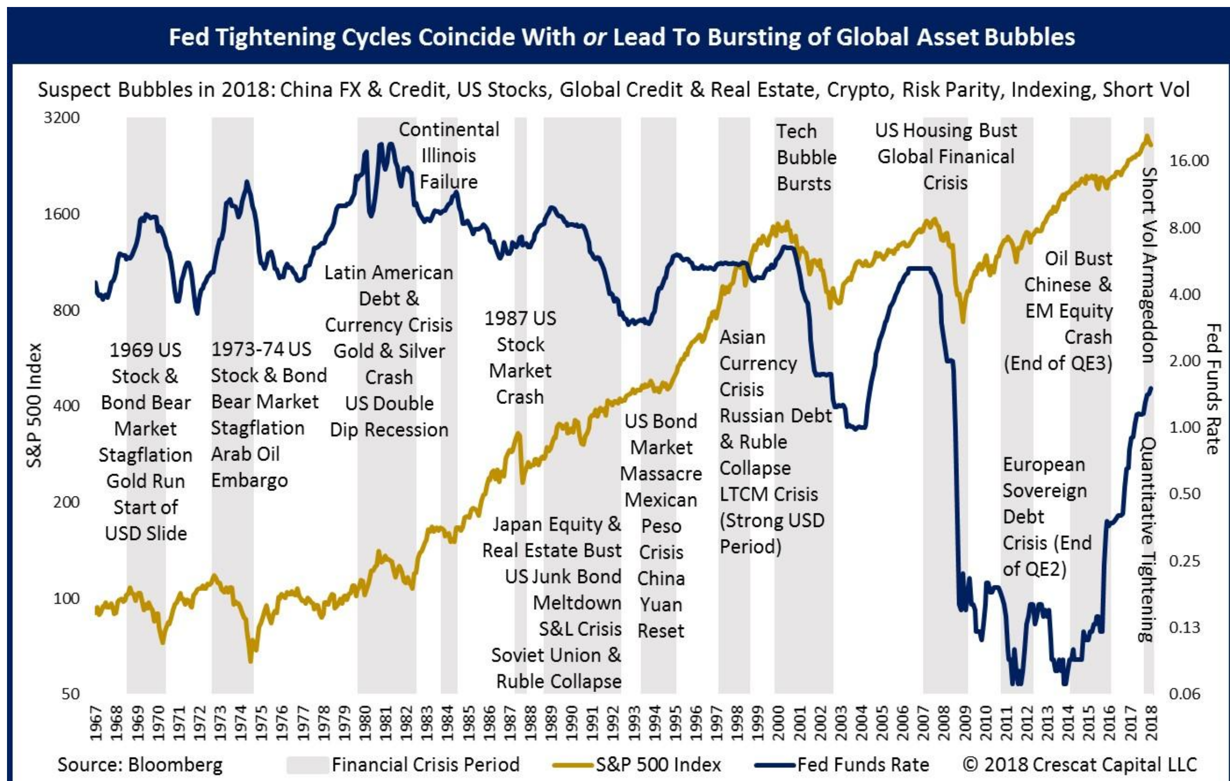
Ayaltis Funds – November 2018 Commentary

Market Commentary

The violent global sell-off of October experienced a bouncy and volatile pause in November. Equity markets finished only slightly positive in November after a non-directional month, driven by the market's repricing of the clear intentions by the US Fed ongoing monetary normalization. Furthermore, fears of a global slowdown in world economies gathered momentum. As equity markets gyrated up-and-down under newfound uncertainty, credit markets for the first-time since a long time have moved down in tandem with equity markets. This episode marks a milestone in the potential evolution of financial markets forward. While the *volageddon* (volatility spike triggered by ETF rebalancing) of February 2018 was mainly technical, the recent sell-off was triggered by multiple negative fundamental market drivers: Firstly, the decade of quantitative easing is finally being reversed and the quantitative tightening (QT) is decisively affecting markets negatively. The excessive artificial liquidity brought a deterioration in credit underwriting standards and an extreme hunt for yields. Investors became addicted to the Central Bank's "Put" for years. The strength of this monetary "insurance" is now fading.

