Ayaltis Funds – July 2019 Commentary

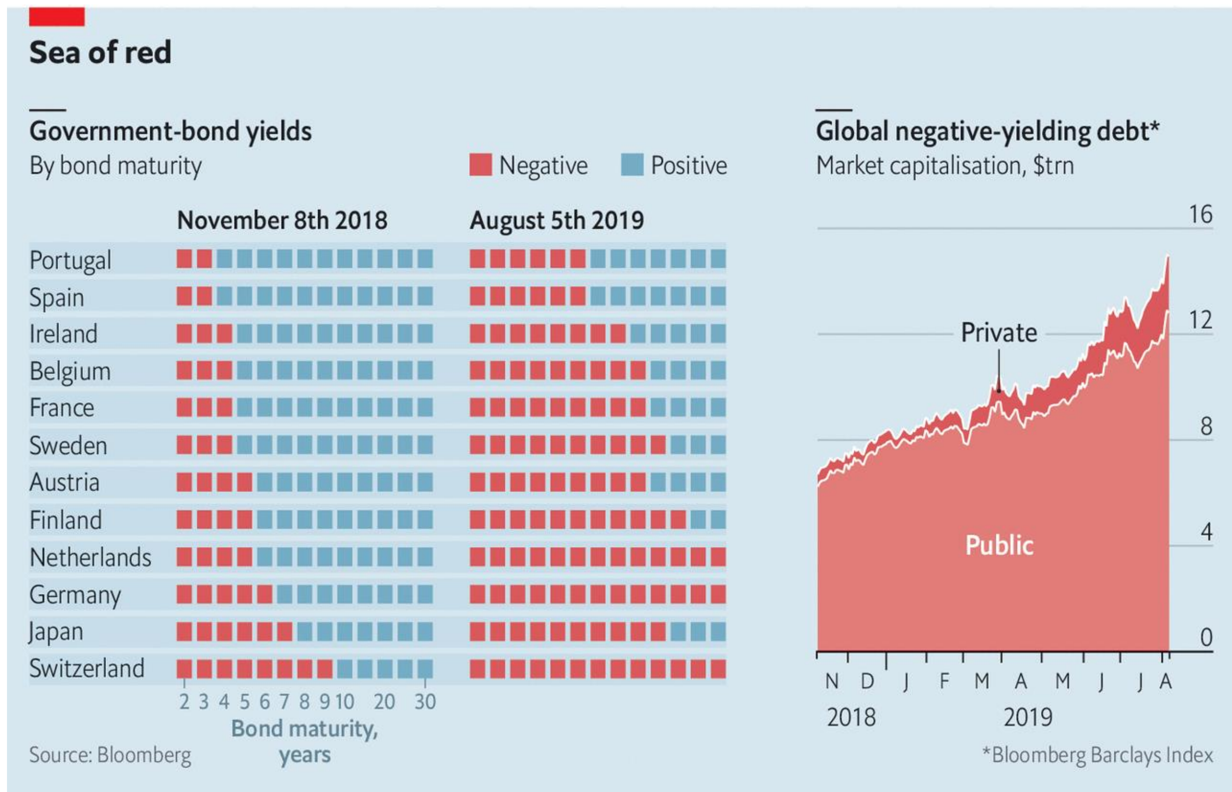
Market Commentary

As the rally waned, volatility compressed and VIX reached a new low for the year. Markets overall were in a stationary mode providing only few fundamental opportunities to trade, as all the eyes were on the FED. Equities were marginally up, US 10 year yield was hovering around 2% with no major change in the term structure. The lack of conviction from markets was felt! Following the rebound of June, equity markets were essentially flat while government bonds took a pause after having rallied relentlessly since the beginning of the year. The trend in bond markets restarted right after the end of July. Commodities marginally came off reflecting re-emerging concerns on global growth. The combination of a weaker corporate outlook, a brewing Brexit brawl on the horizon and a trade war turning into a currency war, dampened the rally in markets in July, but the peace started to change on the aftermath of the FED decision. The relentless yield chasing frenzy, exacerbated by global macro concerns, has pushed a staggering 25% of all sovereign and corporate issued bonds into negative yield territory. The most concerning effect is that even certain securities classified as high yield are also priced at negative yield. Markets are operating in a very cautious mode reflecting widespread concern for future outcomes.

