10 years ANNIVERSARY

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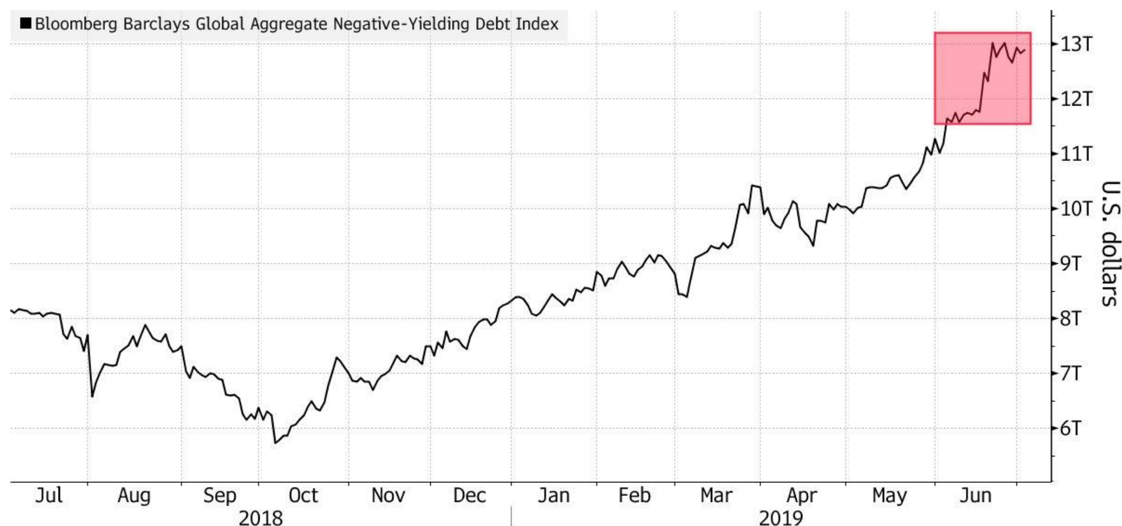
Ayaltis Funds – June 2019 Commentary

Market Commentary

The S&P 500 recovered all the losses of May and it is again scratching the 3000 level, as it last did in September 2018. The market responded enthusiastically to the unconventional speech of Draghi in Portugal and the possibility of having a significant interest rate cut from the Fed. In an unstoppable rally, CDX HY have tightened back to 325bps and we are now close to the lows of September 2018. With the rally in treasuries gathering strong momentum (Austrian 100-year bond yielding just 1% and the "miracle" of a 50-year note issued by Italy at 2.76%) this is a critical time to maintain our focus on risk-adjusted performance through risk factor diversification. Dollar depreciation was supporting commodity prices: gold was up 6% in June and oil around 5%. Even cryptos enjoyed a streak of winning months, supported by fears of monetization of US deficits and high hopes related to the launch of Libra, the new cryptocurrency developed by Facebook and targeting the unbanked. The lowest common denominator behind all these moves? The expectation for a superdovish FED's monetary policy. The impact on markets has been massive: S&P 500 advanced 6.9% in June and 3.5% for the quarter. The index posted its strongest first half since 1997.

Besides, the impact on savings is dusk and worrisome: there is a multitrillion-dollar black hole that grows day by day at the heart of the financial system. Negative-yielding debt doubled since December 2018 and it makes around 25% of global debt.

