10 years ANNIVERSARY

ayaltis

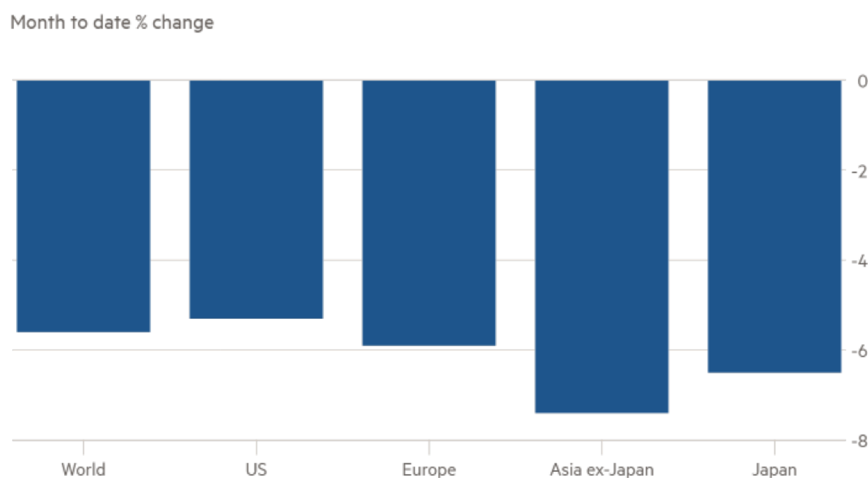
Ayaltis Funds – May 2019 Commentary

Market Commentary

Our flagship fund ended up 1.02% (share class B USD) in May, in a month when the S&P 500 dropped 6.6%, and the majority of hedge fund indices were negative. Please note that a short positioning does not drive our result. It was inspired by a dynamic positioning on macro and micro events while being defensive on markets. The performance is particularly encouraging as financial markets reached what we believe is a crucial fork in the road: for the last ten years, markets have been all about Central Bank support overwhelming valuation fundamentals in the market's arm-wrestling match. While Central Banks controlled the game, having started from low valuations, they delivered a historically long-lasting rally. After a lot of ammunition spent and having reached rich valuations, the famous Central Bank "bazooka" has started losing its effectiveness. At the same time, weak economic growth forecasts are settling-in, which combined with the catalytic effect of trade-war uncertainties, brought pause to markets. The combination delivered the right mix of negative-tweet-news volatility that focused the fear in the minds of market participants and therefore, on a more accurate risk assessment: This is music to the ears of Relative Value! Don't get us wrong; the transition may neither be final nor smooth. An eventual infrastructure deal between the Democrats and Trump may yet deliver another (temporary) leg-up to the rally. However, as more market participants realise, Central Bankers are more and more cornered in their protracted effort to support anaemic economic growth rates.

The uncertainty may engender the gradual return of valuation rationality. Let the Relative Value games return! This time around, massive asset inflows into high-yield bonds ETFs or over-optimistic corporate bond strategies with daily liquidity may come to understand how unwise it was to repackage inherently illiquid and price-gapping assets into liquid structures. Relative Value may thrive on such mistakes.

Graph 1: Sell in May and Go Away

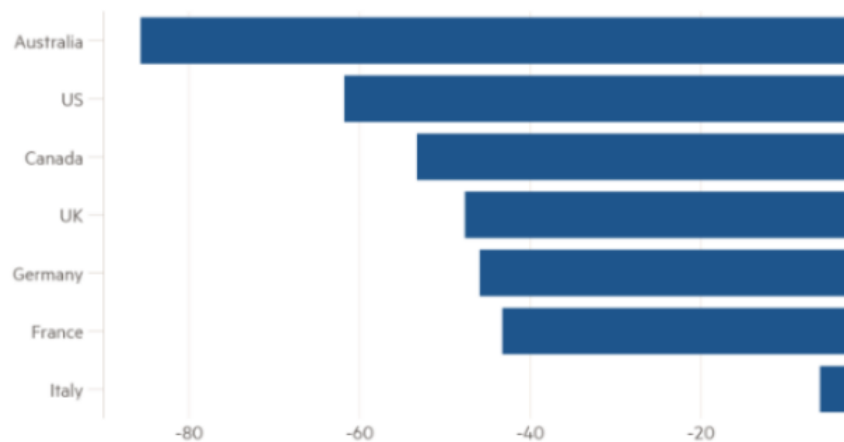


Source: Refinitiv

Furthermore, in a re-edition of the Smoot-Hawley Tariff Act of 1930, the United States' battle against free-trade and globalisation could produce deflationary and retaliatory effects which may further impact global growth forecasts and generate substantial Relative Value opportunities: Risk-off happened. US 10-year yield dropped to 2.07% (and no bottom is on sight), inflation rates are falling, and significant merger arbitrage spreads widened.

