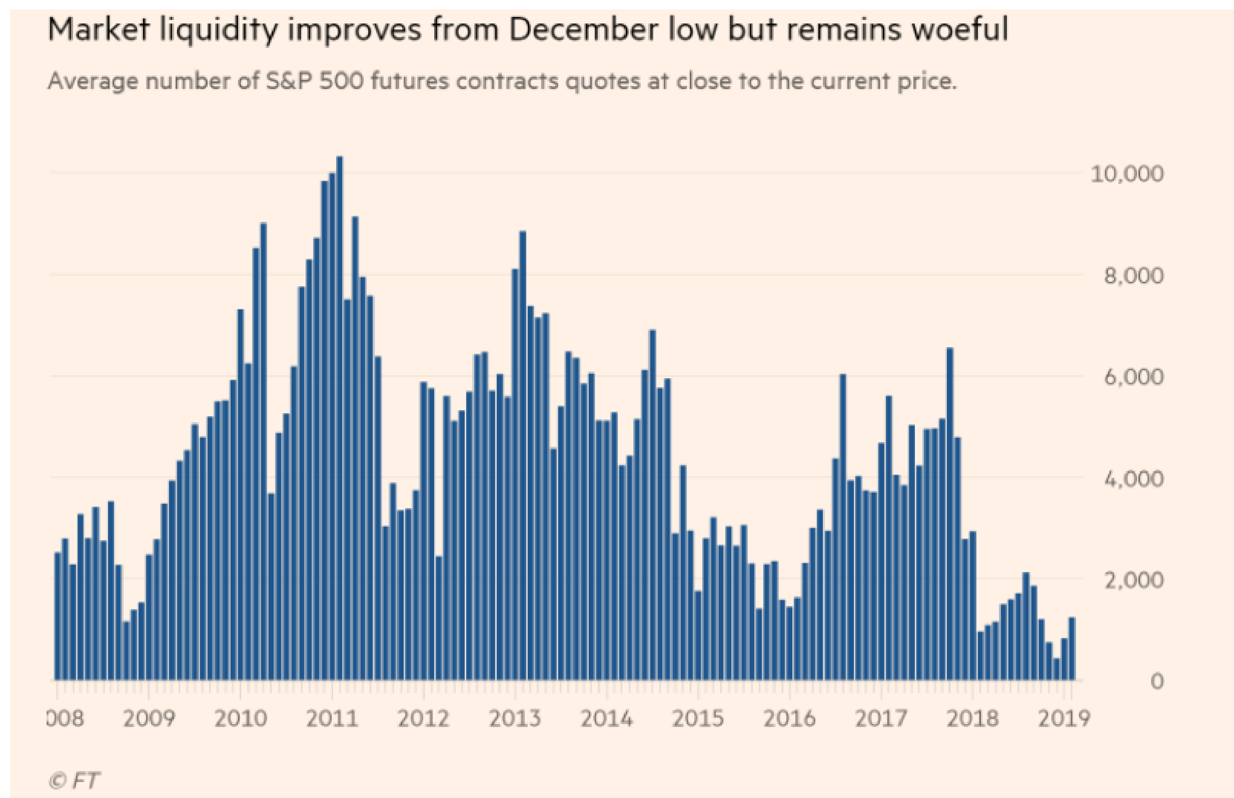
Ayaltis Funds – February 2019 Commentary

