LYXOR / CHENAVARI UCITS CREDIT FUND – UPDATE

Thursday, 2 April 2020

Off to the Second Leg

- *Lyxor Chenavari UCITS fund is up +0.84% (SI USD) and +0.36% (SI EUR) year-to-date as at 31 March*
- *Positioning remains very cautious in the wake of adverse technical forces, and fundamental risks skewed to the downside*
- *Some opportunities arising via new issues notably on Financials and Investment Grade bonds*
- *With a positive convexity profile and close to neutral RV positioning, we feel well positioned to capture the next leg*

Dear Investors,

March 2020 will remain one of the most mind-boggling months of our lives. Things that always felt inalienable to us, like going out for a walk or taking the kids to school, were curtailed in a matter of hours. For most of us this will be a stark reminder of how lucky we are to live in free societies and in good health. But the consequences for our societies are yet to sink in, starting with unemployment, public debt, and potential social unrest.

I would like to thank our investors for their trust over these hectic weeks. We are honoured by your loyalty. As we close the quarter, we are proud to display a positive performance YTD (see chart 2).

Chart 1: Recent performance of key reference indices (week-on-week changes, MTD and YTD)

	January	*February*	*March*	**YTD 2020**
Main s32 5y (IG)	+4.8%	+38.9%	+49.0%	+133.9%
XO s32 5y (HY)	+11.3%	+31.5%	+87.9%	+191.9%
SNRFIN s32 5y	+5.3%	+38.9%	+55.6%	+139.2%
SX5E (EUROSTOXX 50)	-2.8%	-8.6%	-16.3%	-28.4%
SPX (S&P 500)	-0.2%	-8.4%	-12.5%	-23.0%
SX7E (EUROSTOXX Banks)	-5.5%	-7.9%	-35.5%	-46.3%

Note: for credit indices, performance is expressed in spread variations (spreads increase as markets fall)
Source: Bloomberg

Chart 2: Lyxor Chenavari UCITS L/S Credit - gross P&L attribution overall and by Strategy (USD)

	January	*February*	*March*	**YTD 2020**
Total	1.85%	0.73%	-1.28%	**1.31%**
o.w. Corporate	1.04%	0.34%	-1.61%	-0.24%
o.w. Financials	0.77%	0.14%	-0.17%	0.74%
o.w. Structured Credit	-0.06%	0.13%	0.40%	0.47%
o.w. Other	0.11%	0.12%	0.11%	0.34%
Net Perf SI EUR*	1.21%	0.38%	-1.21%	**0.36%**
Net Perf SI USD*	1.36%	0.52%	-1.04%	**0.84%**

Source: Chenavari estimates and Bloomberg, 31 March 2020

With significant cash available for deployment, we believe that we are well positioned to enter the next leg of the market crisis and welcome subscriptions to take advantage of the emerging mispricing opportunities. Our fund is not just offering protection in downside moments. As its track record shows since its "Relaunch" in February 2016[1], it has also been generating performance during phases of market expansion (the SI USD share class is up 6.9% on the past 12 months, and the SI EUR share class is up +4.9%).

