U ACCESS (IRL) GCA CREDIT LONG/SHORT UCITS

Quarterly Comment

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Market Comment

- The third quarter of 2023 saw a pullback in global markets with most asset classes, including global equities and bonds, ending the quarter in negative territory. The only exceptions were commodities and High Yield (HY). Equity and bond volatility increased during the quarter, although only moderately. Developed Market (DM) equities were down -3.4% in Q3, keeping the YTD gains well into double digits (+11.6%), while Emerging Markets (EM) lost -2.8% in Q3 and settled at +2.2% YTD. In DM, the Japanese market was one of the few in positive territory in local terms (+2.5% in Q3, +25.7% YTD for the Topix). The weakening of the JPY vs major trading partners (-12.5% vs USD YTD) continues to be a tailwind. The other positive outlier in Q3 was the UK market, supported by the relatively good performance of energy stocks. In the US, the S&P 500 was down -3.3% in Q3 and is up +13.1% YTD. In terms of styles, value (-1.7%) outperformed growth (-4.9%) over the quarter, which only modestly reduced the YTD gap which sees growth still outperform value by a large degree.
- In Fixed Income, DM government bonds, EM Debt and investment grade were down, negatively impacted by the rise in bond yields. On the bright side, HY managed to be in positive territory, thanks to the high carry and the shorter dated profile the asset class is exhibiting, spreads remained stable over the quarter. On the other end, inflation linked securities were the most negatively impacted by the slow-down in inflation data. The focus of fixed income investors, which had been focused on the level of peak rates, has now started to switch to how “higher for longer” rates will affect the economy and fiscal sustainability. On the economic front, the sharp rise in oil prices in Q3 constituted the main headwind and increasing signs of a slowdown are impacting markets. The other interesting observation is that the correlation between stocks and bonds was once again positive in Q3. For asset allocators, this is a reminder that alternative strategies should be key to diversify against some of the risks the economy and markets are facing.
- This market environment should provide an interesting set of opportunities for our U Access (IRL) GCA Credit Long/Short UCITS fund, a Long/Short corporate credit strategy focusing primarily on high yield, distressed and investment grade opportunities, largely in the US. This strategy enables investors to expand the opportunity set offered by traditional credit, by taking advantage of current dispersion in the market, offering opportunities both the long and short side.

Sources: UBP, Bloomberg Finance LP, BofA Merrill Lynch

Performance Review

- For the third quarter of 2023, U Access (IRL) GCA Credit Long/Short UCITS returned +0.84% (Class B USD, net of fees). During the period, the long strategy contributed (0.60%), the short strategy contributed +0.52%, and net interest carry contributed +0.91%, all expressed on a net of fees basis.

- The portfolio's largest contributing issuer for the quarter was a long position in high-coupon secured bonds of a cruise line operator which announced better than expected Q2 2023 earnings during the period, highlighted by strong demand and further strength in onboard spending, and improved full-year guidance due to continued strong customer demand (even at higher prices) and improved cost controls. These factors in part resulted in upgrades to the company's corporate credit rating by Moody's and S&P. During the quarter, the investment team increased this long position, (before it was reduced when the company partially redeemed the bonds at a premium) and has maintained this long position through the date of this letter as the cruise industry continues to experience rising demand and the high coupon, short-dated bonds continue to offer an attractive yield-to-call opportunity.
- The second-largest contributing issuer for the period was a long position in the short-dated, secured, high-coupon bonds of a global airline. Although this position was partially hedged with a short position in the company's longer-dated bonds, the portfolio benefitted from price appreciation on the long position partly because of the company announcing Q2 2023 earnings that were better than expected, as well as an improved full-year profitability outlook resulting from rising demand as the travel industry continues to recover post pandemic. As a result of its improved operating performance, the company also received upgrades in its corporate credit rating from the three major credit rating agencies during the quarter. The investment team sold its long position and covered its short position in the company's bonds during the period to lock in a gain, then later re-established a long position in the short-dated, secured, high-coupon bonds which was in the portfolio as of the date of this letter as the travel industry continues to experience improving demand and the high coupon bonds continue to offer an attractive yield-to-call opportunity.
- The third-largest contributing issuer for the period was a long position in the short-dated, secured bonds of a U.S. integrated retail electricity and power generation company serving residential, commercial, and industrial customers. Although this position was partially hedged with a short position in the company's longer-dated, senior unsecured bonds (which realized a loss for the portfolio during the period), the portfolio benefitted from price appreciation on the long position partly as a result of the company announcing earnings that were better than expected as well as improved full-year guidance primarily resulting from higher margins. The company also made progress on the acquisition of a competing power producer with the announced approval to own and operate a portion of the competitor's nuclear plants during the period with the expectation that the transaction would close in Q4 2023. The investment team traded around its long position in the bonds to lock in a gain, while closing its short position in the longer dated, senior unsecured bonds at a modest loss, and has maintained the remaining long position through the date of this letter given the company's scale and positive outlook for full-year 2023 and the attractive yield-to-call opportunity for the short-dated, secured bonds.
- On the negative side, the portfolio's largest detracting issuer for the quarter was a short position in the discounted bonds of a global provider of specialty chemicals and materials that are used in many diverse consumer products. The portfolio experienced a loss from price appreciation on this short position as a result of the company's announcement of better than expected Q2 2023 earnings, the addition of a board member from a potential merger candidate, the construction of a new pilot plant to boost margins in its legacy business of producing specialty chemicals used in lithium-ion batteries, and improving credit metrics that may result in the company producing positive free cash flow by the end of the year. As a result of the potential improvement to the company's growth and earnings outlook, the investment team covered the short position at a loss during the period.

