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Ayaltis Funds – October 2018 Commentary

Market Commentary

October brought a global risk-off that drove the S&P 500 in a peak-to-trough drawdown of -9.7%. The MSCI World closed the month down -7.4%, the worst drop since May 2012. The sell-off that at long-last also affected credit instruments, was partially driven by a rise in 10-year real yields on US Treasuries now close to a long-term potential GDP growth rate of 1.5%. Other unsettling factors were the usual suspects: US mid-term election uncertainty, trade wars and unusually hawkish central bankers in Europe and the US. The rise of short-term interest rates in US dollars will balance out the effects of the Republican fiscal stimulus. Trump's recent outburst against the Fed reflects these policy tensions between the two opposing forces supporting current valuations. Economic slowdown and higher short-term interest rates convinced people to cash-in part of the gains that came with the summer rally.

European economies are showing worrying signs of weakness: German growth experienced an abrupt turnaround as the car industry gets hit, mainly because of trade wars.

Graph 1: Surge in 5 Year Credit Default Swaps in Italian Banks

Source: Bloomberg

During the first nine months of 2018, six of the ten largest countries by market capitalization posted a decline. The US was one of the few exceptions. October partially replenished the dislocation in relative valuations. A famous statement reads: interest rates get "in all the cracks". An increase of 50bps on 10-year real yields will have a direct impact on P/E multiples, driving

the market down between 7% and 10%, especially now that the fiscal stimulus is receding. The worst scenario for equities, that implies a surge of long-term real yields, got started in October. Crucially and after months of eerily indifferent tightening, credit spreads began to finally cave in. When real yields start seriously driving the dance, combined portfolios of traditional assets are going to pay a high price.

Republicans, once more, have increased a gigantic budget deficit that sooner or later must be replenished. The beast (read US government) needs more money than ever, at a time when both the Fed and the ECB have announced and implemented a gradual reduction of their balance sheets. With corporate debt having reached scary levels, financing conditions tightening and economic growth at risk, the future of corporate assets looks bleak.

Graph 2: Rise in Nonfinancial Corporate Debt

Source: Goldman

Markets have partially – and finally! - discounted a potential scenario where the economy enters a recession (or at least a slow-down), central banks are cornered, and government stimulus may become pro-cyclical, adding fuel to the fire.

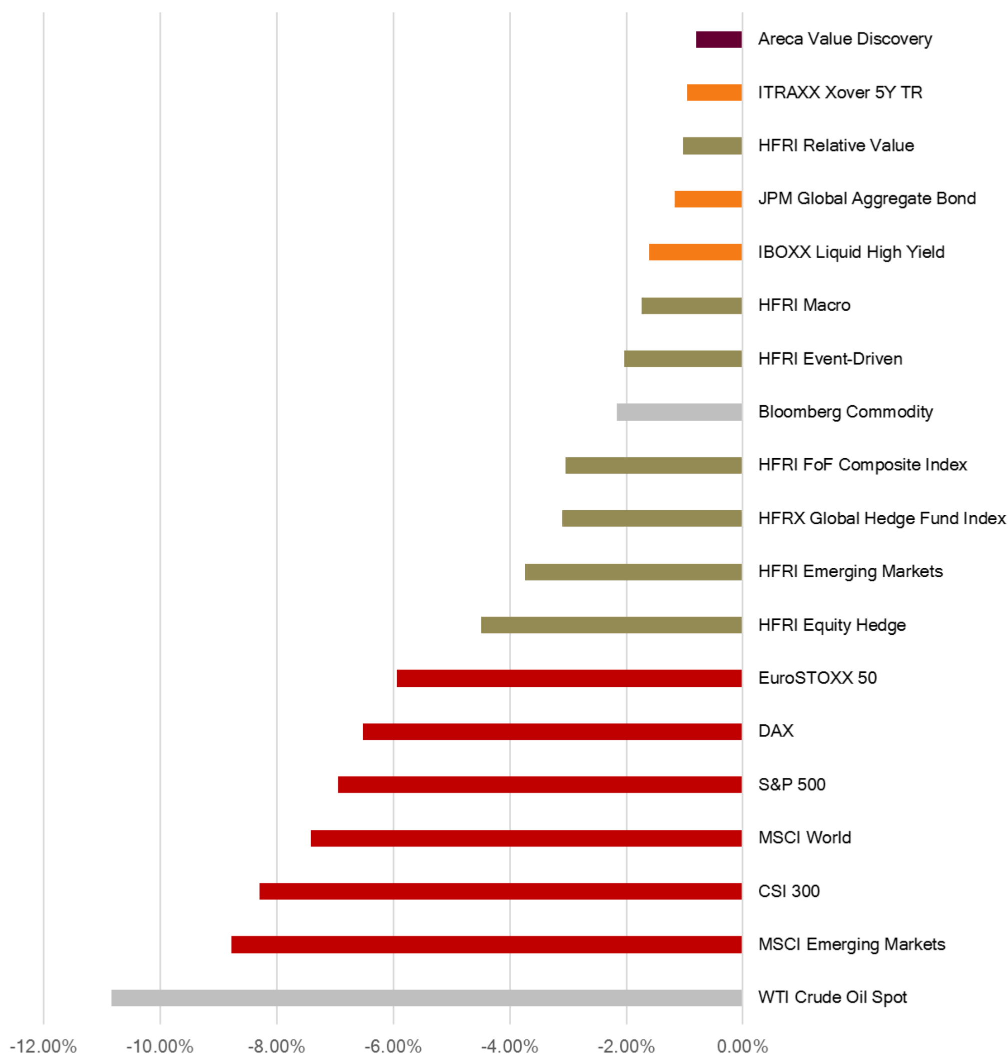
US growth will likely move down to trend by mid-2019 prompted by the recent tightening of financial conditions. The rest of the world (read Europe and China) is significantly decelerating and the markets swallowed the challenging news initially with a hiccup, then with a violent trend reversal.