Graph 1: Global Stock of Bonds Yielding Below Zero Hits Record $13 Trillion



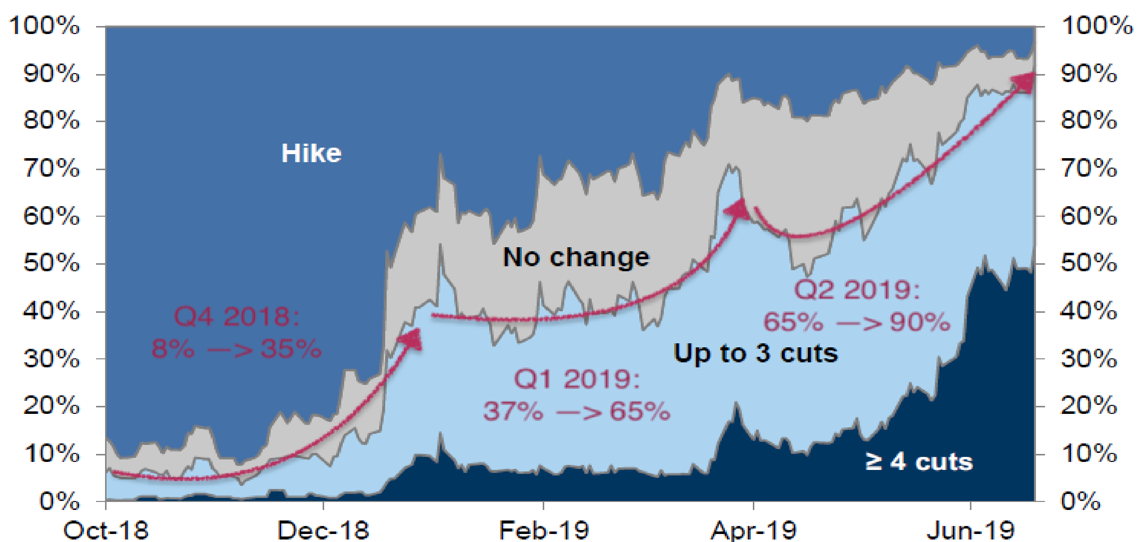
Source: Bloomberg

85% of German government bonds are under water. Not surprisingly, German pension funds were the main buyers of the syndicated offer of a 50-year Italian treasury note: 84% of the demand came from foreign investors and 35% from Germany. Investors queued up with a total

demand of 17 billion euros for 3 billion on offer. This is indicative of the hunger for yields that is spreading across Europe and the overall willingness to lengthen duration to grab the remaining high-hanging fruits on the tree. A 50-year bond issued by a country that is growing at -0.1%, with expected inflation below 1% and no intention to reform does not seem to be the safest long-term investment of a pension fund. But desperation (aka yield-hunting) has become the driver.

So far, the combination of lower growth and monetary accommodation has proven to be the ideal drug for financial assets. The late cycles are usually characterised by higher volatility, but the first half of the year proved to be amazingly quiet. Global economic momentum, as shown by PMIs, is clearly slowing down. However, US consumers, Chinese stimulus and central bank support seem to be able to keep price multiples at the current levels. What seems to be a low risk world may suddenly change into a less benign environment, particularly if central banks are not able to make the horse drink its water. In other words, negative interest rates on reserves may hit the so-called “reversal rate” and fall into the “liquidity trap”: banks will keep money well locked in their coffers. No matter how much money is kept inactive in the banks’ safety-deposit boxes, the lack of valuable investments will reduce money velocity and dampen inflation. The unwelcome result of extreme monetary accommodation may be poor liquidity and a death spiral that amplifies the lack of valuable assets. Such a scenario cannot be dismissed light-heartedly.

Graph 2: Market-Implied Probability Distribution of Various Rate Cut Scenarios



Source: Bloomberg, Goldman Sachs Global Investment Research

Eyes are on the next move of Chairman Powell. In a recent speech he revealed that many FOMC participants see that the case for a somewhat more accommodative monetary policy has strengthened. The most recent initial jobless claims show that labour market conditions are holding up well and inflation, driven by housing cost, has accelerated (while CPI is below the Fed’s target, Core CPI is at 2.1%). Granted, retail sales and industrial production fell in June, but real consumption growth marked a 3.5% annualised in the second quarter. Needless to say that risk assets are at all-time highs. Will lower rates incentivise people to borrow and put more

money in play? We doubt that. The financial industry is getting nervous: Blackrock, the largest money manager in the world, has suggested several times that the ECB should consider buying stocks as a form of additional stimulus. Long-biased managers are concerned by the future of their business and they need the support of central banks to stay afloat. We do not.

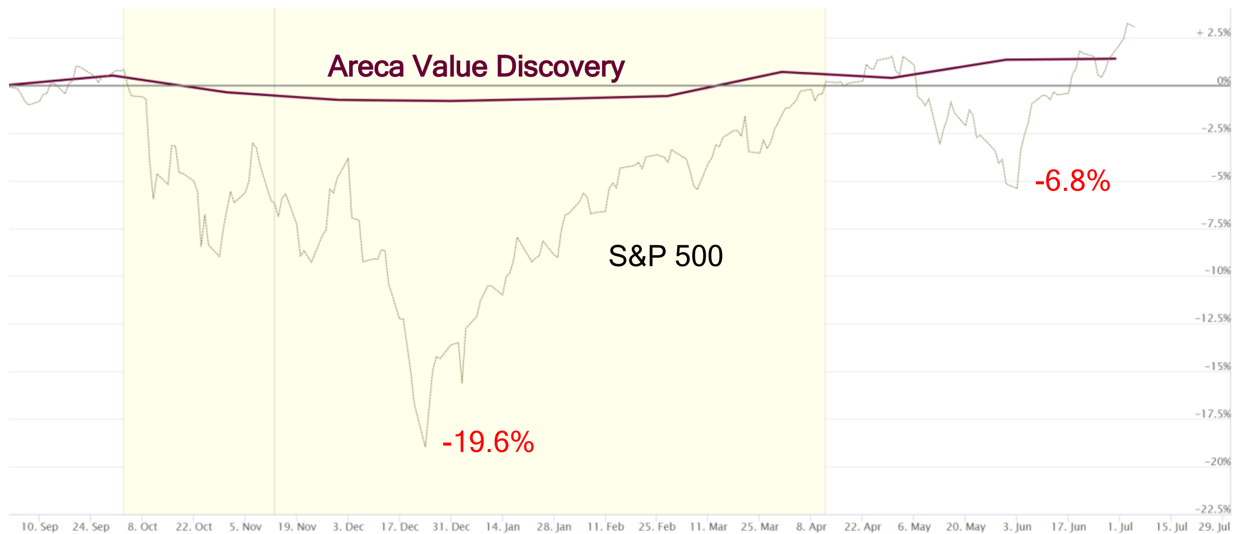
Portfolio Commentary – Areca Value Discovery