Market Commentary

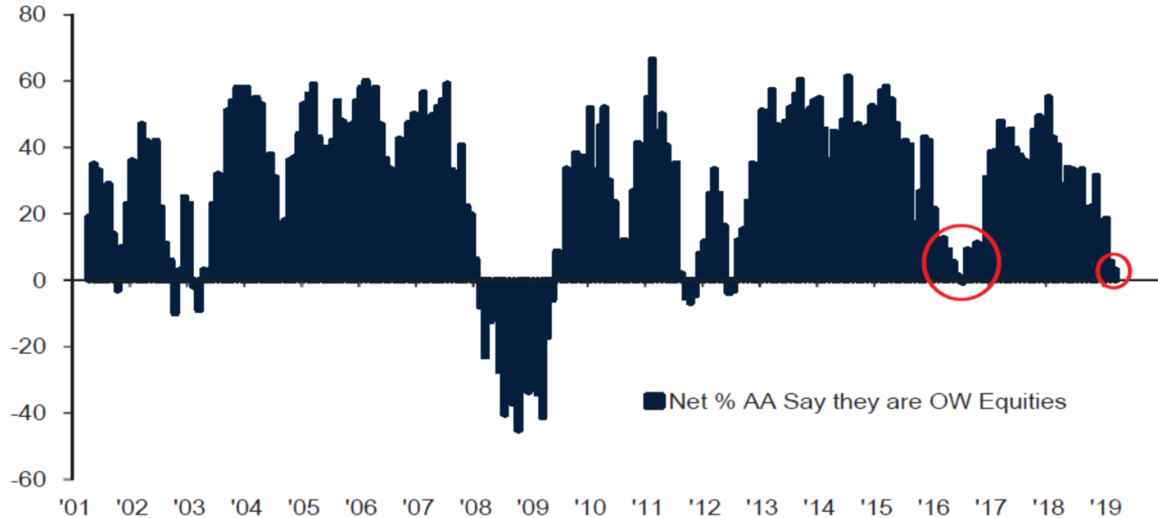
The everything-rally was back on, following the January bounce. Equities, credits, commodities increased while flight-to-safety currencies, the Japanese Yen and Swiss Franc slightly came off. VIX inched substantially lower. Stark contrast to the worst December performance in equities since 1931. For further context, this recent rally reflects the best start to the year since 1991 for U.S. equities and the best gain since 2001 for corporate high yield bonds representing simply a V-shaped recovery.

A stark contrast also to the peacefulness of 2017. What changed is that US treasury yields have not recovered from the drop of Q4 2018, remaining at 2.6% p.a. for the 10 years. The rebound in 2019, following a longer trend, seems to be based amongst others, on corporate share buybacks, which have been fuelled by central bank complacency. Graph 2 below shows that asset managers have adopted a neutral stance on equities during the rebound. Moreover, hedge fund managers seem to agree that liquidity in financial markets has deteriorated (see Graph 1). Only the complacent central bank policy appears to be keeping financial markets afloat; any change in stance could generate a substantial correction, aggravated by poorer liquidity and asset liability mis-alignment of passive investment products.

Graph 1: Market Liquidity



Graph 2. Asset Allocation Decisions Equites



Credit markets continued their recovery in February, following the steep declines seen in the fourth quarter of 2018. In the US, high-yield bonds and loans performed roughly in line. In Europe however, bonds outperformed loans. Through February, loans in the US had recovered approximately three-quarters of the price decline experienced over the last two months of 2018. All risk assets experienced a frenzy-buy fever that is only partially justified by the U-Turn of the Fed. Economic growth uncertainties were just temporarily forgotten by investors trying to lock in gains from the bounce. Global bonds do not share the same opinion.

Graph 3: Dividend Yield vs German 10 Year Yield

The total notional amount of global negative yielding debt soared recently, rising above $10 trillion for the first time since September 2017. Paradoxically, the amount of negative-yielding debt has nearly doubled in just six months. Negative yields mean that investors will lose money just by holding bonds to maturity. Forget about defending purchasing power: real yields are actively digging their own graves with several consequences. The sudden decline of European rates increased the gap between dividend yields and Government bond yields providing an indirect support to the equity market (Graph 3).

Portfolio Commentary – Areca Value Discovery

Areca Value Discovery, our flagship portfolio, delivered +0.22% in USD for Class B. The portfolio did not chase the rally in January and February 2019 since it was structured to be market resilient in order to avoid exposure to the sell-off, such as Q4 2018. Two thirds of the portfolio were positive contributors, mainly coming from our buckets "Relative Value Fixed Income" and "Discretionary Relative Value". The main detractors came from hedges: short high-yield corporate bonds and short soon-to-be-distressed ("stressed") companies. The second biggest detractor came from a bearish view on the yield curve. Corporate debt is fragile due to its historically-high level and the approaching maturity wall hitting in the near future. This is one major concern for bond investors, but we are confident these positions will gain when markets get stressed, playing a paramount role in our portfolio. The events that our underlying manager target, have been at an extremely slow pace in January and February. We expect these catalysts to speed up in March.