Portfolio Commentary – Areca Value Discovery

Given the gloomy perspective of corporate assets, our portfolio is structured to have reduced exposure to equity and credit beta. This month's performance displays minimal exposure to a sharp market sell-off, while sitting on multiple opportunity sets. Our portfolio delivered a

defensive performance of -0.8% as opportunities were captured during the turbulent market. Within the universe of hedge funds, almost all types of strategies were strongly negative, with the Barclay hedge fund index down -3.35%, its worst monthly performance in seven years. Furthermore, the HFRI Fund Weighted Composite just published -3% in October, putting the index down -1.66% on the year. According to our database, only 16% of hedge funds were positive for the month and the sector had the worst month in seven years. Never pleasant to be down, but our performance is comforting as interest rates rise and broaden the cracks in valuations.

Graph 3: October Performance of HFRI Indices, Market Indices and Areca Value Discovery



Source: Ayaltis

There is an important lesson that investors should learn from October: the traditional (“all weather”) balanced portfolio may not be fully equipped to navigate a rising rate scenario. The usual flight to quality did not come to rescue equity-exposed “constant volatility” programs. In addition, basic hedge fund strategies like trend-following, who were wrongly marketed as

portfolio protection, were dragged down -3% on average as the market reversal caught them by surprise. The only strategies that delivered positive returns were quasi-arbitrage and Relative Value strategies. The main ones anchoring our portfolios.

Since the sharp market correction in February, our fund captured a high percentage of the mean-reversion in relative values driven by market normalization. During the October correction, we lost -0.80%, representing roughly 10% of the market correction. We could have saved a few bps more, but the result is in line with our risk management framework. That asymmetry of returns between capturing a strong part of the upside of the markets while being exposed to very little of the downside is at the core of our portfolio construction. We currently focus on managers with a convex return potential.

Our **Systematic Relative Value** strategies were mixed: The contribution was overall down mainly due to the relative underperformance of a small allocation into a manager who trades US listed securities on price action and option open interest. It displayed strong resilience during several past market drawdowns, by deploying capital on short-term corrections and capturing rebounds, on top of idiosyncratic events. However, the recent past shows a decay of its trading edge: the equity downside capture ratio has increased while the upside has stayed stable. We have decided to redeem from that manager to deploy capital to much more resilient strategies.

Discretionary Relative Value managers suffered during October. Fundamental equity market neutral managers were the main draggers. All geographic regions were slightly negative contributors. Companies in the financial and material sectors were significant detractors. One manager, who takes short-term directional bets, took the opportunity of the equity sell-off to selectively deploy capital: from +22% at end of September, his net exposure increased to 49% at the end of October. Having gradually deployed capital during October, he printed a minor negative month but is very likely to benefit from the rebound on specific oversold stocks of fundamentally-sound companies as he captured value on the downside.

Our **Event Driven** managers delivered a marginally down month at -0.12%. The main detractor is a manager who trades hard catalysts and relative value baskets, with a strong emphasis on hedging, mainly via options. The net exposure remains always very nimble. However, the risk-off that happened in tech stocks and some specific styles (growth and momentum) affected his performance. Our Asian event managers had a marginally positive contribution. Agriculture companies were strong contributors, as well as cross-border trading between Hong Kong and China.