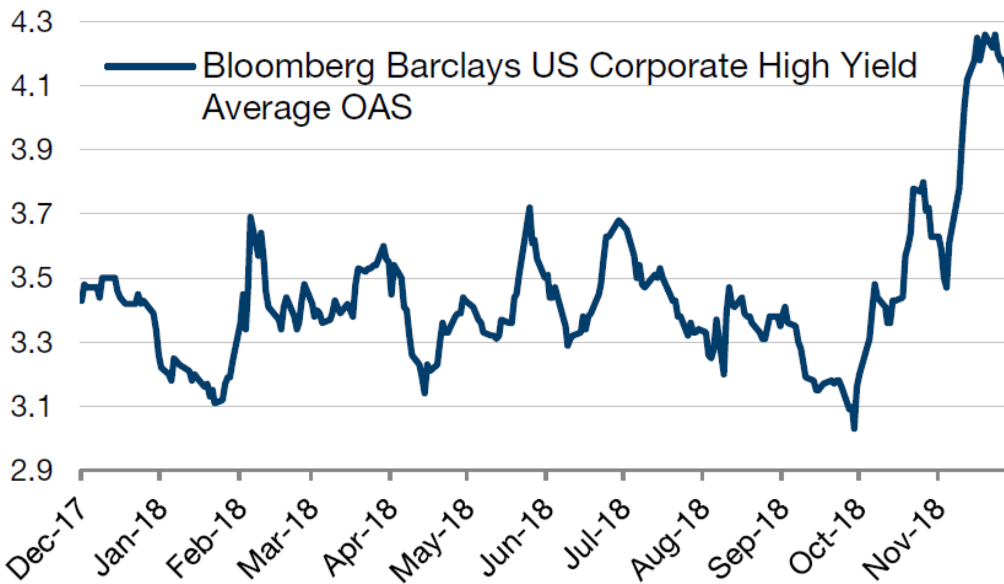
Graph 1: Fed Tightening Cycles



Secondly, two years after the US Presidential election, markets are slowly pricing the negative repercussions of the short-sighted policies implemented by the current US administration. The internal political battle (government shut-down) and the external trade conflict with China created unintended consequences offsetting the benefits of fiscal stimulus and tariff reduction.

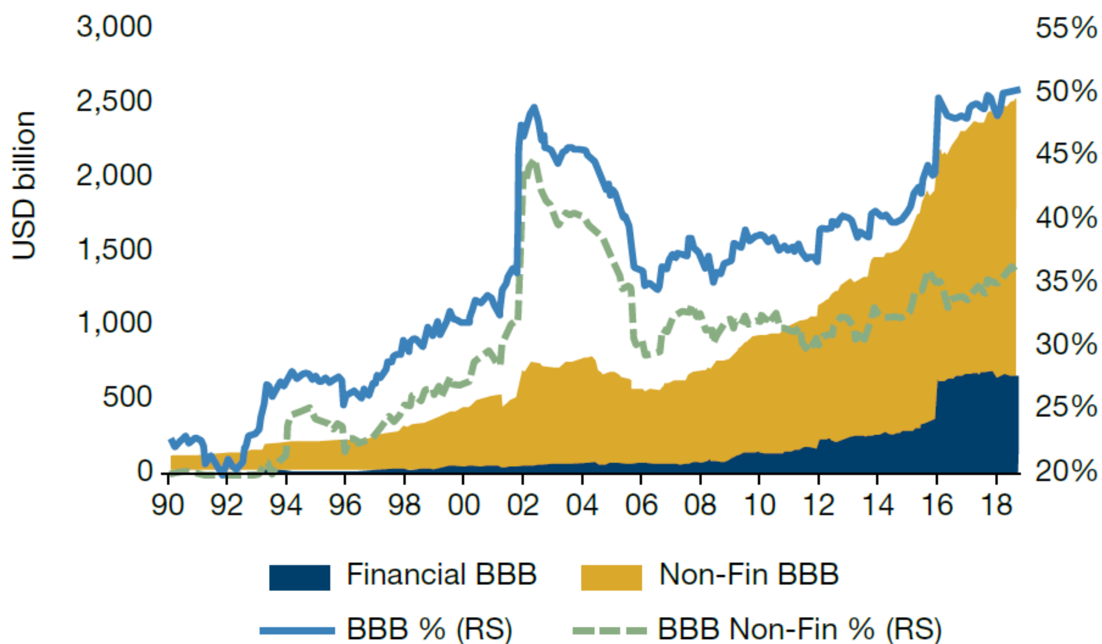
Thirdly, as expected and after years of easy money, corporate credit is showing worrying signs of deterioration. General Electric, Ford and General Motors have more than $100 billion of debt outstanding and their credit ratings may be downgraded to junk. The impact on the $1 trillion high-yield sector would be significant and credit spreads are starting to price the risk. Fourthly, increased covenant-lite loan issuance in the CLO space, higher levels of BBB- rated debt in the IG corporate bond market, low-quality Subprime Auto ABS and higher rates of delinquencies in consumer credit, are all worrying signs of the fragility of credit markets.

