Ayaltis Funds – 2018 Review and Outlook 2019

2018 ended with global investors holding their breath. The second half of 2018, the fourth quarter and in particular December 2018 were a big challenge to investors' nerves, while our funds were able to provide its diversification characteristics as most of our funds finished December remarkably on the positive side.

Table 1: Net Performance of Ayaltis Funds in USD, CHF and EUR

NAVs and Performance as of December 31, 2018	December	YTD 2018	NAV	2017	12 Months Rolling Return	12 Months Rolling Volatility	Liquidity
Areca Value Discovery B USD	0.03%	**-0.32%**	125.13	7.72%	-0.32%	3.95%	Quarterly
Areca Value Discovery B CHF	-0.34%	**-3.53%**	114.64	5.45%	-3.53%	3.98%	Quarterly
Areca Value Discovery B EUR	-0.29%	**-3.09%**	116.86	5.99%	-3.09%	4.08%	Quarterly
Areca Azure C USD	-0.75%	**1.16%**	105.80	5.48%	1.16%	3.43%	Monthly
Narrapuno SPC - Spectrum A USD	-0.40%	**-0.11%**	1,515.47	8.27%	-0.11%	4.63%	Quarterly
Narrapuno SPC - Spectrum A CHF	-0.76%	**-3.47%**	1,337.57	5.53%	-3.47%	4.60%	Quarterly
Areca Convexity B USD	1.07%	**3.85%**	103.85	-	-	-	Monthly

Final NAV and Performance as of December 31, 2018	December	YTD 2018	NAV	2018	12 Months Rolling Return	12 Months Rolling Volatility	Liquidity
LSF Alaya Diversified (UCITS) B USD	0.39%	**0.39%**	100.39	0.39%	-	-	Bi-weekly

Ayaltis Organizational Update

In 2018, Ayaltis was proud to celebrate its 10-year anniversary and its successful growth story. On top of our existing funds (our flagship fund Areca Value Discovery, our concentrated "high-convictions" fund Narrapuno Spectrum and our equity-opportunities fund Areca Azure), two new products enriched the Ayaltis product range:

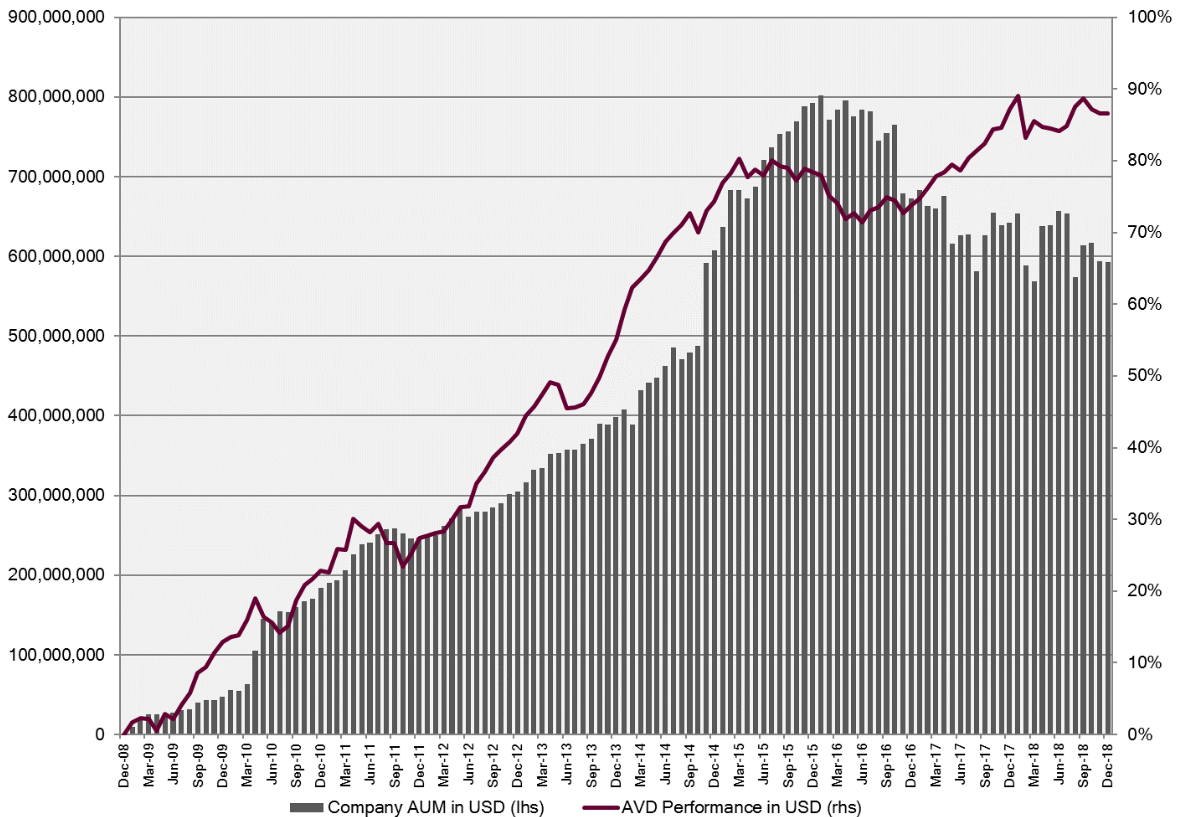
1) In August 2018, the Areca Convexity fund was launched. It aims at identifying opportunity sets that provide protection in case of extreme adverse market events while minimizing or even neutralizing the cost of carry. The product lived up to its name, with a consecutive positive performance during the five most challenging months in 2018.