Our flagship fund was up 0.16% in June to cap a strong positive performance through the May drop in markets. We decided years ago not to participate in the hunt for yield described in the market comment above. The decision is obviously two-faced: in months like January, February and June we do not keep the pace of a charging bull market. On the contrary, when volatility and uncertainties come back, like in March and May, we overperform our peers and hedge fund indices nicely.

In June in particular, Relative Value Fixed Income and Global Macro managers performed strongly. Several traders have been able to capitalise on a few decisive movements in Government bonds such as the compression of back-end yields and the violent steepening of the US yield curve, the sympathetic movement in Australia and New Zealand, the sudden flattening of the European yield curves as well as the catch-up of inflation-linked securities. On the other side of the spectrum, Structured Relative Value was the largest detractor, giving back all the substantial gains made in May as the embedded credit protection retreated. While Event Driven and Discretionary Relative Value managers recovered the losses of the previous month, Systematic Relative Value detracted 21bps from the total P&L. We closed the first six months of the year up 2.70%. Our hedge on corporate bonds, embedded in Structured Relative Value, has cost us almost 1% since January 2019. A price that we paid to keep our exposure to market sell-offs as low as possible and to reduce our volatility.

The combination of winning and losing strategies (Structured Relative Value was the best performer in last quarter of 2018) delivered an extremely appealing protection profile that smooths the returns. The portfolio is designed to navigate most market scenarios, making money from opportunities that are as much as possible independent from common market trends. The main advantage is hidden in the track record, but clear to mindful observers. Our underlying managers, once pooled together, offer a unique way of grabbing hanging fruits without going too high along the trunk or too far on the shaky branches. When markets are complacently scratching the ceiling of price multiples or the basements of negative yields, a protected, prudent and liquid investment style may not look the most exciting opportunity around. We all learnt through crises and bounces that the most valuable investment propositions require patience and wariness. Negative yields are forcefully pushing investors into riskier bets in the attempt to breathe the remaining oxygen molecules. Our low level of volatility (less than 3% across all our portfolios on a rolling 12-month basis) allows us to compete against riskier investment propositions (HY bonds, European peripheral government bonds, cov-lite leveraged loans, private debt) with a clear advantage for our investors. Areca Value Discovery in particular is designed to deliver a stable bond-like performance without falling in the trap of running duration and credit risks for small returns and sometimes sure losses (negative interest rates).

Graph 3: Stable Performance of Areca Value Discovery (Class B USD) vs. S&P 500



Source: Ayaltis, Bloomberg

The global growth outlook has significantly weakened, forcing the Federal Reserve to consider an accommodative monetary policy that may imply a first interest rate cut in July. Although the manufacturing sector suggests a turn towards stagnation, common economic indicators are not univoque. Industrial production, capex and goods exports are shrinking but consumer data are holding up. Inflation indicators are falling but US Core CPI raised by the most since January 2018, amid strong increases in the prices for apparel, household furnishings and used cars. From June to June, the Core CPI climbed 2.1% and it is right where the FED want it to be. Nevertheless, the equity markets are expecting the usual support from central banks. The dice is cast for fixed-income instruments, with very limited upside and growing risks on the downside. We chose to focus on Relative Value trading opportunities with the intention to offer a unique alternative to low-yielding assets, preserving a good level of liquidity. More than ever, we believe this is an ideal proposition when long-only asset valuations are stretched.

Global Macro was the best performing bucket. The main contributor trades government bonds and benefited from the flattening of the European yield curve and from the steepening of the US yield curve. Moreover, being long duration in US, Australia and Europe helped bring strong positive returns. The second best contributor trades across macro instruments but more with a quantitative approach, seeking asymmetric returns. Building equity indices volatility trades , more from a relative value point of view, with vega neutrality, alongside cross-asset correlation trades allowed the manager to deliver steady returns, as long as the implied volatility / correlation remains mispriced relative to the realised volatility / correlation. The vega neutral bucket delivered the best returns.