Graph 2: High-Yield Credit Spreads, Alarming Signs



Source: Bloomberg

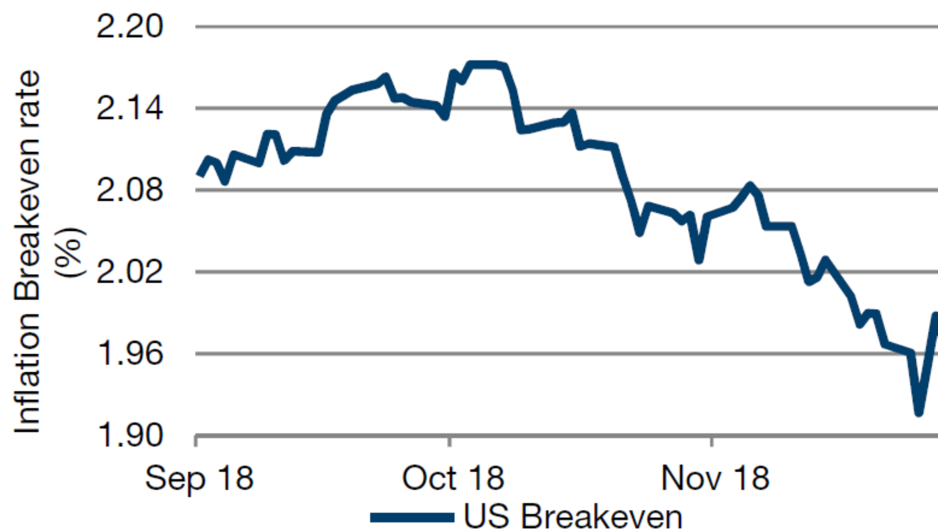
Graph 3: Investment-Grade BBB's Total USD 2.5 Trillion!



Source: Bloomberg

And finally fourthly, but probably most importantly, real interest rates ended November still at very high levels, although breakeven rates moved significantly down. A toxic combination for global business.

Graph 4: Lower US 10-Year Breakeven Inflation Expectation



Source: Bloomberg

However, it is important to note that as this difficult year for all asset classes progresses, the new market regime with normalised volatility seems to be finally and decisively changing back in favour of Relative Value investing. For us this is an ideal development given both our long-term strategy focus and our current positioning.