2) In December 2018, Ayaltis embraced the UCITS universe and launched Alaya Diversified UCITS. Ayaltis will apply its long-term expertise to carefully select UCITS funds, that have the best market-neutral approach. The fund capitalizes on Ayaltis' key focus: non-correlated returns with strong factor neutrality.

Ayaltis Company AUM Growth in USD

Assets under management remained stable throughout the year 2018.

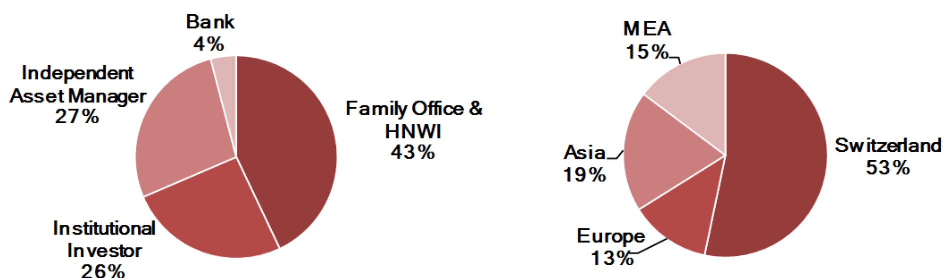
Graph 1: AUM Development Since Inception in 2008



Source: Ayaltis

Overall, the client base consists of family offices/wealthy individuals, institutional investors, independent asset managers and sovereign wealth funds. Looking at geographical diversification, 53% of our clients come from Switzerland.

Graph 2: Client Structure by Type and Region



Source: Ayaltis

Areca Value Discovery – 2018 Review & Outlook 2019

The Areca Value Discovery fund ended the month of December 2018 with a remarkable positive performance of +0.03% for the B USD Class, despite plummeting risk-asset markets that witnessed a jaw-dropping peak-to-trough drawdown of -19% in the US and -16% in Europe for the last quarter 2018 in USD. This brings the YTD 2018 performance of the fund to -0.32% in B USD. The CHF Class ended December -0.34% (YTD 2018: -3.53%) and the EUR Class -0.29% (YTD 2018: -3.09%).