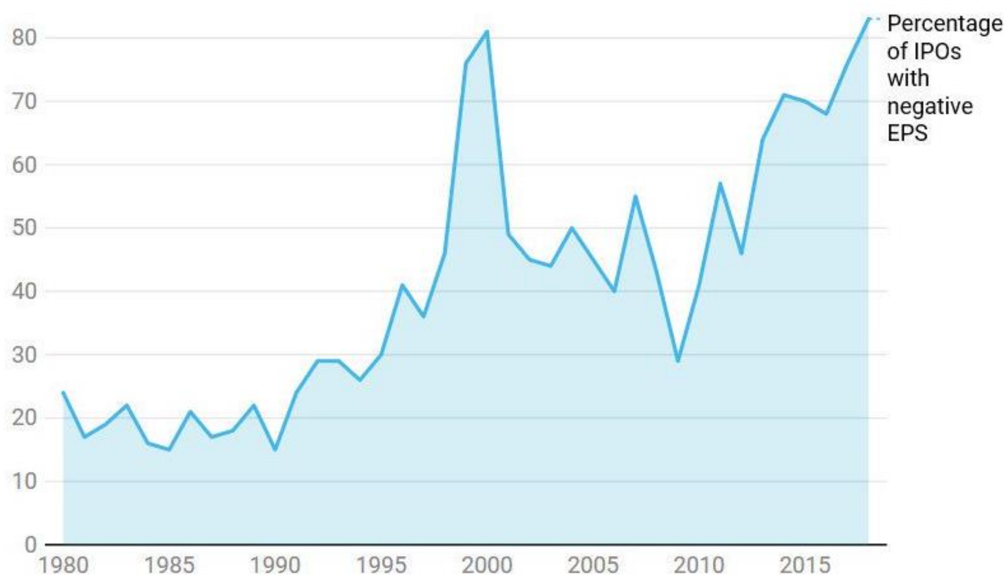
Yes, we experienced less-than-exciting performance in the first two months of the year. As we enter the difficult part of QE reversal, we expected markets to become more erratic. We communicated it over the past several quarters as we noted the increased likelihood of market sell-offs and possible recoveries that our portfolio has successfully navigated. We continue to see significant risks to the downside as global growth signals a slowdown, and we continue to highlight the robustness of our portfolio by controlling volatility. We urge investors not to become complacent in believing there will always be a market bounce up. While credit and equity are marking one of the best starts of the year ever, the yield curves across the globe are sending the clear signal that troubles are lurking. One year back, US 2yr/10yr spread was at 60bps while today the curve is flat like it was before the Great Financial Crisis. Of all market signals, this one has a more likely history to inspire prudence on the market downside.

Our **Systematic Relative Value** managers brought a marginally positive performance in February. The main performer is a Relative Value equity manager with extensive expertise in artificial techniques applied specifically to market frenzies, exactly as it happens during violent rebounds. They are one of the few managers that understood how to successfully exploit the limitations of AI applied to financial markets: limited sets of data, non-stationary processes and low signal-to-noise ratio. In February, discretionary managers were stronger performers than systematic, and we are witnessing the exact opposite happening the first weeks of March: maintaining such a healthy balance between systematic and discretionary is key. Systematic managers usually underperform compared to their discretionary peers in an up-trending market.

Discretionary Relative Value was the second best contributor. All managers had positive returns. The main contributor held an almost flat net position throughout the Q4 sell-off, building back a net long bias of +30% going into 2019. Following the rally in Jan and Feb, positions have been halved, locking in some of the profits. Such dynamic trading is important to directional managers in order to achieve uncorrelated returns.

Our **Event Driven** managers contributed positively in February, mainly from opportunities in Asian markets. With the markets still at high levels, the opportunities in mergers and acquisitions remain plentiful. Moreover, the diminishing US-China trade war rhetoric can only be favourable to trigger new cross-border deals, that have been waiting for clarity on potential new trade tariffs.

Graph 4. IPOs with Negative Earnings at All-Time-High



Relative Value Fixed Income was the biggest contributor to performance in February. The clear change of stance of the Fed made investors become more dovish. The new Libor calculation methodology also created exploitable volatility. There was also interesting trading activity in Euro interest rates on the back of weak economic numbers. Just like the Brexit mayhem creates opportunities in the Sterling rates.

