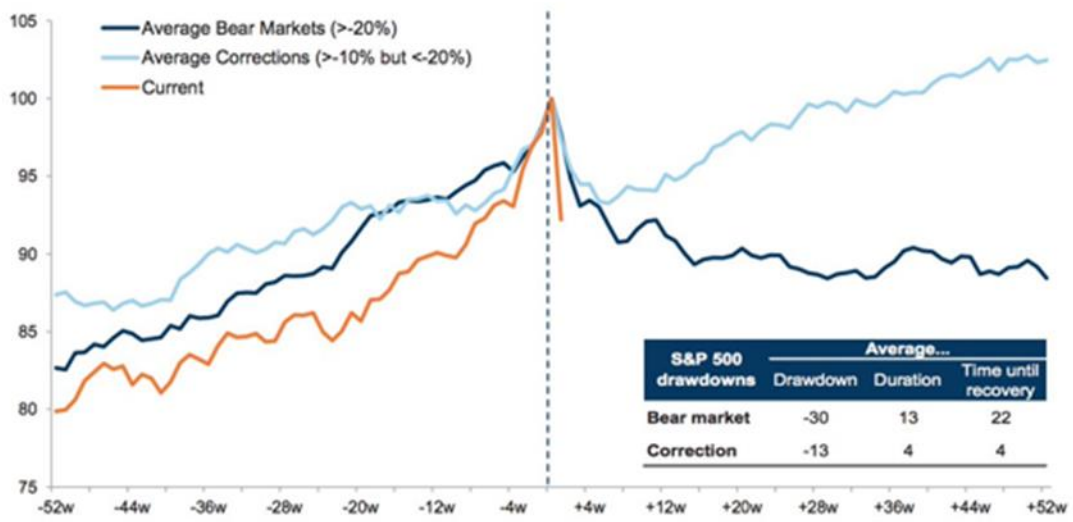
Ayaltis Funds – February 2018 Commentary

Market Commentary

February saw one of the sharpest equity sell-offs in the recent history, delivering the most violent one day move on the VIX ever, after lingering at historical lows for a year! The magnitude of the move was much higher than any other one-day move in the last 39 years, including the 2008 global financial crisis. For managers involved in the volatility asset class, it was a unique event, with multiple ripple effects.