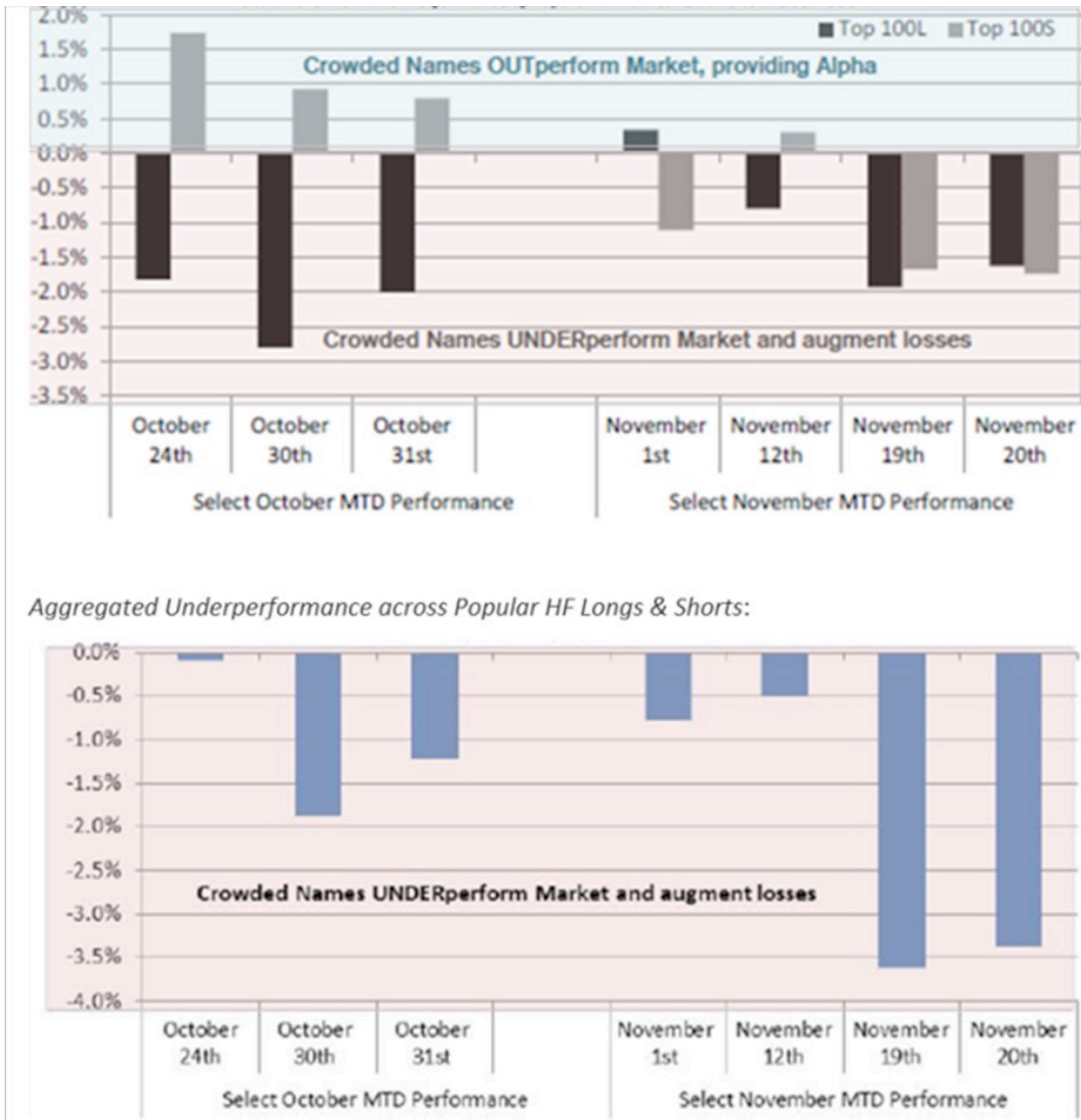
Portfolio Commentary – Areca Value Discovery

Our flagship fund was slightly down -0.32% in USD for November despite a very erratic and trading environment that saw the S&P 500 ranging within a 6.5% intra-month. Our reinforced relative value market neutral positioning in equities cruised unharmed through the ups and downs of these extremely challenging markets. Event Driven and Systematic Relative Value, had a strong month, with the latter being the best performing strategy contributor for the month. The completion of a few large corporate actions in M&A allowed our Event Driven managers to crystallize substantial profits, even while confidence among investors declined and deal spreads in some outstanding deals increased due to higher market uncertainty. Systematic Relative Value managers that we expect to be agnostic to market direction, benefited from the increase of volatility. Relative Value Fixed Income managers were the second best positive contributors to the portfolio. Global Macro managers performed poorly, partially neutralizing the contribution of the above-mentioned strategies. Although they did not directly lose on long-risk assets positions, their exposure to short-term movements and sudden market regime changes created moderate and unexpected losses, mainly from a marginal steepening of the US curve and a drop in UK bond yields that followed the uncertainties related to the Parliament vote on the Brexit’s deal.