Our managers in **Relative Value Fixed Income** were the second best contributors. Significant gains came from a fund with more than 20 portfolio managers, each specialised in a specific region or on a specific type of trade (quantitative, fundamental, options, flow analysis, yield curve, relative value, …). The profits came from the same themes exploited by our Global Macro managers, long duration and yield curve decoupling between Europe and US, but other trades

were also favourable: inflation-linked bonds vs nominal and tactical short-term trading on UK Gilts.

Only one manager in the **Structured Relative Value** space detracted a significant portion of the performance, following an amazing return in May. The large short position in High Yield bonds offers an attractive way of shorting overleveraged companies, turbocharged by the pro-cyclical activity of central banks. A number of non Investment Grade bonds is now yielding negatively: quite an irrational and unprecedented situation. The good balance reached by our portfolio allowed us to reduce the size of our allcation to the manager. Besides, we found new and cheaper opportunities to protect our portfolio without being whipsawed by sudden reversals in monetary policy.

Portfolio Commentary – Azure

Within our equity-focussed Azure fund, Event Driven and Discretionary Relative Value managers recovered the losses of the previous month while Systematic Relative Value detracted 31bps from the total P&L, delivering an overall negative performance at fund level for June.

We closed the first six months of the year up 2.23% and we are up 4.66% on a 12-month basis. Our largest position, Renaissance Diversified, is not performing in line with its target return (10% annualised), but we remain confident that a less directional market will be more supportive for their trading style. In general, the implications of the reversed yield curve in the US are reducing the ability of systematic equity managers to exploit their common trade factors. For instance, the overextended support of central banks is moving investors out of value companies and into growth or overindebted stocks. The usual natural selection of businesses is no longer guaranteed by the current financial environment and stock trading has become disconnected from traditional fundamentals.

Azure's performance was slightly impacted in 2019 by the headwinds typical of a trending market. The fund is generally ready to deliver stable returns in many market scenarios, but macro-trends are not particularly supportive of a Relative Value portfolio that is designed to exploit idiosyncratic variations. We keep our stance conscious that the long-term risk reward will be on our side.

Portfolio Commentary – Narrapuno Spectrum

Within Narrapuno Spectrum, Global Macro and Relative Value Fixed Income managers performed strongly during June. Several traders have been able to capitalise on a few decisive movements in Government bonds such as the compression of back-end yields and the violent steepening of the US yield curve, the sympathetic movement in Austrialia and New Zealand, the sudden flattening of the European yield curves as well as the catch-up of inflation-linked securities. On the other side of the spectrum, Structured Relative Value was the largest detractor, giving back all the substantial gains made in May as the embedded credit protection retreated. While Event Driven and Discretionary Relative Value managers recovered the losses

of the previous month, Systematic Relative Value detracted 21bps from the total P&L, delivering an overall negative performance at fund level for June.

We closed the first six months of the year up 2.33% and we are up 4.11% on a 12-month basis. One of our largest positions, Renaissance Diversified, is not performing in line with its target return (10% annualised), but we remain confident that a less directional market will be more supportive for their trading style. In general, the implications of the reversed yield curve in the US are reducing the ability of systematic equity managers to exploit their common trade factors. The portfolio is designed to navigate most market scenarios, making money from opportunities that are as much as possible, independent from common market trends.

Portfolio Commentary – Convexity

Convexity ended June with a negative performance of -0.57%. The worst performance was generated by our long position on overall volatility. Equity volatility in particular was the most negative performing asset class while commodity volatility was supported by USD weakness. We benefited from a deterministic manager who constantly seeks the cheapest convexity across all asset classes. Our equity managers had an overall negative month.

During the last few months we came across a strategy that may help reduce the impact of prolonged periods of low volatility. Although we are quite satisfied by the first half of 2019, we aim to improve. As of end of July, we will replace the current long volatility position with a more dynamic strategy that allows us to take profit on market sell-offs by being short the major equity indices with close-to-zero cost. It is a rather unique and exclusive opportunity and we invite you to get in contact with our Investor Relations team to learn more.

Our Convexity fund carries on delivering the returns it is meant to provide: high positive returns in stressed markets while keeping flat returns in low volatility markets. In current uncertain environments, it is a highly sought-after strategy to reduce the beta of any portfolio. Remember that controlling drawdowns is key to successful long-term compounding of returns.

The Ayaltis Team,
23 July 2019

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