Graph 1: February Sell-Off Sharper Than Previous Ones

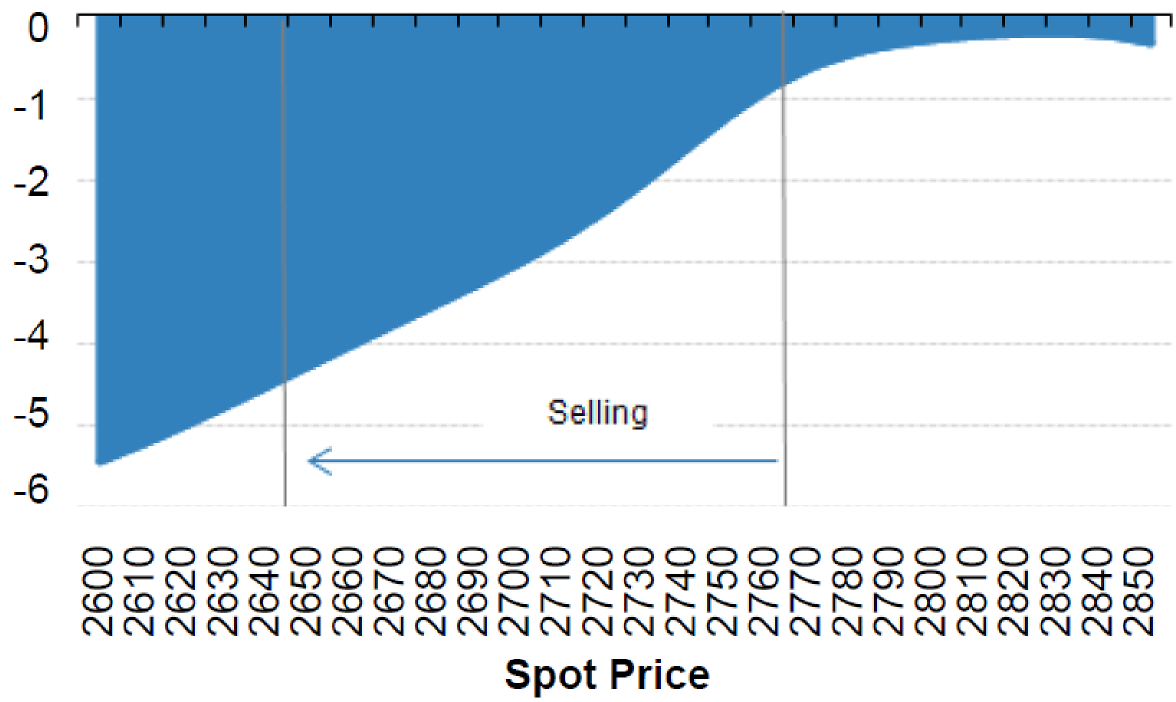


Source: Goldman Sachs

The S&P 500 dropped -11.6% in the first 10 days of the month. The initial market drop was probably triggered by the long-feared increase of treasury yields. However, the dramatic acceleration, linked with high correlation across most equity sectors, was exacerbated by the forced unwind of short-VIX ETFs. The automatic hedging process of short-VIX vehicles (ETFs and ETNs) amplified a sharp sell-off in the equity space as short gamma traders were compelled to sell more and more futures on equity indices on the way down as shown in Graph 2 and 3.

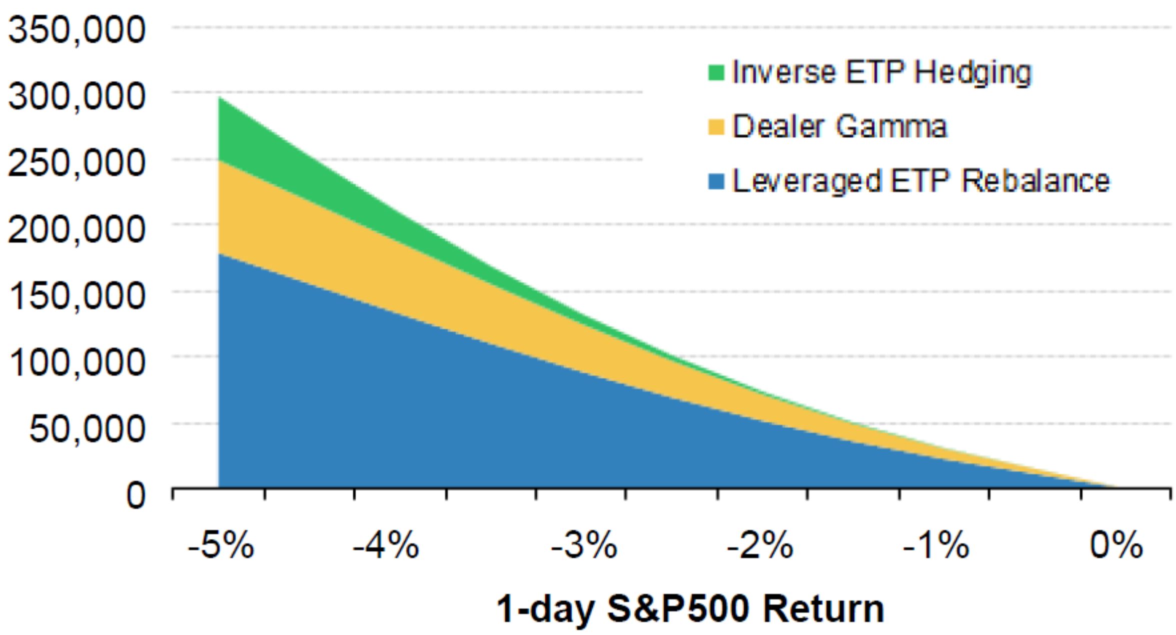
Historically, implied volatility is driven by equity market moves and it represents the most relied-on indicator of future realized volatility. It follows a so-called “smile”, a figurative expression of its shape: when equity prices increase, volatility drops (here, we voluntarily do not specify implied or realized as they are closely linked). When equity drops on the other hand, volatility increases, in a convex fashion, hence the term “smile”. The rationality (irrationality?) behind this relationship goes beyond the scope of this letter but it can be simply summarized as follows: when investors sell equities, it happens in a rush, with crowded positions that took years to be built unwound in a hurry, resulting in large market swings.