Although November appeared on month-end results less difficult to trade than October, the strong rotation in stocks and credit due to massive deleveraging transformed markets into a dangerous minefield. As the graph 5 below depicts, crowded trades suffered strongly, both on

the long and short side. Losing strategies (risk premia, momentum-driven and risk parity) had to quickly deleverage their portfolios and the snowball suddenly became an avalanche. Fundamental managers, with holding periods longer than systematic managers or short-term traders, had a poor month, but still in line with our expectations.

Graph 5: Crowded Trades



Source: Credit Suisse

Our **Systematic Relative Value** managers were the best performers during November. We specifically choose them because of their low beta-exposure and their focus on short-term trades so they can exploit the new market regime with normalised volatility. As equity moves were amplified, the opportunities to trade were plentiful. One of our core positions in this strategy has systematically delivered higher-returns on average when markets were under stress during it 15 years of track record. By holding thousands of positions, running an even larger number of

models, our systematic relative value managers achieved a high diversification that is highly suitable for the current market environment. We purposely chose our systematic driven investments among those that may offer a good level of downside-protection.

Our **Discretionary Relative Value** managers trade on a strong fundamental basis and under very stringent risk management frameworks. They were actually quite affected by the partial risk-off that occurred in the majority of their positions. It is a rather a common fact that when investors are taking risk off their portfolios, they tend to sell their positions regardless of the fundamental fair value of their positions. One of the most reputable diversified relative value equity managers had one of its worst months in over 10 years, losses arose primarily from its relative value fundamental equity positions. These events tend to be a good entry point and represent a strong opportunity for the replenishment of relative-value trades. Those manages represent about 22% of our portfolio and deliver strong portfolio resistance paired with the systematic managers through fundamental decorrelation to the market. Going forward we expect fundamental discretionary managers to achieve good returns, by being actively invested in the long and short side and letting fundamental valuations play their role. Systematic Relative Value managers, on the contrary, capture strong opportunities when markets get stressed; due to their short holding periods, they capture short lived dislocations amplified by higher volatility, with market patterns easily detectable to the emotional nature of trading that takes place during stressed markets.

Our Event Driven managers contributed positively as well. The M&A sector was the best strategy bucket in November. There were two large deals closed, Aetna and CVs in the healthcare industry and United Technologies acquiring Rockwell Collins, in the aircraft industry. The decision by China to approve the deals had a positive impact on several other M&A spreads, curbing the uncertainty about possible geopolitical disruptions in the merger acquisition space. The political inference in the NXP deal is now a bad memory. Though our managers have some degree of exposure to some of the largest trades, we focus on managers that also look on under-monitored deals. Spreads are not fully immunized vs heightened tensions: this is the main reason why we have been reluctant in adding to this space in the recent months,

Our **Relative Value Fixed Income** managers, that trade on a non-directional relative-value basis, delivered only a marginally positive month, mainly thanks to cash-basis trading in the US, Europe and on basis-swap in Sterling vs USD. With the recent speeches by the Fed's chairman and the latest economic numbers that show a slowdown in economic growth in the US and Europe, the expectations of further rate hikes have dramatically dropped. The uncertainty surrounding Brexit, with a draft agreement between the EU and the UK prime minister who faces internal disputes, added volatility on the Gilt curve, with the front-end of the sterling rate rallying. In the cross-currency market, demand for US dollars has receded, certainly as a consequence of more dovish FED's interventions. Funding remains under pressure as the USD Libor OIS spread widened again. Our Relative Value Fixed Income bucket represents 15% of our positions and we continue to see plenty of replenished opportunity sets in this space.

Our manager in **Structured Relative Value** delivered a marginally negative month. The whole structured credit industry is witnessing a degradation of the quality of the borrowers. This tends to end up with higher delinquency and eventually higher default rates. While the structured credit market is going through a very delicate transition, the manager has implemented multiple shorts in place that are not only hedges but can also be pure sources of alpha returns. While losses occurred in corporate debt and equities in the housing market, short on high yields both in USD and Europe generated some valuable positive returns. Legacy RMBS remain stable while more are being called.