2018 was a very challenging year for traditional markets. The massive regime change that started in the second half of 2018 and accelerated in the fourth quarter of 2018 exposed the true risks of long-biased, basic risk-premia and trend-following strategies. According to HFR Indices, hedge fund performance in 2018 was down -4.5% on average across all strategies globally. Considering this was the first year since 2008 that hedge funds generated negative yearly returns on average, and that we just lived through the most challenging second half 2018 in a decade, our positive performance during this turbulent second half of 2018 puts us among the leading fund of hedge funds in the world. It is important to note that generic hedge funds, as measured by alternative indices, became increasingly long-biased as the rally extended. They captured a reasonable part of the upside but then lost all because they were fully exposed to the downside. Our strong risk-adjusted return profile has proven that, by portfolio construction, we are poised to capture idiosyncratic, market-neutral independent sources of return (i.e. corporate and macro events…), while being very resilient to potential stressed markets. This is particularly important when considering market scenario expectations into the future.

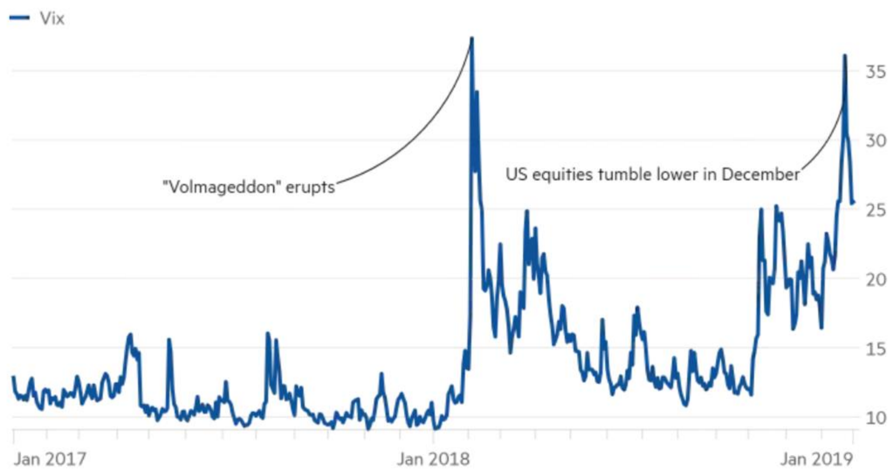
Market Review 2018

In our 2017 review, we wrote: *"2017 was an exceptional year. Let's look at the facts: The S&P 500 never had a single month below 2% and the largest drawdown was a paltry 2.8%. The index was up every single month of the year for the first time in its history! In 90 years of history, which include the aftermaths of WW2, the Great Recovery, the Internet and the Sub-Prime bubbles, we never had such a peaceful, non-volatile rallying year. An ideal environment for passive investing."* Magic? No, central banks and deficit-building tax cuts set the ground for this development.

Passive investing met its nemesis in 2018: as we expected, 2017's financial market "honeymoon" crashed in 2018 as unrealistically exuberant market valuations collided with newly-found central banking hawkishness into a sharp market reversal, hitting both equity markets and credit markets hard. February 2018 saw one of the sharpest equities sell-offs in recent history, delivering the most violent one day move on the VIX in 39 years. Considering that implied volatility lingered at historical lows during the irrationally subsidized rally of 2017, the ripple effects brought the S&P 500 down -11.6% in the first 10 days of the month of February 2018. Though the true catalyst was the long-feared increase of Treasury yields. The dramatic acceleration drove correlation up across most equity sectors and was exacerbated by the forced unwind of short-VIX ETFs.

Following the February 2018 volatility crash, markets were stuck in a conundrum where profitable equity-focused trading opportunities were whipsawed by erratic geopolitical macro drivers. Strong corporate results helped valuations go higher while yields did not quite react. 80% of US companies reported earnings per share above estimates in Q2 2018.