Graph 1: Argentine Century Bond (Cents on the Dollar)

Source: Financial Times, Bloomberg

Graph 2: Government and Corporate Bonds at Negative Yields



Source: The Economist

The numerous risk factors we highlighted are not vanishing. On the contrary, the outlook is deteriorating quickly and Central Banks are hurrying up: just in the last few weeks, the central banks of the US, New Zealand, Hong Kong, India, Thailand, Mexico, Brazil, Russia, Turkey, South Africa, South Korea and Indonesia, to cite only major countries, cut interest rates. More concerning, members of the ECB were eloquently speaking of a possible “monetary bazooka” to be loaded in September. On the fiscal side, German government officers have promoted a fiscal stimulus of around Euro 50 billion before the end of the year. Germany has just issued a 30-year bond with no coupon and a negative yield of 11bps! With such interest rates, every borrower has an interest in increasing his debt level. The amount of negative earning corporate and government debt globally is now more than USD 15 trillion. Investors, either actively or passively via their pension schemes, are being forced into taking more and more risk at lower returns at a time where the effect of stimuli becomes less and less effective to counter macro concerns, prompting a more sustainable return of the more fundamentally volatility at the heart of alternative trading strategies.

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Portfolio Commentary – Areca Value Discovery

Our 10-year-old flagship portfolio was marginally up +0.05%. In line with general markets, July was pretty much uneventful as equity volatility decreased to new annual lows. Other asset classes (commodities, Eurodollar, treasuries…) displayed a slight increase in volatility; maybe an early indicator of the risk-off move, in August. Our Relative Value Fixed Income managers were the best contributors, followed by Global Macro with the only exception of a commodity manager who detracted 24bps. Systematic strategies had also an acceptably positive run, despite the lack of opportunities. The overall distribution of returns remained in a narrow band, with no outliers. The portfolio displayed a strong risk weighted balance as the contributions of core underlying managers ranged from +0.14% to -0.13%. Two non-core managers (one macro and one diversified commodities) delivered higher contributions (+0.19% and -0.24% respectively). Both are diversified long-term performers and they are both having a good year so far. Achieving such a balance does not purely rely on historical volatility and covariance matrices, but also on a fundamental forward looking assessment of potential risks. The market sell-off in August and the ensuing rush into safe assets (treasuries, gold, Swiss Franc) may represent something more consequential than just short-term deleveraging. Since our portfolio is structured around idiosyncratic alphas, agnostic to market directions, such increase in volatility has historically created opportunities. And our initial performance indications for August are very promising!

Our stable and perhaps subdued performance should not be misunderstood. We have always employed a hedged approach to investing. This technique has been effective, especially during the last 12 months, to mitigate the impact of market sell-offs as we approach a market era where even the intervention power of central banks begins to wane. Attempting to catch temporary market uptrends and unnaturally high yields, given the widely acknowledged market risks and uncertainty, is like dancing on a ticking-bomb. The recent past is littered with multiple episodes of sudden price action reversals. Argentina is, once again, a perfect showcase of the insane expectations and choices bond investors have been driven to make in the search for yield. The country was able, few months ago, to issue a 100-year bond at aberrationaly favourable conditions. After just one year, investors lost more than half of their capital. We have seen similar events in IPOs, corporate bonds, subordinated bonds and even UCITS funds. Due to the unstoppable yield hunt, that central banks are shamelessly promoting in their desperate attempts to generate growth. The future will be more exposed to localized crises. We are convinced that our portfolio represents an ideal way of navigating this late stage of the credit cycle without running unwanted beta and credit exposures, as the events on which we focus are unleashed by current market uncertainties, to deliver uncorrelated performance.

Our **Global Macro** bucket had the widest distribution of returns, with a traditional macro manager focusing on fixed income, as the best contributor, and a diversified commodity specialised manager, as the biggest detractor. The latter is a long-term performer which has developed some of the most sophisticated AI (artificial intelligence) engines to trade price anomalies in a market dominated by trend-followers and fundamental investors. While the engines rely heavily on complex statistical methods, there is a strong degree of macro environment analysis: the use of machine learning technics to analyse inventories, flows, production… are unique in that space. The fixed income manager continues to benefit from the relative steepening of the US and Australian curves versus Europe.

Our only remaining investment in **Structured Relative Value** delivered 7bps of contribution on the back of higher valuations of subprimes, CLOs and a couple of corporates positions. The protections on the portfolio, through swaps and options, were marginal detractors, as expected in such stable and low volatile markets. The position has behaved recently like a convex strategy, mainly because of short high yields and long puts on S&P 500. Legacy quality subprimes still represent 50% of the book. We have reduced our position as we detected more suitable ways to express convexity.

Discretionary Relative Value was slightly positive, driven by the strong performance of a large multi-manager fund while a small allocation to a healthcare-specialist long-short manager detracted a few basis points. The latter is a substantially diversified long short equity portfolio with a net short bias. The longs were the largest detractors while the shorts did not deliver the expected returns. In general, investors have been very complacent as many companies were priced with 30x or 40x earnings. Even though the expected rate cuts from central banks will be supportive of markets, price multiples have reached unreasonable levels. The manager does not fall into this complacency and remains market neutral.