Graph 2: Estimated SPX Dealer Gamma by Spot Coming into Monday 5th February



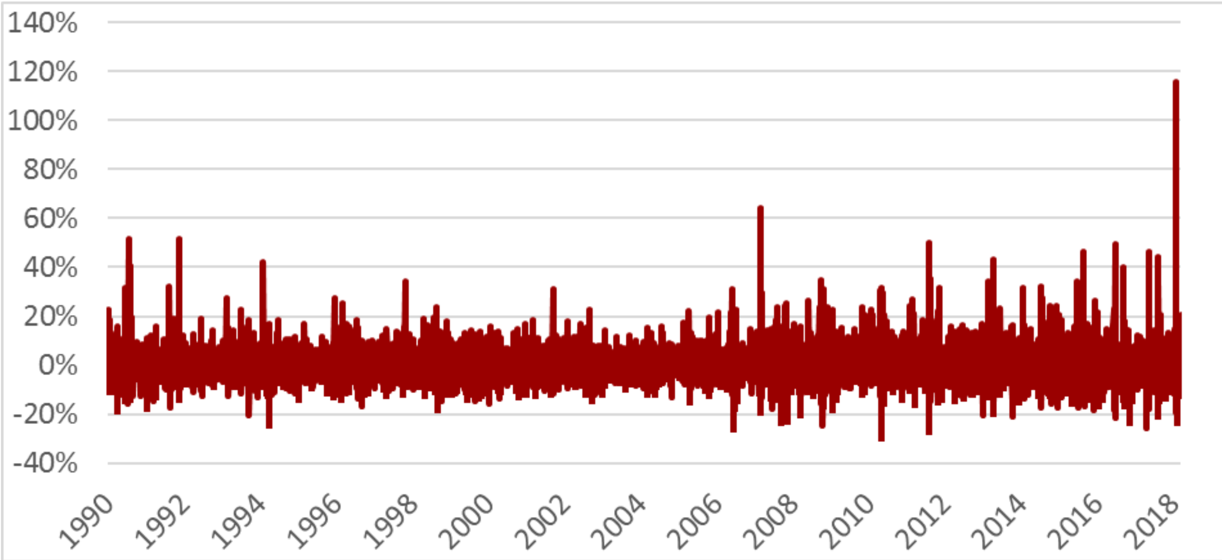
Source: Morgan Stanley QDS, March 2018

Graph 3: VIX Futures to be Bought as the S&P500 Declines (Number of Contracts)



Source: Morgan Stanley QDS, March 2018

Graph 4: Volatility Spike



Source: Ayaltis

In February, the volatility tail wagged the fundamental equity dog. The technical equity episode did not affect credits in the same measure (Graph 5). The fundamentally overvalued credit dog was spared as the downside acceleration happened mostly in equities for exclusive technical reasons of that market. The anomaly is the result of volatility having been adopted as an "asset class" on its own by carry-seeking investors willing to short it as it went into hibernation. Even if the initial equity sell-off was caused by the rationally expected increase in rates, the VIX short squeeze was purely technical to its market and its violent overreaction as depicted in Graph 4 was the epicentre of the storm in the equity teacup.

