to equity and credit markets substantially, while sitting on very strong and idiosyncratic sources of return. As markets continue evolving, we are able to identify new and exciting sources of decorrelated returns. As volatility clouds continue to emerge in the world trade relations, we are excited by the positive effects it brings into our diversified return pockets.

On the **Systematic Relative Value** side, our managers were net performance detractors. Equity market neutral managers were the biggest detractors to performance as the entire space suffered from the dampening volatility typical of the end of rallies. As investors rushed to capture the last leg of a receding rally, they flooded equity market funds with inflows, temporarily compressing sources of Relative Value alpha. As the rally recedes, profit taking outflows will replenish this source of alpha. One of our managers trading with artificial intelligence models (data transformation), in which we were early investors, had a very strong month and soft-closed, after receiving substantial inflows.

Our **Discretionary Relative Value** managers were slightly positive in April. They focus largely on Relative Value equities. The complacency in the bull market that started after the drop of Q4 2018, was favourable to discretionary managers but lost momentum in April. Since we have built a strong balance between discretionary and systematic managers, naturally decorrelated strategies, there happen to be periods when they can be spuriously correlated. We experienced such a time span in April when both suffered.

Our **Event Driven** managers have the biggest allocation in the portfolio. They were marginally down in April. The strongest contributor was an Asian manager trading across multiple events, soft and hard catalysts. The worst contributor focuses on very specific sectors, rotating quickly as opportunities move around. The Event Driven sector overall has residual exposure to downside markets but with strong asymmetry. We seek managers that can capture diversified

idiosyncratic events with strong emphasis on controlling the drawdown. Combined with other strategies that provide convexity, our portfolio benefits from a powerful balance.

The best returns came from trading **Relative Value Fixed Income**. The search for USD funding triggered increases in short rates and had multiple effects: cross-currency basis widened, repo rates increased, overnight Fed Fund Effective Rate increased mid-month, bringing it 4 bps above the rate of interest on reserves. This is expected to reverse in the near term. As a consequence, expectations of rate cuts on interest on reserves gathered momentum and so did expectations for an earlier end of Fed balance sheet tightening.

The only manager on the **Structured Relative Value** side was the main detractor to the portfolio, detracting 21 bps. Having quality legacy RMBS bonds in the portfolio, the manager has substantial short positions on high yields both in swaps and options as a hedge. Although we share the concern of too high valuations of credit instruments, the current lifeline sent to financial markets by central banks supports irrational valuations, temporarily affecting the hedge. As worldwide growth slows, corporations might start to run into trouble and credit spreads might start widening, from which the manager can substantially benefit forward.

Global Macro managers generated roughly 0.20% to the fund. The main contributor is a volatility trader, who made money on Relative Value volatility trades and directional volatility positioning. Although the compression of volatility across assets, linked to the market rally makes Relative Value more difficult, the manager benefited from compressed volatility on TWD and CNH. Another manager continued to perform in tactical trading, around government auctions and by taking a tactical position on the steepening of the US yield curve.

Our **Distressed Securities** strategy represents our smallest allocation, shy of 5%. We have only one manager, focusing on stressed and distressed long and shorts, that was marginally down in April. They find strong opportunities in the energy and financials sector, from a Relative Value basis. As valuation remain high, and distressed situations have not picked up, the manager remains market neutral. Once a global sell off happens with a recession hitting, following a wave of distressed situations, the manager could opportunistically build on some beta. Not now! And Ayaltis fully shares the view that beta positioning might bring the wrong risk return asymmetry.

Portfolio Commentary – Azure

Our portfolio dedicated to equity managers with a strong bias to positive asymmetry, was marginally down -0.52% due to the appeasement of reversion. The bulk of the losses came from our Systematic Relative Value managers. Equity market neutral managers were the biggest detractors to performance as the entire space suffered from the dampening volatility typical of end of rallies. As investors rushed to capture the last leg of a receding rally, they flooded equity market funds with inflows, temporarily compressing sources of relative value alpha. As the rally recedes, profit taking outflows will replenish this source of alpha. We already saw the exact opposite rebound in performance in the first half of May, as equity markets were strongly down. Moreover, one of our managers trading with artificial intelligence models (data transformation), in which we were early investors, had a very strong April and is now closed to new investors,

after receiving substantial inflows. As the equity momentum that started in January lost impetus in April, discretionary managers captured less returns.

We added a manager specializing in the healthcare sector with a strong approach of risk management. The manager has the strong diversification required to neutralize the jump-risk of securities in the sector. Our Azure portfolio delivers an ideal equity replacement role, capturing very specific opportunities with strong asymmetry (low exposure to the downside and strong upside capture).

Portfolio Commentary – Narrapuno Spectrum

Our portfolio of high conviction ideas, Narrapuno Spectrum, targets by nature higher returns but with potentially more volatility. It was down -0.42% in April. The main detractors came from Structured Relative Value, Systematic Relative Value and Event Driven. The main culprits were hedging positions on market beta. Having quality legacy RMBS bonds in the portfolio, our Structured Relative Value manager has substantial short positions on high-yield both in swaps and options. Global Macro and Relative Value Fixed Income delivered attractive returns. Although we share the concern of sky-high valuations for credit instruments, the additional lifeline offered to financial markets by the central bank's stance reversal further supports irrational valuations. As worldwide growth slows forward, corporations might start to run into trouble and credit spreads might start stressing and eventually widening, from which the manager can substantially benefit.

Portfolio Commentary – Convexity

Our Convexity portfolio was down -0.92%. As a reminder, this portfolio has a unique approach to deliver strong returns when markets sell off. It aims to achieve this with minimal cost of carry. This is an ideal protection for any portfolio that has residual beta to equities or credits. One has to remember that the rule of compounding teaches us that if your overall portfolio remains as flat as possible during market drawdowns, it only needs to capture part of the market upside to outperform it substantially.

The fund was launched on 1 August 2018. It delivered +3.85% in 2018, delivering the strong returns per its mandate. As the speculative rebound followed in 2019 and brought the index to the level prior to Q4 2018, our fund gave back only half of the strong returns. As of the first two weeks of May, Convexity is already performing strongly again as markets experience material selling pressure.

The portfolio loss in April came mainly from a deterministic tail risk strategy which pays high carry to deliver very strong defensive returns. As volatility got compressed, opportunities for our volatility traders were not as plentiful this month. Overtime, we would expect the carry to be even smaller.

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