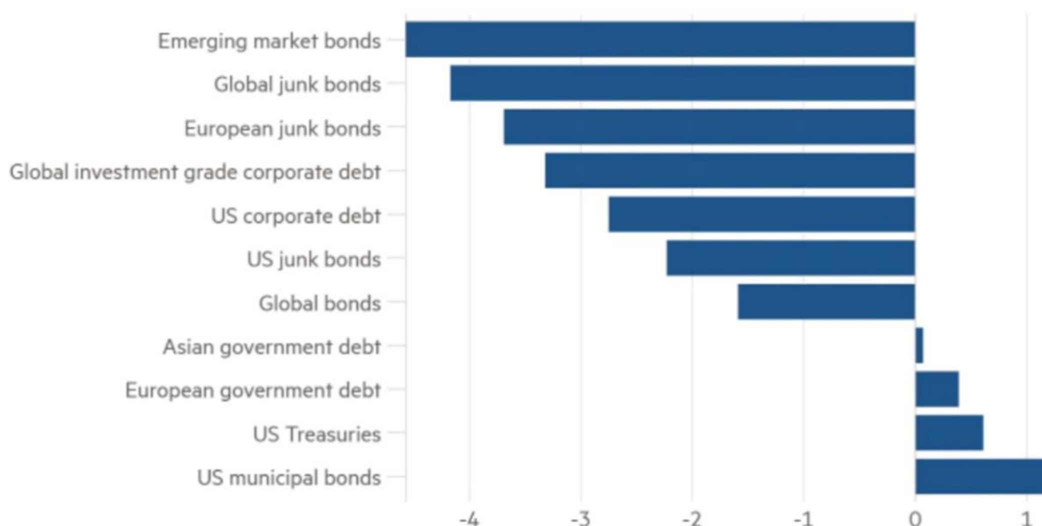
Graph 3: VIX Index in 2018



Source: Ayaltis Research

In the meantime, the global economic expansion entered its tenth year. During the last few weeks of the first half of 2018, concerns grew that a recession could be imminent. Investors started to price-in recession risks, or at least a slowdown in global growth. Expectations of companies' earnings growth became unrealistic. US Treasury yields continued their relentless increase throughout the third quarter of 2018, with the 10-year breaching the psychologically important 3% barrier going from 2.8% to 3.10%. Real yields got closer to the long-term potential GDP growth rate of 1.5%.

Graph 4: Bond Performance in 2018



Source: Ayaltis Research

The combination of these factors triggered an abrupt equity sell-off in early October. The scenario that we were anticipating. Though the first days of drop seemed benign, it triggered an equity rebalancing by many managers, generating substantial factor rotations and a flight-to-quality into Treasuries that brought the 10 years US Treasury yield back down to 2.6%. Contrary to the February market correction that was mostly technical, the drawdown in the fourth quarter of 2018 was more profoundly fundamental with substantial risk-off from equity and credit markets. By focusing on non-directional strategies, our funds performed positive in the second half of 2018.

Fears of a global slowdown in world economies gathered momentum, stoked by the stimulus reduction speech of the Fed's chairman Powell. At the same time, developed economies were running at full capacity and the first signs of economic slow-down were spreading from country to country.

In the past, recessions were caused by the following factors:

1) Inflation: tension on prices induced by central banks to tighten monetary policy, reducing the fuel injection in the economic engine.
2) Financial imbalances: the impact of deleveraging measures in a global economy where public and private debt reached unprecedented levels triggers a recession.
3) Trade tensions: free markets are certainly an important growth factor. Any obstacle to free trade may quickly escalate into a worldwide recession.
4) Political tensions: populism, Brexit's outcomes and the risk of other countries leaving the European Union.