Graph 5: No Contagion from Equity Sell-Off

Source: Bloomberg

A second leg of the drawdown started three days after the initial downturn. Most selling was driven by generic systematic trend following strategies, which were fully deployed in ”free riding” mode on the back of the prolonged rally across all asset classes, and from constant volatility constrained managers, forced to aggressively reduce their exposures.

We have never believed that trend-followers can effectively protect a portfolio against sudden short-term shocks or during choppy downward markets. February confirmed our belief and exposed the fragility of a model built on a false and out-of-date expectation that trends are always clear and capturable in a down market. We also believe that in February we were just few points away from a more severe sell-off. Official and unofficial risk-parity strategies were on the verge of starting their required deleveraging process. Their intrinsic slow-moving investment approach precluded them from entering the deleveraging “red zone” this time. Investors should remain keenly aware that the almost unprecedented, “all positive”, upward movement of the last year has inflated prices across all asset classes. While “official” risk-parity allocations are genuinely and openly following the rising tide, many other managers were “unofficially” jumping onto the rally bandwagon, disregarding the net risks that a nervous late-ride invariably entails. We have always been particularly cautious not to be exposed to end rallies. Despite our drawdown, we are more confident than ever that our portfolio is perfectly suited for what we expect to become a bumpier future. We are waging a long-term performance war with a strongly resilient set of managers.

Objectivity requires us to confront hedge fund performance (our’s) with equity markets and we note that the last three years were misleadingly characterized by a strong equity markets. Some of you will be surprised to learn that if one draws a horizontal line from the top of the summer of 2015’s performance, we can see that all European country’s markets, China, the UK and Japan are flat or negative. The only developed market that shows a euphoric upward straight line is the US. Three main reasons explain the divergence: weak dollar, lower corporate taxes and diminishing shares supply (share buybacks). Inflation, lower growth, monetary tightening, anti-globalization acts are only a few of the uncertainties piled against financial markets and started rearing their heads in February. The initial steepening of yield curves worldwide rang the alarm bells for most investors. Although fundamentals remain strong, valuations are so stretched that a simple hiccup can suddenly develop into a serious illness. The era of easy financial conditions “antibiotics” has weakened the financial market’s “immune” system. When low volatility finally reverses its course, the three main drivers of the latest bout of US overperformance will suddenly disappear leaving the market in a fragile and more volatile state.

Although we believe that the odds of a recession remain low and that corporate earnings are still healthy and in many cases above expectations, we cannot dismiss the recent turmoil as a temporary incident without paying attention to the warning signs. The February payroll report showed an unexpected uptick of hourly earnings that together with the pro-cyclical policy of the US administration made investors ask for higher borrowing rates.

We know three things for certain: (1) short-term rates are going to rise, (2) low volatility will not come back soon and (3) the US government wants to feed more fuel to the engine by raising debt. Each of these three factors increases downside risk. The Fed has now two choices: hiking preemptively or letting the markets run hot. Both solutions are negative to markets and market participants are becoming weary of the awkward situation. So far the market has reacted with an increase of the real yield component while inflation expectations have barely moved, when observed through the fixed income expert's best predicting prism: the 5-year-forward 5-year inflation swap.

We believe the first potential victim of a scenario of low inflation and higher real yields will be credit. The increased government spending at higher rates will convince investors to leave the too low-yielding corporate space to pick up the new attractive Treasury rates. Credit was only partially affected by the recent correction sparred by the technical equity nature of the sell-off. Despite the apparent solidity of the credit asset class, the increasing borrowing cost for governments will put more pressure on the historically low spreads of corporates and consumers, particularly on high yields and structured loans. We keep our firm intention to minimize our exposure to credit spread widening.

Areca Value Discovery – Portfolio Commentary

Our portfolio was unexpectedly down 3% in February. This disappointing result derives from two distinct contributions: One manager unnecessarily overexposed itself and was severely affected (contribution: -2%) while the rest of the portfolio was down (contribution: -1%).