Our only **Structured Relative Value** manager was again a negative contributor in our portfolio, mainly on their short in high-yield positions. There is always a temporal gap between the price action of the long book and the short book. The latter is usually very quick in reflecting new market conditions while the first, being less liquid, can take slightly more time. The recent volatility in this strategy is not unexpected. We remained invested in this sector only under the conditions of being adequately protected against a credit sell-off. We are confident that those positions can actually deliver strong returns as the large corporate debt, most of it of poor quality and covenant-light agreements, will become a major issue in the near future.

All but one **Global Macro** manager were positive. Opportunities were strong in the commodities space, as well as in cross-asset (equities versus currencies) trades. We also benefited from a strong rebound in shipping agreements. The detractor is a manager that maintains a bearish view on the yield curve, while capturing opportunities in the sovereign bonds auction markets. Their tactical bearish positioning has already been vindicated in March.

Our **Distressed Securities** manager, who has a unique approach of finding opportunities in the traditional long positions but also in short to-be-distressed corporates, was a modest performance detractor. The loss came largely from the short book, especially on a European retailer that received a tender offer. Some losses came also from positions in UK oil companies and from a newly established long distressed bond of a European wind turbine manufacturer. The extraordinary capacity of the manager to capture negative events gives us enough comfort that a less benign market for risk assets will open more opportunities in this area.

Portfolio Commentary – Azure

Azure delivered another strong month in February. The portfolio is doing better than the market since the equity sell-off started at the end of September and it continues to capture a good part of the upside. Azure, fully focused on equity, is delivering best-in-class risk-adjusted performance since its inception date. The fund has two and half years of track record which shows an enviable capacity for offering a high Sharpe Ratio both in peaceful and stressed times. The positive performance is spread across all strategies and geographies. The high diversification of the fund makes the portfolio able to navigate through a period where corporate buybacks, retail and short-covering accelerations moved the markets close to their pre-sell-off levels. We are also convinced that, as it happened during the last market correction, the superior blend of Event Driven, Discretionary Relative Value and Systematic Relative Value managers that we selected for Azure, are well equipped to be able to withstand the return of volatility.

Portfolio Commentary – Narrapuno Spectrum

Narrapuno Spectrum, our best of class portfolio, delivered +0.17%. Because we structure our portfolio to be market resilient, we were not exposed to the sell-off of Q4 2018 and hence are not chasing the rally of January and February 2019. Two thirds of the portfolio were positive contributors, mainly coming from our buckets “Relative Value Fixed Income” and “Discretionary Relative Value”. The main detractors came actually from hedges within a market neutral portfolio: short high-yield corporate bonds and short soon-to-be-distressed companies. Corporate debt is fragile due to its historically-high level and the approaching maturity wall hitting in the near future. This is one major concern for bond investors, but we are confident these positions will gain when markets get stressed, playing a paramount role in our portfolio. Furthermore, Event Driven managers lost money mainly due to events related to Electronic Arts and Kraft-Heinz. The latter reported a tremendous write-down of goodwill while Electronic Arts reported extremely weak numbers for Q4. The events our underlying managers target have been at extremely slow pace in January and February. We see these catalysts to speed up in March.

Yes, we experienced less-than-exciting performance in the first two months of the year. As we enter the difficult part of QE reversal, we expected markets to become more erratic. We communicated it over the past several quarters as we noted the increased likelihood of market sell-offs and possible recoveries that our portfolio has peacefully navigated. We continue to see significant risks to the downside as global growth signals a slowdown, and we continue to highlight the robustness of our portfolio by controlling volatility. We urge investors not to become complacent in believing there will always be a market bounce up. While credit and equity are marking one of the best starts of the year ever, the yield curves across the globe are sending the clear signal that troubles are lurking. One year back, US 2yr/10yr spread was at 60bps while today the curve is flat like it was before the Great Financial Crisis. Of all market signals, this one has a more likely history to inspire prudence on the market downside.

Portfolio Commentary – Convexity

Our Convexity portfolio delivered an expected, slightly negative month given the market bounce. The portfolio is structured to deliver favourable asymmetric returns, strong performance when markets are under selling pressure, with very little or no cost of carry. The loss from the tail component was offset by relative value opportunities in equities, volatility and cross-asset correlation. Since the launch of the fund in Aug 2018, the fund displayed how it can play a paramount role as beta mitigator in any portfolio, with the addition of very idiosyncratic sources of return.

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