After the end of a troubled month, Central Bankers reversed their stance: the ECB President Draghi made a surprising speech in Portugal where he announced additional stimulus, citing protectionism as a threat for the Bank's inflation target. The Fed's FOMC adjusted its dot plot to reflect one rate cut in 2020. Bond and equity markets are anticipating a much more accommodative Fed, predicting a rate cut already by the end of July 2019.

Graph 2: Decline in Major Sovereign Bond Yields Since January Peak



Source: Financial Times, Bloomberg

Portfolio Commentary – Areca Value Discovery

In our portfolio, Systematic Relative Value, Global Macro and Structured Relative Value were the main contributors. Our focus on Relative Value and the recent addition of convex strategies allowed us to benefit from credit spreads widening, treasuries trading and systematic quantitative equity models. A combination of alpha factors that keeps our volatility low, while delivering positive performance in the era of negative interest rates.

Global Macro traders have been able to exploit the uncertainties around the global economy successfully. At the end of April, on the premise of the US and China's broken negotiations and the tough stance taken by the US in Middle-East, they increased risk-off positions versus risk-on. Right on time. The massive rally of long-term bonds was captured entirely. Our Global Macro managers remain long duration in the US, Europe, Australia and New Zealand but with an essential difference: European flattening vs US steepening. The reason is straightforward: if Central Banks need to jump in to support a sluggish economy, Powell has a lot more ammunition than the ECB. Structured Relative Value, in line with our expectations and due to a compelling hedging strategy, took advantage of the rise in volatility and in credit spreads and delivered a

strong performance. Systematic Relative Value showed the intrinsic level of convexity that investors aim to have when asset correlations go to 1. Discretionary Relative Value and Event Driven managers are naturally exposed to market reversals, but losses were contained to no more than 10bps.

Overall, opportunities are abundant. We continue to screen strategies that will add more sources of performance while keeping our usual low-risk profile, and we plan to keep our portfolio as much as possible dynamic. Our efforts result in a compelling Sharpe ratio and a lack of exposure to the most common risk factors. In May, we passed another hard test successfully.

Our **Structured Relative Value** manager was the strongest contributor in May. The portfolio of seasoned pooled mortgages is seeing decreasing defaults and lower collateral losses. The recent developments have also seen the embedded optionality reach a higher value. The real performance kicker came from the portfolio hedges that are independent alpha sources: high yield short positions triggered healthy profits as spreads widened 14 points. It was not as violent as during Q4 2018 but enough to deliver strong, valuable decorrelation. Although we recently decreased our investments to allocate more to new active alpha sources, this strategy continues to have a very appealing structure of durable carry from legacy high-quality RMBS combined with synthetic shorts to benefit from potential risks arising from the highly levered corporate sector.

Global Macro trading was our second best performer. The core of the opportunities arose from sovereign bond auction trading and syndicated issuance. The managers were perfectly positioned to take advantage of the unstoppable rally in Treasury bonds. Long duration in US, Australia and New Zealand paid off. It is worth noting that the ten year US rate, having been one of the end-of-2018-sell-off catalysts when it reached 3.2% in early October 2018, has now come out at 2%. The continuous rally in Treasuries in 2019 has shown a surprising correlation with equities and the rhetoric of “bad news is good news” continues, as long as Central Bankers are willing to support an equity market at its peak. As Europe is more exposed to a near-recession than the US, the two curves can be traded by combining European flatteners with US steepeners. Overall, the managers remain long duration worldwide with a clear negative bias versus Europe.

Systematic Relative Value managers were the third best contributors to our portfolio. The best performance came from a significant equity strategy that has a high degree of market neutrality while allowing some sector biases. In general, the systematic equity market neutral segment has seen a lot of inflows during 2018 with mitigated results. As many managers focus on identifying a large number of significant risk factors, sometimes up to 90 (far and away from the 4 Fama-French), the deep level of market neutrality reached by the algorithms, had a significant negative impact on performance. Alpha drivers were decimated among generic market neutral funds. We have been aware of the risk, and we focussed on managers who achieve an overall satisfying level of neutrality by keeping exposure to multiple factors. Portfolio diversification ensures a high level of protection and, in months like May, a certain degree of convexity.