Let's cover the single manager first: This Discretionary Relative Value fund was specialized in exploiting the inefficiency of events in credit-sensitive financial assets, exploiting those events with strong structural trade resilience to the market (downside protection). After a few months of struggling against the most indiscriminate rally in risk assets, the manager capitulated and significantly increased their equity exposure anticipating the continued positive impact of US Tax reform and of an eventual spending bill in infrastructure. When the market suddenly turned, the fund detracted 2.0% of performance to our portfolio. Going back in time, as that fund grew in AUM in 2017, we were disappointed to see the manager unable to identify sufficient events to exploit and consequently sent a redemption notice in January. Importantly, the risk reports and estimated performance numbers of the fund displayed no sign of complacency or abnormal risk taking: the intra-month performance in January showed +0.75% while the equity market was up +7.5%, and the 95% daily Var showed 0.46%, with only 15% of risks coming from equities. Hence and unfortunately for us, the entire loss of the fund was primarily due to a poorly timed, last minute decision by the manager to participate in the wrongly expected equity rally. We aim to invest in non-directional relative value trades. This was the explicit trading style of the manager. The unexpected and severe loss on this position, amplified what would otherwise had simply been a very moderate setback for our portfolio, despite the violence of the correction.

Two questions that came lately from our investors, related to this manager's unwise positioning, are worth answering. Would you have been able to predict the event? And, why have you not intervened earlier, maybe reducing the size of the position?

We work hard to minimize the number of negative events in our portfolio, but it is impossible to avoid that from time to time, a very small minority of our exposures are negatively affected by strong and sudden market dislocations. The best way to enhance the robustness of our portfolio is to reiterate our commitment to be highly diversified in this erratically nervous environment. An earlier size reduction would have sparred us from part of the drawdown but would have still invariably hurt. This is why we believe in a diversified portfolio structure.

The rest of the portfolio detracted only 1% displaying a satisfactory level of resilience when compared to the market. The core of the portfolio remained muted. Two thirds of our market neutral positions navigated the volatility in in line with our expectation. Our more idiosyncratic positions were this time less of a shock absorber. We attribute this to the suddenness of the correction. Our portfolio base has extremely low structural sensitivity to the downside of markets leaving aside the unfortunate mistake of a single manager. Investors should never forget that the recipe for long-term absolute performance consists of capturing only the largest portion of the strongest risk-adjusted portion of rallies, while crucially mitigating loses by capturing only a much smaller portion of the worst part of the market drawdowns. This is what the portfolio construction delivered. This is the core of our strategy.

This a tremendously bittersweet moment in our history: we are extremely sad and disappointed that a single manager obscured the strength of our portfolio resilience we would have been proud to deliver to our investors in February. We know performance this month is going to be hard to stomach for our investors, but we are confident the core of our work has resulted in a most resilient portfolio.

Our selective **Global Macro** managers focused on capturing distortions around opportunistic government bond issuance. Having held long positions on peripheral Europe, he turned around his positions ahead of new issuance from Italy, Portugal and Spain. He also implemented calendar-based equity strategies: although they had been long-term performers, recent market sell-offs were strong headwinds. Overall, our Global Macro strategies were net detractors of performance in February with only a small part coming from beta positioning.

Our **Systematic Relative Value** managers were detractors to the overall performance. Very few systematic managers were able to detect that sharp market reversal. No early signals allowed to trade on that event; moreover, as the acceleration was based on a purely technical aspect of market-making of an ETF, the XIV, quantitative engines struggled in the first week of the month. The biggest loss in that space was derived from a quantitative short-term manager, trading all US securities based on statistical methods. His February loss was fully linked to equity index ETF, though only 20% of assets were allocate to them. From being long 76% at the beginning of the month, he turned short 96% at the end of February. The second biggest loss came from a systematic manager who trades all US securities based on price volume actions, as well as on listed options activity. As none of those indicators (price, volume, options) gave early signs of a potential market sell-off, the manager entered February with a net long bias. He held on that bias until the peak of the rebound on Feb 16th, a time at which the engine reduced automatically the net exposure by half. Lastly, our best contributor of the month is also in the Systematic Relative Value space. Our manager who builds relative value trades on VIX futures, S&P 500 options and futures, had a very strong month, reversing a disappointing January. As the VIX term structure had started inverting prior to the February 5th correction, the manager benefited from calendar trades as well as from discrepancies between S&P 500 options and futures. The bulk of their performance was generated during the market sell-off and nothing was given back during the rebound and the drop in implied volatility.