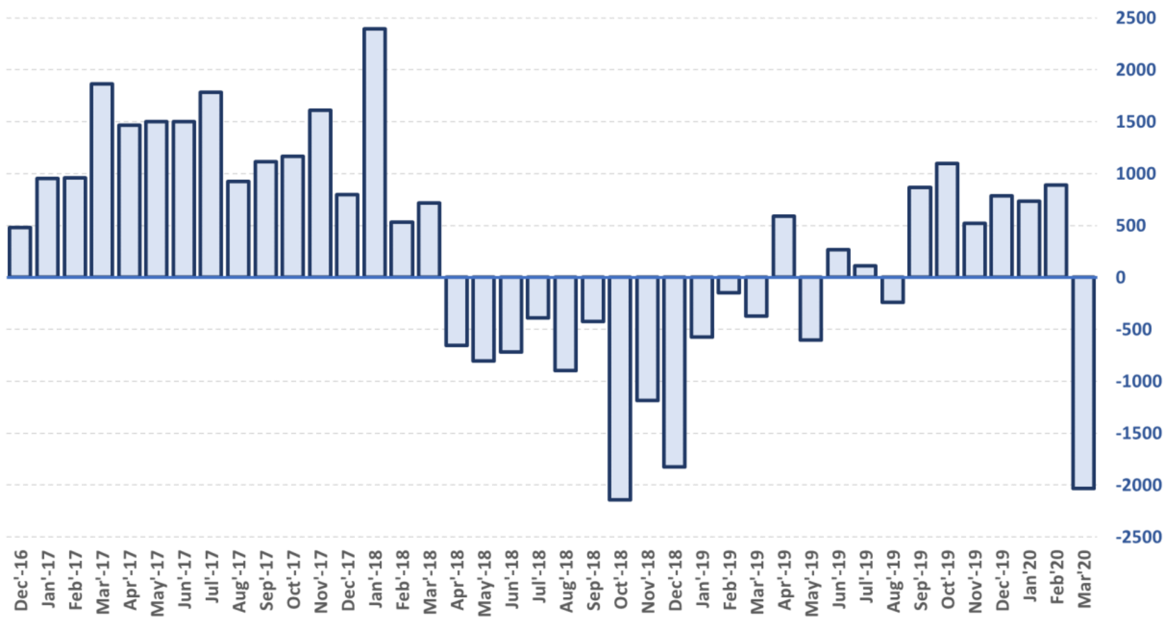
* * *

Technicals: liquidity freeze is the new sneeze – Fundamentals: drifting away from a V-shape recovery

The coming days will be essential to get a better grip on the forces at work on the flows side.

As other market participants, we have consistently expressed the view that there was a liquidity mismatch at play in some areas of the UCITS universe. Combined with high levels of leverage, and hence margin calls in times of market pressure, this can lead to significant dislocation. So far, this has not been the case. Only a small number of funds have announced that they were gating (or had similar actions introduced, such as hefty levies on redemptions). In the AT1 world, the market froze for a while during the month but recovered well in the last week of March. Whilst redemptions were significant for some of the largest UCITS funds in the area (close to 15% of their AuMs for some of them), they remained manageable most probably thanks to some cash buffers in place at the outset of the crisis (see Chart 3).

Chart 3: Flows in Credit Financial Funds (USD bn)



Source: Chenavari unaudited estimates, based on Bloomberg data until 31 March 2020 (NB data from some fund may still be unreported for March 2020 as at 2 April 2020)

[1] See full track record in Appendix at the end of this letter

We believe that the picture on the impact of flows will become clearer in April. With the end of the calendar month and quarter last Tuesday, the cut-off date for redemptions has just passed for funds with monthly or quarterly liquidity. Investors' decisions to redeem their money or not will be the key driver on certain asset classes with a potential liquidity pinch.

In the meantime, we believe that it may look prudent to stay out of strong directional bets and observe whether this big liquidity freeze materialises, the risk being more on the downside there.

Admittedly, there is decent value in certain areas of the market, and we are starting to review them cautiously. However, the absence of visibility on the resolution of the Covid-19 crisis, and the issue of the state of economies after the lockdowns end could impact markets further from current levels. As an anecdote, one may note that the S&P 500 is still c.65% higher than it was at the peak of 2007, before taking the dive of the Great Financial Crisis ("GFC"). As chart 4 illustrates, spreads for European High Yields and AT1 bonds are not dissimilar from the wides of early 2016, before the ECB launched its massive QE programme. We are not (yet) in dislocation mode.

Chart 4: Evolution of Spreads for High Yield and AT1 bonds since 1 January 2015 (%)

Source: Chenavari unaudited estimates, based on Bloomberg data until 1 April 2020

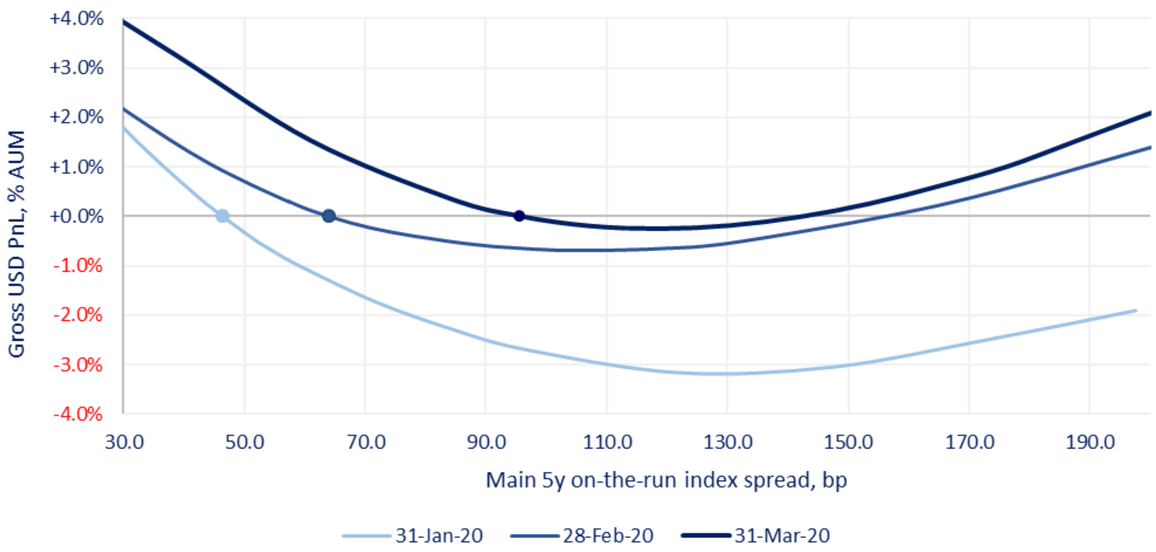
Indeed, the unprecedented actions undertaken by governments and central banks in Europe and the US in the past couple of weeks have helped stabilise the markets. However, these responses only constitute patches to a dire underlying situation. The freeze of large areas of the economy are creating mass unemployment, defaults and social distress among developed economies. As yet, the full impact is very hard to appreciate (as sell-side projections can attest, showing a wide range of outcomes); but as lockdowns settle in, it looks more and more improbable to hope for a return to normality once we are allowed out.