Of these four possible factors, China represents the biggest uncertainty. International trade headwinds and worsening asset performances are new challenges for a government that was trying to keep the grip on an economy which is changing its main characteristics. By positioning our portfolio away from the impact areas of those factors (cross border trades, corporate debt, specific country exposure such as China or the UK), we have increased our resilience:

1) The Chinese equity drop of 32% had no impact on our managers with an Asian bias,
2) The credit sell-off had a positive impact through our managers with short high-yield positions and
3) The emerging markets drop during 2018, when the Turkish Lira suffered a 50% depreciation, had no impact on our Global Macro managers

Since the Fed started a gradual normalization of its monetary policy, the slope of the Treasury curve flattened from 300bps to around 80bps. This move has reduced the cost of the monetary soft-landing, but it also sent a clear message to investors: do not expect the old pre-crisis glory days to come back: 2017 equity-Disneyland should be over.

Portfolio Review 2018

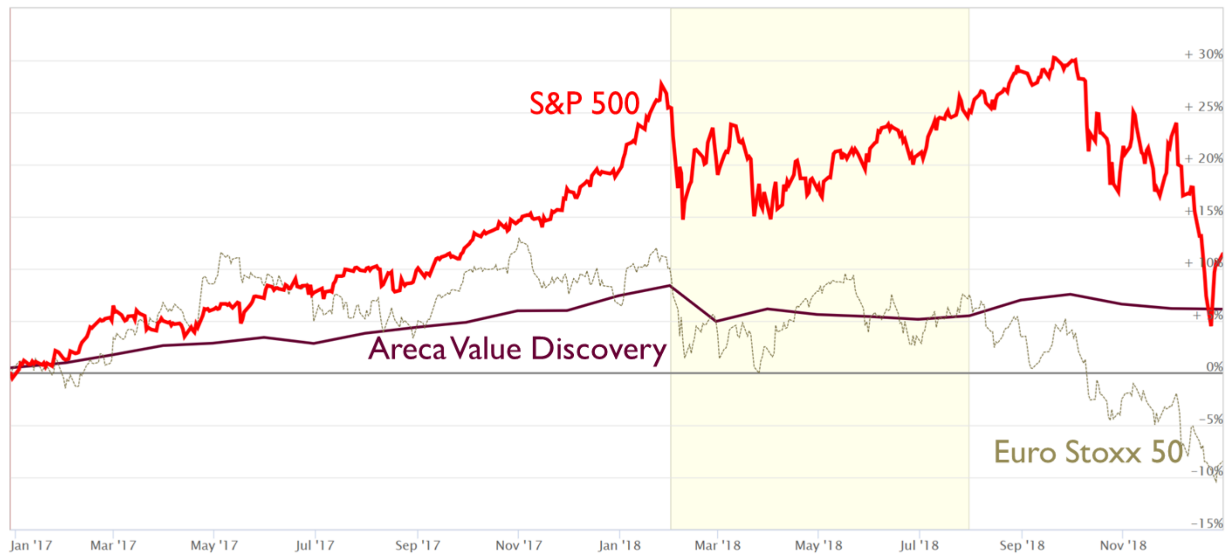
During 2018, we continued enhancing our portfolio with highly specialized strategies, which combined delivered strong resilience and de-correlation to markets. We did this without sacrificing liquidity. This achievement is particularly noteworthy since market prices are still a fallacious and significant risk-premium to illiquidity. Forward returns of traditional assets, equity (public and private) and bonds, display higher risks for lower potential returns even after the turbulent 2018.

One of the main indicators of economic health, the shape of the yield curve, remains contradictory: as long as the back end of the curve remains unattractive compared to dividend yields, equity markets will be supported. The difference between longer dated 10-year Treasury yields and shorter dated 2-year Treasury yields dropped significantly. A curve flattening suggests that investors expect growth and inflation to be subdued in the years to come. Low inflation expectations kept longer-dated bond nominal yields low even as the Fed boosted the cost of borrowing in the near term. Inflation was still below the Fed's target and investors were clearly doubting whether inflation would accelerate. When investors expect prices to rise, they require extra return to hold longer-dated bonds, but if expectations are for a mild inflation, they are willing to pay more to cash-in the higher yields. The current "conundrum" continues to challenge many Global Macro managers and is supporting leveraged risk-parity strategies. We made the deliberate choice to face the problem indirectly, by favouring hedge funds strategies that are designed to keep a more market neutral and idiosyncratic approach. Basic hedge fund strategies like trend-following, who were wrongly marketed as portfolio protection, were dragged-down as the market reversal caught them by surprise. We avoided them as well as the traditional risk-premia strategies (carry positions, momentum) and basic risk-factor models which suffered heavy losses in 2018.