The **Structured Relative Value** component was a positive contributor. While holding a portfolio of very selective RMBS bonds that deliver strong carry, the manager built on short positions in CMBX and in High Yields. As the equity markets tanked, the portfolio of bonds remained resilient and as the small panic spread over to the credit side, the short positions started delivering strong performance. At the bottom of the drop of the equities, the manager was up around +3%, mainly on the shorts. This position represents the mindset we are in: finding managers with strong expertise in a specific opportunity set, with hedges in place while managing the resulting inherent risks.

The biggest detractor of the February performance resided in the **Discretionary Relative Value** space. The irrational behavior of that manager is responsible for 2/3 of the monthly loss. The manager had a mandate to focus on downside protected relative value trades, mainly in credits, but decided instead to expose himself to what he anticipated would be a continued rally. Starting at the end of January, he decided to build directional exposures, long equities and short VIX. Not only was it very poor timing, it was also at the opposite of his stated strategy: building a portfolio as market neutral as possible, focusing on short-term trades, relative value opportunities and short-lived dislocations.

We currently avoid the directional bets, complacent with the market, with linear payoffs and no protection on the downside. February has proved us right. We focus on convex payoffs. In conclusion, the manager abandoned his investment style discipline and capitulated to the rally, in a way we despise. There was no early indication in reports published by the manager of the change in investment bias, as it all happened within the last few days of January. We would like to emphasize the fact that we strongly focus on avoiding such directional trades. Since it is impossible to fully eliminate the risk of having managers radically change their investment style, we build a diversified portfolio to mitigate the impact of such irrational behavior, by sizing single positions accordingly, and limit the risks by running in-depth due diligence prior to investing and even more thoroughly post-investment.

The rest of the funds in the **Discretionary Relative Value** bucket delivered slightly positive returns. Their aggregated intra-month drawdown was less than a tenth of the equity drawdown, and they re-entered positive territory within a few days, while the equity market was still under water.

Our **Event Driven** managers had overall a slight positive performance, which is in line with our expectations. Event Driven strategy funds tend to have residual beta to equity markets; fully aware of that bias, we have been allocating to managers that have higher-than-average risk management skills, providing convex payoffs. Most of those managers use options to structure their trades and hence limit potential losses to the premium paid. While being well-positioned to capture opportunities in an environment that is rich in events (high valuations, US cash repatriation…), we have structurally managed to mitigate our downside exposure. This is highly important as the US administration is getting entangled in M&A deals: AT&T and Time Warner, Broadcom and Qualcomm. Such interference is impossible to trade without an ex-ante option hedge and is just another source of uncertainty. The deal-break of Akorn and Fresenius had a negative impact, with the former dropping 49% within the month, despite the definite merger agreement. One of managers who provides financing to high growth companies through convertible bonds and hedging with equities, suffered a small loss as the systemic sell-off that occurred in February affected even profitable positions in a Canadian company that was completing a merger.

The managers in **Relative Value Fixed Income** delivered a flat performance. As equities were under strong selling pressure, credits were largely unchanged and only corrected slightly and with delay. The US yield curve steepened during the equity drawdown and quickly receded as the markets recovered. Such increase in volatility generated opportunities as the basis was mispriced due to futures and cash markets being less in sync. The **Relative Value Fixed Income** space remains a strong source of potential returns for the foreseeable future.