Whilst market sentiment remains currently (mostly) driven by Covid-19 cases and prospects for the unlocking of economies, within a few weeks we will be facing the horrid reality of collapsing activity numbers both at macro and corporate levels. The very severe recession we believe we are embarking on will require great skills to tame and reverse, especially in a world shaken by the growing burden of public debt and populism.

Positioning

Consistent with the above, our current positioning is very flat, with a theoretical max drawdown of c.-25bps (see Chart 5, based on our risk team's standard scenario) and significant cash available.

Chart 5: Fund level systemic stress as a function of on-the-run iTraxx Main 5Y spread (the dot representing the position of the Main index at the time of the Curve)



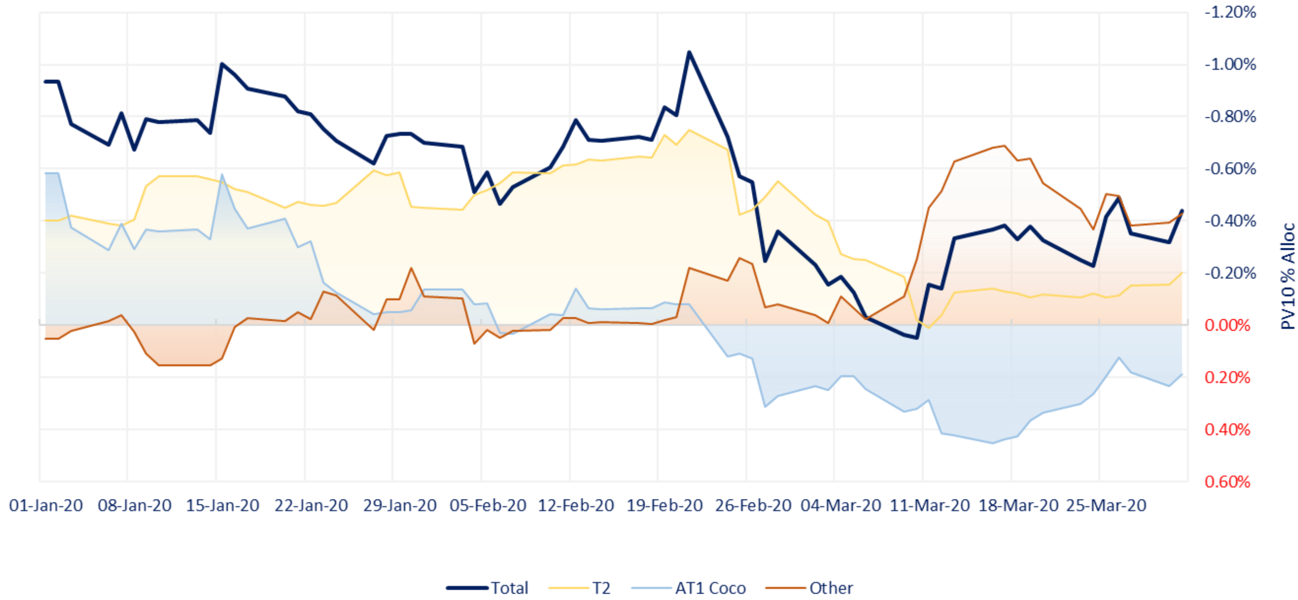
Source: Chenavari unaudited estimates, 30 March 2020

On **Financials**, the tone has turned more positive on AT1s after most banks announced that they were going to skip dividends and bonuses – yet reassured on the payment of the AT1 coupons. We believe that fundamental analysis can identify some attractive opportunities within AT1s, as they show yields to call in the region of 12%, and yields to maturity in the region of 6.5%.

As highlighted in chart 6, the Fund was net short on AT1s by mid-March (PV10[2] of c. +0.45%, i.e. positive performance of c.0.45% performance at allocation level should spreads widen by 10%). Since then, we have reduced this overall short position by half, looking at value on the long side- but remaining quite cautious overall on the asset class given our worries on technicals.