We broadly enhanced the market resilience of our portfolio: neutralizing the little remaining beta to equity and credit markets while capturing idiosyncratic sources of returns. Multi-year low high yield rates, covenant-lite corporate loans and the negative spread between normally more expensive high yield bonds and corresponding loans were our canaries in the market "coal-mine". We wrote in our September 2018 monthly letter: *"In recent weeks, the worst fears have materialised, and the risk of another crisis has become much higher."* Our portfolio "skeleton" is decisively shaped around allocations that favour short-term uncorrelated strategies while avoiding beta-sensitive directional long-term exposure. Essentially, we made the portfolio nimbler, more short-term trading oriented.

Our focus on adding hedge funds with a convex profile, geared to deliver higher returns when markets get stressed, by buying on cheap long-volatility options, long-correlations positions or by opportunistically capturing over-extended spread widening has been key.

Graph 5: Areca Value Discovery Performance Comparison



Source: Ayaltis Research

Looking at the portfolio from a strategy bucket perspective, the positive contributors were Event Driven, Structured Relative Value, Relative Value Fixed Income and Global Macro. On the other hand, Discretionary Relative Value and Systematic Relative Value were detractors. Despite the adverse implications of geopolitical issues into cross-merger deals, our **Event Driven** managers delivered a good year as well and were the strongest contributor to performance in 2018. Our **Structured Relative Value** manager held fundamentally strong legacy mortgage bonds alongside credit shorts, not only as a hedge but as another source of returns. The **Relative Value Fixed Income** managers captured some opportunities in the liquid currencies yield curves. **Discretionary Relative Value** managers captured most of the upside on equities and provided strong defensiveness when equities dropped during the end of the year. However, one manager went into a major style drift in January, turning market complacent at the worst time, and suffered a heavy loss in February while our redemption was still pending the notice period. **Relative Value Systematic** managers, on top of having idiosyncratic sources of returns, provided a clear decorrelation to more discretionary managers. However, as factors rotated in a faster manner, and as markets went into a major regime change, some engines were less quick than expected to adapt. Even though the overall strategy contribution of **Global Macro** managers was positive during 2018, the performance was dragged down by one manager, who has by structure more volatility than other funds, but a very appealing long-term return. Another manager, specializing in shipping financial instruments, got affected by an unforeseeable external event, a new environmental regulation. During the last quarter of 2018, the portfolio built a position in the **Distressed Securities** space, with a manager that actively trades shorts in order to achieve some neutrality, even potentially some downside convexity.

December 2018 performance was a good example of market de-correlation we aimed at achieving in our portfolio. With equity and credit markets substantially down, we delivered +0.03%. The residual minimal market beta that comes from equity and Event Driven managers was offset by short credit positions and by market neutral sources of returns, mainly coming from quantitative managers.

We continue to be very active and dynamic in monitoring alpha decay, rotating as markets evolve into new opportunity sets. The asymmetry between upside-capture power and downside-protection is at the core of long-term investing. Capturing strong alpha sources while minimizing drawdowns through Relative Value trades is the true secret of long-term wealth protection and value creation. Our fund pipeline is comforting: not only the current portfolio has demonstrated to be robust and dynamic, but we continue to find compelling managers that will add new alpha sources.

Portfolio Outlook – 2019 and Beyond

Going into 2019, we maintain our stance in non-directional Relative Value strategies. The correction in credit markets was swift but the true stress test is still outstanding. The amount of dangerously structured debt (covenant-lite loans, the supposedly safest part of the capital structure) is truly colossal: according to Moody's the recovery rate of second lien loans could drop to 11%! Yes, 11%!