Portfolio Commentary – Areca Azure

The **Discretionary Relative Value** bucket delivered slightly positive returns. Their aggregated intra-month drawdown was less than a tenth of the equity drawdown, and they re-entered positive territory within a few days, while the equity market was still under water. Our managers in that space trade equities, single stocks, with various approaches. All of them were positive contributors showing a very attractive resilience to the markets. One of the managers which tends to have a long bias, holds a large part of the assets in cash and invest very opportunistically when markets dislocates. This allows him to be partially protected from corrections and to benefit from rebounds. This is at the core of the investment strategy we apply at the portfolio level: controlling the drawdowns and having substantial exposure to market rebounds combined with steady returns, is the key to long-term returns. That manager holds 70% of assets in cash and will deploy to capture specific individual stock patterns over a few days or weeks. The dislocation we are witnessing in March confirms his fears. By being positioned in mid and large caps, the manager is avoiding the pitfalls of lower liquidity of small caps, in case of stressed markets. Moreover, the sharp correction the equities witnessed at the beginning of February were characterized by one of the highest sector correlation in US equity history, which is a strong headwind for equity managers. However, the weeks that followed were marked by high volatility but with increased dispersion. This is a favorable environment for equity stock pickers. European healthcare, for instance, was a positive contributing sector.

Our **Event Driven** managers had overall a slightly negative performance, which is perfectly in-line with our expectations. Event Driven strategy funds tend to have residual beta to equity markets; fully aware of that bias, we have been allocating to managers that have higher-than-average risk management skills, providing convex payoffs. Most of those managers use options to structure their trades and hence limit potential losses to the premium paid. While being well-positioned to capture opportunities in an environment that is rich in events (high valuations, US cash repatriation…), we have structurally managed to mitigate our downside exposure. This is highly important as the US administration is getting entangled in M&A deals: AT&T and Time Warner, Broadcom and Qualcomm. Such interference is impossible to trade without an ex-ante option hedge and is just another source of uncertainty. The deal-break of Akorn and Fresenius had a negative impact, with the former dropping 49% within the month, despite the definite merger agreement. One of managers who provides financing to high growth companies through convertible bonds and hedging with equities, suffered a small loss as the systemic sell-off that occurred in February affected even profitable positions in a Canadian company that was completing a merger.

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Portfolio Commentary – Narrapuno Spectrum

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The biggest detractor of the February performance resided in the **Discretionary Relative Value** space. The irrational behavior of that manager is responsible for 65% of the monthly loss. The manager had a mandate to focus on downside protected relative value trades, mainly in credits, but decided instead to expose himself to what he anticipated would be a continued rally. Starting at the end of January, he decided to build directional exposures, long equities and short VIX. Not only was it very poor timing, it was also at the opposite of his stated strategy: building a portfolio as market neutral as possible, focusing on short term trades, relative value opportunities and short-lived dislocations.

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The other managers in this strategy contributed positive performance figures. One of these managers tends to have a long bias, holds a large part of the assets in cash and invests very opportunistically when markets dislocate. This allows him to be partially protected from corrections and to benefit from rebounds. This is at the core of the investment strategy we apply at the portfolio level: controlling the drawdowns and having substantial exposure to market rebounds combined with steady returns, is the key to long-term returns. That manager holds 70% of assets in cash and will deploy to capture specific individual stock patterns over a few days or weeks. The dislocation we are witnessing in March confirms his fears. By being positioned in mid and large caps, the manager is avoiding the pitfalls of lower liquidity of small caps, in case of stressed markets. Moreover, the sharp correction the equities witnessed at the beginning of February were characterized by one of the highest sector correlation in US equity history, which is a strong headwind for equity managers. However, the weeks that followed were marked by high volatility but with increased dispersion. This is a favorable environment for equity stock pickers. European healthcare, for instance, was a positive contributing sector.

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The Ayaltis Team

26 March 2018

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