Graph 3: US 10-Year Treasury Rally

Source: Financial Times

Discretionary Relative Value managers are more exposed to market sell-offs. The severity of May drawdowns for the long-only industry was dramatic. Our managers had been able to limit their losses to few basis points. While the equity rally is in a consolidation phase and exposed to sudden reversals, we are adjusting our allocations to be less sensitive to market direction. While we reduced our exposure to our low-beta-sensitive managers, we add on strategies that can exploit specific sector opportunities, like in Biotech and Specialty Pharma, with no directionality (pure stock picking).

Performance within **Relative Value Fixed Income** was primarily driven by cash basis in the US and Europe, trading around the future rolls and from short-end strategies. At the end of April, the market was pricing around 21 bps of cuts from the Federal Reserve in 2019 and 66 bps by the end of May. The 10-Year German Bund hit an all-time low in yield, even below the level reached during the Euro-area debt crisis. Volatility is back, and events are plentiful. The flattening on the EUR sovereign curves are expected to pay off nicely in June as well, despite equity markets curving up from the bottom.

Our sole investment in the **Distressed** Securities space delivered positive returns. We keep a low exposure to the distressed space as no repricing has happened yet. Companies have benefited from cheap financing and from the asset purchase programs of Central Banks. They remain afloat - for the time being. Our focus is on a manager who invests in long, but also short opportunities. In May, he profited from long convertibles and bonds in oil exploration companies. An equity position in liquidating gas assets was a strong contributor. Detractors were positions in Italian bank bonds. We do not want to be invested in all types of strategies all the time; distressed trading is market cycle dependent and finding the right managers with the suitable portfolio for the current environment is a difficult task. We remain very opportunistic, and our long-term experience in investing across all asset classes provides the knowledge on when to deploy capital on which strategy.

Our **Event Driven** managers were the sole detractors during the month of May. As markets became stressed, deleveraging by many market participants triggered some merger arbitrage spread widening. Deals with a perceived higher level of risk were indiscriminately softer on no specific news. The sector has certainly become more attractive and allows our managers the opportunity to initiate and/or increase exposure to a number of situations with higher embedded returns. Our focus on managers who avoid the most crowded trades reduces our sensitivity to such stressed events. One of our managers decided in previous months to increase its exposure to SPACs, increasing its resilience. Cross-border deals still present strong opportunities, also benefiting from increased volatility on specific currencies. Our managers avoid trades that are linked to the trade war, as the uncertainties of the outcome make such trades look like a binary bet (toss of a coin).

Portfolio Commentary – Azure

Azure was up +0.29% during the equity market sell-off of May. Our focus has not only been in finding multiple sources of alpha in the equity space but also achieving resilience. Our Systematic Relative Value managers drove the performance. Event Driven managers were marginally negative as merger arb spreads widened since risk-off markets triggered some deleveraging. The main performance came from an equity strategy that has high degree of market neutrality, while allowing some sector biases. The second best contributor was a US equity manager that deploys multiple machine learning techniques, with a strong multi-year track record. In the Global Macro bucket, the core of the opportunities arose from sovereign bond auction trading as well as from long duration holdings on US, Australia and New Zealand.

Portfolio Commentary – Narrapuno Spectrum

Narrapuno Spectrum provided a healthy return of +1.24% in May. Structured Relative Value and Global Macro managers had equal positive contributions of roughly 50 bps. Event Driven and Discretionary Relative Value managers were marginal performance detractors. The best contributor holds a portfolio of high-quality legacy RMBS in combination with short high yields. The credit spreads widening was a boon for the manager. The core of the opportunities in Global Macro arose from sovereign bond auction trading. The manager also decisively benefited from the rally in treasuries, holding long positions on US, Australia and New Zealand. Narrapuno Spectrum is more concentrated with slightly higher volatility but higher expected returns, focusing on the best ideas of our extensive research.

Portfolio Commentary – Convexity

Convexity ended May with a strong performance of +1.41%. The portfolio is structured to deliver high positive returns when markets drop, while keeping flat to slightly positive returns in low volatility markets. The best performance was generated by equity volatility relative value trading. Our managers keep long skew exposures. Moreover, in a high volatility environment, spreads tend to widen, and the opportunities captured have higher octane.

Additionally, we benefited from a deterministic manager who constantly seeks the cheapest convexity across all asset classes. Our equity managers had an overall flat month, with a wide range of returns. Our Convexity fund carries on delivering the returns it is meant to provide: higher returns in stressed markets at minimal costs. 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,
24 June 2019

Ayaltis – Your Contacts:

Managing Partner and CEO

Son Nguyen, CAIA
Phone: +41 43 501 37 62
Email: nguyen@ayaltis.com

Ayaltis Investor Relations

Phone: +41 43 501 37 60
Email: ir@ayaltis.com

For further information, kindly visit: www.ayaltis.com