Our Relative Value managers may not only remain resilient, but feed on the after effects of market dislocations. When passive investors rush out from crowded trades, when investors are stopped out, forced to sell, that is when the most interesting opportunities are to be captured and crystallized after the mean-reversion processes kick-in. We are confident that by remaining resilient in market dislocations, we can opportunistically deploy capital in spreads that have widened or into fundamentally sound companies that were temporarily affected as collateral damage. We witnessed our managers capturing positions at the end of the year.

Markets always anticipate the real economy and sometimes create a retro-feeding vortex. Higher interest rates and more importantly, worsening credit conditions, are likely to start reducing consumer spending, by shrinking auto and personal loans. Financial markets could substantially drop further, while poor economic numbers would only show at a later stage.

Without fiscal stimulus "drugs" and massive central bank's interventions, US economic growth could go back toward a long-term rate of 2%, at best. The US economy shows a low unemployment rate, a narrow output gap and the first signs of wage inflation: we are clearly at a late stage in the business cycle. As reality hits, markets are likely to be under pressure, and more Relative Value opportunities could arise. Although Europe and Japan seem to be still on their way toward the top of their economic cycle, that false sense of safety should be mitigated with multiple headwinds. The latest figures of China (exports/imports, private credit growth and so on) show how difficult it is for the government to keep the pace of previous years.

Lower unemployment and higher wages are not putting pressure on prices. Not only are globalization and technological substitution of labor force clearly forcing prices to stay low, but the high amount of debt accumulated in the developed economies makes sustainable economic growth and high inflation unachievable.

Global central banks will strive to gradually normalize their policies, but the process is likely to be slower than expected in the face of a decelerating growth path. Who else can replace the lost buyer? As central banks lend less via their own balance sheets, the private sector will move into

Government paper and yields of other asset classes are likely to adjust. The sluggish performance of credit in 2018 is clearly linked to this phenomenon that is, in our opinion, likely to continue in 2019.

Global equities have rewarded patient and risk-prone investors with an annualized return of around 12% in the 10 years that followed the global financial crisis. At the same time, our portfolios captured a good part of it, with much lower risk and volatility than passive strategies. Today, valuations are clearly stretched. Price/earnings ratios remain at alarming levels, despite the recent sell-off and particularly in the US. Robert Shiller's cyclically adjusted P/E ratio (CAPE), regardless of inherent flaws, is currently close to the 95th percentile of its historical range of values. Although we are aware of the distortions caused by a historically low inflation rate, equity multiples are, if not at bubble level, certainly not attractive. For all these reasons, we believe that traditional assets should be significantly underweighted.

Corporate bonds have disappointed investors in 2018 and we continue to find their attractiveness quite low. The yield hunt from non-savvy passive investors did not stop with the recent downturn. With corporate debt having reached dangerously high levels, financing conditions tightening and economic growth at risk, the future of corporate assets looks bleak. The problem in credit has been exacerbated by the emergence of liquid ETFs as modern repackaging vehicles for crisis-illiquid OTC bonds; the evident liquidity mismatch may eventually trigger a sharp repricing. High yield ETFs are offered with daily liquidity despite substantial amounts of their underlying bonds trading at best only once every day in normal market circumstances. We will remain very cautious in credit market, selectively selecting Distressed managers that could potentially benefit from a credit unwind.

Large investors, like pension funds, are incessantly looking for solutions to their never-ending problem of assuring a good level of purchasing power to their clients. To do that, they are pushed to fish in the muddy waters of illiquidity and low credit quality, generating unattractive risk return ratios. Being nimbler, we can enter much more opportunistic and less crowded strategies.

To try to increase portfolio returns, investors increased their allocations to higher-expected-return assets: high-yield, private debt and emerging market equities were the preferred options. The small additional return that is added to the portfolio does not justify the high risks associated. Moreover, advisors pushed clients into the dangerous higher yielding parts of credit: CLO (collateralized loan obligations), leveraged loans and low-rated corporate bonds. On the contrary, savvy investors should not underestimate the value of Relative Value liquid strategies in protecting their capital and the call for prudence that comes from several fundamental indicators.