Taking a step back (and looking at the bold blue line on chart 6), the fund's positioning on Financials has moved slightly long risk (from marginally short by mid-March), as we deployed cash on attractive senior bond issues. We saw spread offered at 5 times the levels seen at the start of the year. For example, Credit Suisse printed at 350bps last week vs 60bps as of 15 January. We will continue to scrutinise bond issues in the space.

Chart 6: PV10 by seniority (as a percentage of allocated capital), Financials strategy



Source: Chenavari unaudited estimates, 30 March 2020

As for the **Corporate** strategy, it has remained even more cautiously positioned than the Financials strategy. according to our risk models, a widening of 20% of indices ("PV20") would trigger a drawdown of c. 10bps, which means the strategy is very close to market neutral.

At the moment, the corporate book can be split between a long/short HY book, and a long/short IG book.

[2] In our view, the best way to discuss the positioning of the Sub-Strategies in detail is to look at the PV10, that is, the theoretical reaction of a given Strategy to a 10% widening of spreads, as measured by our risk team under certain modelling assumptions.

As an order of magnitude, we would estimate that an unlevered Long Only fund invested in single B instruments with a duration of 5 years would have a PV10 of c. -2% (i.e. a drawdown of 2% if spreads were to widen by 10%). A PV10 of zero shows a perfectly market neutral strategy, and a positive PV10 indicates a net short positioning (positive performance if indices were to widen by 10%).

On the High Yield part, the longs are highly concentrated on TMT including issuers like United Group, Altice and Matterhorn. On the short side, we have focused on more cyclical sectors like Industrials, Chemicals and Consumer Cyclical. Issuers on the short side include Ineos, Salini Impreglio and Antolin.

On the Investment Grade segment, our goal is to favour long solid IG credits that offer attractive New Issue premium, whilst going short names that could potentially be downgraded to High Yield. On the long side issuers include Carrefour, Coca-Cola and Fresenius; on the short side Issuers include Clariant, Stora and Klepierre.

The new market regime will rely heavily on alpha generation, with much more emphasis on stock picking than during the QE period. We believe we are in a good position to explore the best alpha opportunities thanks to our research team and their bottom-up analysis process.

In these challenging times, our focus will be primarily on liquidity and sustainability of business models.

Lastly, it is worth highlighting that our **Convexity** strategy has also played a role in this volatile market environment. The Lyxor Chenavari UCITS credit fund has a very limited allocation to Convexity, equal to c. 7% of the capital consumption as at 31 March. The underlying credit exposure of the convexity strategy is limited to IG index portfolio (no illiquid bespoke portfolio, no High Yield or Crossover portfolio). The strategy generated positive returns in Q1 2020 (+5% gross YTD at the allocation level), as it benefited from the rise of correlation.

* * *

We hope the above helps explain the Fund's positioning in the current environment.

Should you wish to arrange a follow-up discussion, please do not hesitate to contact us:

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Appendix: Track record since Inception in June 2015 and Relaunch in end February 2016

	YTD	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2015	-3.61%						-0.19%	-0.11%	-1.58%	-1.68%	0.15%	0.27%	-0.52%
2016	2.05% FY **7.95%** Since Relaunch	-3.06%	-2.56%	1.40%	0.73%	0.14%	0.43%	1.60%	1.34%	-0.07%	1.48%	-0.15%	0.88%
2017	**7.41%**	1.34%	0.96%	0.95%	0.28%	0.64%	0.71%	0.67%	-0.12%	0.76%	1.19%	-0.32%	0.13%
2018	**0.67%**	1.07%	-0.67%	-0.38%	0.30%	-0.07%	-0.02%	0.78%	0.10%	0.64%	-0.19%	-0.63%	-0.24%
2019	**6.67%**	-0.08%	0.20%	0.49%	0.36%	-0.04%	1.21%	0.61%	0.86%	1.26%	0.44%	0.44%	0.87%
2020	**0.84%**	1.36%	0.52%	-1.04%									

Note: Performance in light blue denotes the performance before the "Relaunch" at end February 2016

Source: Bloomberg and Chenavari, as of 30 March 2020. Returns and performance are representative of Class SI USD

Disclaimer:

Estimations reflect conservative modelling assumptions, but do not reflect the best and worst case scenarios. Estimates are based on the market conditions at the time of modelling and are therefore, subject to change. Stress Tests present a set of hypothetical scenarios that assume changes for one or more market variable in order to assess the effect on the portfolio. The results shown represent estimated gross performance of the Fund under the market conditions stated. Chenavari has made assumptions that it deems reasonable and uses the best information available to calculate the stress test estimates. If a different set of assumptions were used in this calculation, there could be a material difference in the calculated estimates. Please refer to Offering Document for risk parameters.

Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or to adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.