We had a slightly positive contribution from our **Relative Value Fixed Income** managers. Being long swap spreads helped them benefit from the sell-off. We strongly focus on managers that emphasize on holding the safe assets long while being short the riskier assets. We avoid basic carry trades that tend to hold positions the other way around. There were also strong opportunities in basis swaps trading and cross-currency wideners. Opportunities are likely to be plentiful as volatility seems set to remain thanks to uncertain Brexit conditions, Italian tough budget negotiations with the EU and the US debt financing issue.

Our **Structured Relative Value** manager delivered a strong positive contribution. Our focus in that space has been very selective as we only kept one allocation due to the high level of hedging

skills of the manager. On top of the high quality of the structured bonds which he holds, the manager benefited from short positions on corporate credits, mainly in the high yield space. We had identified the position as not only a hedge but also as an idiosyncratic source of return. We specifically kept a large allocation with the manager in light of his tested attitude to opportunistically take advantage of credit spread widenings. In the recent past, the allocation has crucially contributed to increase our resilience versus market turnarounds.

With a large dispersion in their October returns, our **Global Macro** managers delivered -0.23%. A detractor to performance is our new small allocation into forward freight agreements. A fully idiosyncratic event is producing one of the most interesting distortions in the market that we expect to capture in the coming months. The forward contracts must change the composition of the fleets, due to a more stringent anti-pollution regulation. Aggressive sellers distorted the price way beyond fundamentals and we suffered from this pressure on prices in October although we believe the sector shows signs of stress that may be soon reverted. Our best contributors were volatility relative value traders who positioned on cheap, selective convex options or swaps. As the markets dropped, they displayed strong positive convexity, as expected. We will focus going forward on identifying more managers with such return profiles. Unlike in February, there were very few opportunities on the trade of VIX options versus S&P 500 options.

After several years of following the strategy from the side-lines, we have re-entered the **Distressed Securities** segment. Our Distressed Securities manager contributed positively in October. In a very volatile and challenging environment, several expected catalysts started to materialize. The portfolio is diversified and, in many terms, unique, with a strong focus on European events. A number of liquidations, not correlated to the rest of the markets, appreciated according to their schedule, in Norway and Germany. On top of that, a position in a Turkish bank, severely under pressure during the Turkish crisis, is getting out of the woods with a state-sponsored capital injection. Half of the performance came from short positions in the Italian financial sector and French business services. The manager continues to be particularly active on the short side. A characteristic that convinced us to make an investment, knowing that high equity multiples are not the ideal scenario for distressed funds. The sell-off in October confirmed the high quality of the manager and our conviction.

Portfolio Commentary – Azure

Our portfolio with a focus on equity strategies delivered -0.96% in October. The HFRI Equity Hedge Index was down -4.49%. All strategies were marginally negative contributors. Our Event Driven managers were the most affected. The main performance dragger was a manager that trades mergers and special situations. A US judging against the enforcement of a merger in the pharmaceutical space worked against them. The global market uncertainty combined with some Event Driven managers shutting down or returning capital to investors contributed to a certain degree of spread widening. Special situations were also negative contributors, mainly in the US, in the telecoms and semi-conductor sectors. However, this portfolio also benefited from our strong focus on reducing directional market exposure as demonstrated by some managers within the Global Macro and Systematic Relative Value segments who generated positive returns during October.

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Portfolio Commentary – Narrapuno Spectrum

Our portfolio of best ideas delivered -0.71% in October. Global Macro and Event Driven strategies were the main draggers on performance, while our Structured Relative Value manager was a positive contributor. The Barclay hedge fund index was down -3.35%. According to our database, only 16% of hedge funds were positive for the month and the sector had the worst month in seven years. Our focus on the Structured Relative Value space has been very selective as we only kept one allocation due to the high level of hedging skills of the manager. On top of the quality of the structured bonds he is holding, the manager benefited from short positions on corporate credits, mainly in the high yield space. In the Systematic Relative Value space, the main contribution came from a manager that has been recently adding strategies linked to alternative data. We have been focusing on reducing our beta to equities and credits, especially illiquid assets, in order to focus on Relative Value trading with an additional focus on downside convexity. Our portfolio has been fully delivering the favorable asymmetry of returns we created: limiting the downside exposure while capturing a larger part of the upside is paramount.

Portfolio Commentary – Convexity

The latest of our products is the Convexity portfolio, which focuses on having a larger allocation to our most convex managers. It delivered a positive performance of 1.16% in October. It is structured with a combination of deterministic and more probabilistic convex strategies. It aims at delivering flat to slightly positive returns in normal market environments, while providing higher returns in stressed markets. It fully played its role in the October sell-off. The returns came from managers who had identified cheap options across assets classes, as well as positioned themselves on correlation positions on assets that are highly likely to correlate in stressed markets. This is a very satisfactory month for our fund, providing some degree of hedging against the multiple uncertainties the world and financial markets are facing.

The Ayaltis Team,
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