Not only corporate debt, also Government rates are still compressed by the action of central banks. Almost the entire German curve is yielding negative yields and real interest rates are negative. The US yield curve flattened significantly in the course of 2018, with shorter-term interest rates rising much more than longer-term yields. Real rates are, in many cases, negative, and investors must accept a certain degree of credit risk to exit the risk-free trap. Besides, flat curves offer poor advantages to investors with longer investment horizon.

Outside of traditional asset classes, we recommend careful diversification into particularly sophisticated hedge fund managers considering the likely economic scenarios given current fundamentals: fragile growth, sputtering economy or recession.

Having achieved a well-positioned and resilient portfolio which is neutral to most factors, we enter 2019 and beyond with optimism. Our portfolio structure and return opportunity seeking has enabled us to capture truly unique opportunity sets. We will not rest in identifying the most profitable strategies supported by the most talented hedge fund managers to maintain our research edge as we successfully overcome the investment landscape transformation. The opportunity sources are plentiful for those willing to go the extra mile, thinking beyond the traditional strategies, while avoiding generic long-biased carry pitfalls. Our portfolio is structured with a strong focus on maximising uncorrelated sources of returns that have a very low downside capture ratio. We find opportunities, in Relative Value strategies, with short holding periods, within liquid assets. At the equity level, the application of machine learning techniques on financial and alternative data has proven to be a key breakthrough based on performance results. Our Event Driven managers have a paramount focus on structuring downside protected corporate events to ensure minimal drawdowns. Both our hedge funds with convex profiles and distressed allocations were nicely positive in Q4 2018! Our Relative Value Fixed Income managers in interest rates ensure that a flight-to-safety move will not affect the returns.

We would like to share with you a few ideas of where we think our current portfolio will be able to benefit from the environment we are facing:

- Systematic Relative Value managers, especially in quantitative equity models can capture short-term patterns, they are highly adaptive to market dynamics, with the most sophisticated adaptive quantitative models in an ever-evolving machine learning environment.

- Dedicated Relative Value managers who choose to focus on volatility and Global Macro views who buy under-priced assets at low prices, that deliver high returns in case of sharp sell-offs. They are in a sweet spot to pick and choose assets as banks need to reduce the risk in their balance sheets. We benefit by selectively buying cheap under-priced volatility, or cheap correlation from banks. Trading volatility is a very lucrative management tool as investors count on volatility returning to normal levels after going to an extreme.

- Financing (via debt issuance) for corporates will become more and more difficult through the reduction of debt/bonds buying by central banks and by the changes brought in the US taxation in the end 2017 that makes it less tax friendly to issue bonds. Investing in Event Driven managers with solid company analysis skills, a strong relationship to the holding company and outstanding skills in implementing structures assure protection on the downside.

- We were out of Distressed opportunities in the last two years, but since October 2018 we re-invested in this area through a hedge fund with a European focus. We expect the distressed cycle to start slowly in near future, and the funds we invested in, should be profitable with trades both on the short side and on the long side.

In 2018, we celebrated our tenth anniversary. Our Relative Value investment approach has not changed during all these years. It remains anchored to market fundamentals. It has successfully evolved to overcome the market changes that challenged many hedge funds. It is currently poised to take benefits from our focus on extracting the maximum achievable return while cognizant of the paramount importance of preserving capital as the most important ingredient of long-term performance.

We therefore express our gratitude to all our investors and interested parties for their continued trust and support during the last ten years since inception of the fund.

We are optimistic that the divergence of key market factors is strongly expanding our Relative Value opportunity set going forward, and we are confident that our well-balanced portfolio represents a very attractive alternative for a potentially eventful 2019.

The Ayaltis Team

28 January 2018

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