The second-best performing bucket is **Systematic Relative Value**. The main contributor is a large quantitative manager who trades stocks. Although the risk allocation between US and non-US liquid equity markets is equal, US stocks delivered a better performance. The environment, characterized by low and declining volatility, was not ideal for systematic managers and other funds were mainly flat.

Our investments in **Relative Value Fixed Income** are with two multi-managers hedge funds who exploit very complementary strategies. They were our best contributors in July. One manager trades basis, rolls and “technical” inefficiencies across all fixed income instruments while the other one has a collection of diversified directional bets. The latter had a position on the flattening of the EUR curve and a steepening in the USD curve, as well as an aggregated short USD exposure. At the end of the month, the term structure trades had been crystallized and the manager entered short treasury positions giving back some of the gains in August.

A **Distressed Securities** manager, who positions himself not only to benefit from distressed situations on the long side but also trades against companies that may be negatively affected by commodity price movements, was a marginal performance detractor. The main detracting position was represented by bonds of a UK exploration and production company: despite announcing higher production than expected, the securities were sold as the company announced a 5% equity placement. Another loss arose from a liquidating German real estate fund as one of their properties was sold at a significant discount to the book value. We remain underallocated in the distressed space, but very opportunistic.

Event Driven managers delivered a flat month. Merger-arbitrage managers had a good month, while the main detractor is a Canadian manager with exposure to SPACs and tailor-made investment solutions based on convertible bonds in growth companies. Our Asia focused manager is also having a lacklustre year as opportunities have not been thriving in that region; needless to say that the growth concerns in China with its spill over effects, combined with the social unrest in Hong Kong, is weighing on financial markets. We remain focused on the Event

Driven space, particularly on merger-arbitrage managers, as the conditions are ideal to generate abundant opportunities, mainly driven by the large amount of cash available in company's balance sheets. Such strategies, when selectively chosen, provide an interesting asymmetric payoffs: low exposure to the downside with high upside capture ratio

Portfolio Commentary – Azure

Our equity-focus portfolio was marginally up +0.06%. July was pretty much uneventful with equity volatility reaching new annual lows. Other asset classes (commodities, Eurodollar, treasuries…) displayed a slight increase in volatility; maybe an early indicator of the risk-off from August.

Systematic Relative Value managers delivered the strongest contribution. The main performance came from a heavy quantitative manager that trades equity stocks. Dispersion in July was really low with all sector indices either flat or slightly up. Only the healthcare sector was under selling pressure. It was a very dull month compared to the dispersion that happened in August. Multi-factor neutral managers struggle in such environments and they failed to deliver good returns. The main detractor within the Discretionary Relative Value bucket was a heathcare long short specialist. The longs were the largest detractors while the shorts did not deliver the expected returns. In general, investors have been very complacent as many companies were priced with 30x or 40x earnings. Even though the expected rates cuts from central banks will be supportive of markets, the expected growth has reached unreasonable levels. The manager does not fall into this complacency and remains market neutral.

Portfolio Commentary – Narrapuno Spectrum

Our high conviction portfolio was down 0.22%. July was pretty much uneventful with equity volatility reaching new annual lows. Other asset classes (commodities, Eurodollar, treasuries…) displayed a slight increase in volatility; maybe an early indicator of the risk-off from August.

Systematic Relative Value managers had an acceptable positive run, despite the lack of opportunities. Structured Relative Value was the strongest contributor while Global Macro managers detracted performance. The main detractor was a diversified commodity fund. The manager suffered losses on oil and gas, while metals were positive contributors. The antagonism between the health of the US economy and the geopolitical tensions triggered weak and conflicting signals that are hard to trade. The manager delevered its positions across the whole portfolio waiting for stronger entry points. It almost recovered the losses in the first three weeks of August.

Portfolio Commentary – Convexity

Convexity was down -0.63%. Due to the low intra-month volatility and the nature of the fund, it represents the expected price of insurance. Overall, the portfolio is well diversified. Two of the

managers delivered positive performance, but in sum this positive contribution was outweighted by the cumulative, small losses of the other holdings. Such environments, presenting no substantial volatility, are by definition difficult to trade for convex managers. The very interesting element of our portfolio structure is that on average it delivers close to flat carry. One of the detractors is a quantitative manager that has sentiment signals and flow strategies. While the former had a good run in July, the lack of flows in the markets (as investors were in stand and watch position) generated a low signal to noise ratio, hard to trade. The sell-off in August is actually when our Convexity portfolio is able to show its power.

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