Unfortunately, our **Global Macro** managers were the biggest performance detractors. But on YTD basis our Global Macro allocation was one of our strongest performance contributors. Losses occurred on short UK gilt positions. As Brexit updates hit the news, Gilts rallied. A steepening of the back-end of the US yield curve generated losses. The manager remains long sovereign as the end of the year tends to be a supportive season, with short equity positions, while maintaining long developed market versus short emergent market currencies spreads. Another manager was hardly hit by the sell-off on forward freight agreement in the Baltic exchange. Given the concentration of this fund in only a few different contracts, this position remains marginal. As scrubbers (devices to reduce pollution) are expected to be implemented on cargo ships in 2020, the impact on the how the contracts will be settled has not been clarified by the exchange yet and represent a strong opportunity. And markets do not like uncertainty.

Our newly added distressed manager within the strategy bucket **Distressed Securities**, represents 4% of our fund, delivered another good month, in volatile markets, contributing positively to portfolio performance. We selectively looking at distressed opportunities, even we believe it is too early to enter this sector. However, this selected manager has a very interesting approach of shorting securities of company which are likely to go in distressed situation. So important to note: Even we re-entered in Distressed strategy: we have selected a manager who does “Stressed” opportunities, before going into “Distressed”. The manager not only is able to bottom-fish when distressed companies are offered at attractive prices (Turkish banks) but he repeatedly monetized on short positions, particularly in the financial sector. The manager hedges the macro components of the portfolio. As such, one of the core drivers of performance in November was his position in the oil industry: while his securities position remained flat, his short oil position triggered substantial gains. In a similar fashion, positions on UK companies were hedged with equity puts that delivered positive returns. The manager is seeing currently more opportunities on the short side, which is specifically the sort of asymmetry we seek. Capturing idiosyncratic events, with strong hedges, while betting on substantial deterioration of market conditions.

Portfolio Commentary – Narrapuno Spectrum

Our concentrated best-ideas portfolio suffered a loss of -0.56% in USD. Given that it only holds a smaller number of positions, it shows higher volatility but also with high potential returns. The main detractors were the Global Macro managers, that lost on short UK gilt and long flatteners on US yield curves. A manager that focuses on trading forward freight agreements on the Baltic exchange also took a hit despite being non-directional. Our Systematic Relative managers had the best contribution: during stressed markets, when emotional trading takes over, the signal to noise ratio improves and patterns are easier to detect for sophisticated engines.

Portfolio Commentary – Azure

Our equity focused portfolio delivered 0.77%. A strong positive month, in broad contrast with other equity focused funds which were flat or slightly negative. Our Systematic Relative Value managers positively contributed to the returns, while discretionary managers, with longer holding periods faced negative marks-to-market as deleveraging triggered moderate losses on crowded trades. November was one of the strongest months in the M&A space, with two major deals closing and consequently, spreads in other outstanding deals narrowing. After stable and strong returns in 2017, the fund continues to deliver despite equity markets are having a particularly heavy correction. The quality of a hedge fund derives from a combination of good

performance and strong risk management. Although Azure’s track record is shorter than our flagship’s fund, it has so far lived through significantly difficult periods showing enviable resilience.

Portfolio Commentary – Convexity

Our newly launched fund delivered its fourth positive month. The single positions represent a concentrated portfolio of the funds that are most likely to deliver positive returns when markets get stressed, while generating marginally positive in a moderate to low volatility market environment (convex profile). The largest contributions came from a combination of long volatility and long correlation positions across asset classes but also from quantitative models that tend to outperform in high volatility markets. This product has been specifically created for higher volatility regimes and it is delivering in line with our expectations as we expected the end of the easy credit cycles to usher attractive relative-value opportunities.

On behalf of the entire Ayaltis Team, we would like to thank you for your support, trust and valuable cooperation during the last years.

The Ayaltis Team, 27 December 2018

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