- The second-largest detracting issuer for the period was a long position in the bonds and equity of a U.S.-based broadcasting/media company. During the period, the company announced Q4 2022 earnings which included a decrease in net income year-over-year and cited expectations for a potential decline in full-year 2023 operating revenue due to lower political advertising and cable TV revenue, which have the potential to be offset by regional radio station acquisitions. Also, during the period, the company missed reporting deadlines with the SEC for Q1 and Q2 2023, citing accounting issues in part relating to its investment in a regional casino, and the hiring of a new outside accounting firm to remedy the issue. The investment team added to the long position in the equity and bonds during the period as it continues to believe that there are future growth opportunities for the core broadcasting business of the company, as well as debt reduction opportunities, and has kept this long position intact through the date of this letter.
- The third-largest detracting issuer for the period was a long position in the discounted, unsecured bonds of a U.S. independent, regional operator of broadcast television stations. The portfolio experienced a loss from price depreciation (notwithstanding the company reporting Q2 2023 earnings that beat guidance and analyst consensus estimates) due in part to a deterioration of investor expectations for spending on TV advertising. The investment team sold a portion of its long position in the bonds during the period at a loss and maintained the reduced long position through the date of this letter given the company's commitment to debt reduction and the expected sequential increase in political advertising revenue through the end of the year and into 2024.

Portfolio Activity

- The high yield market, as measured by the ICE BofA US Cash Pay High Yield Index (the "BofA HY Index"), had a positive quarterly return of +0.53% gross during the period as the option-adjusted spread on the BofA HY Index tightened by 5 basis points, while the yield on the ten-year U.S. Treasury increased by 73 basis points and the yield on the five-year U.S. Treasury increased by 45 basis points. Given still elevated inflation levels and expectations for continued tightening by central banks, the investment team remained concerned with the downside risk for near-term growth prospects for high yield issuers during the period. Gross exposure at the end of July, August, and September measured +121%, +124%, and +128%; and, on a net basis, +64%, +61%, and +59%, respectively. The average month-end exposure during the quarter was approximately 61% net long, up from approximately 47% net long during the second quarter of 2023, which reflects an increase in long exposure and a modest increase in short exposure.
- At a more granular level, the long portfolio activity included adding more relative value positions in the Energy, Housing, and Consumer Products sectors among others as well as higher coupon, shorter duration bonds that are likely candidates for refinancing at premiums to their call prices. The investment team reduced.certain long positions in the Aerospace, Food and Drug, and Service sectors among others. The short portfolio activity included adding short positions in Other (risk mitigants), Service, and Broadcasting sectors among others.
- At the overall portfolio level, the exposures at the end of September 2023 were +128% gross and +59% net (as mentioned above), with 94% gross long exposure and 34% gross short exposure.
- The largest long sector exposures at the end of the quarter were (in order) Gaming/Leisure, Energy, Transportation, Utility, and Service.
- The largest short sector exposures at the end of the quarter were (in order) Other (risk mitigants), Gaming/Leisure, Broadcasting, Healthcare, and Metals/Minerals.

Outlook

- Many of the same market challenges seen in the first three quarters of the year continue into Q4 2023 with central banks maintaining hawkish stances, interest rate volatility, somewhat resilient global economic data, and high (though moderating) U.S. inflation. With expectations for continued volatility, uncertain credit market conditions, and likely tightening bank lending standards, the investment team has many reasons to remain cautious on fixed-coupon corporate bonds. That said, with still low default rates, low unemployment, and steady consumer spending, there are some fundamental justifications for the current level of credit spreads (especially if a recession can be avoided). In addition, the higher absolute yields (compared to the last few years) appear to be more attractive to many yield-oriented investors.
- In this environment, the investment team sees opportunities on both the long and short sides of the portfolio due to the dispersion which often occurs within corporate credit markets in volatile environments. On the long side, the investment team continues to find select opportunities in short-dated relative value longs, especially in higher coupon and/or secured bonds which have maturities of three years and less and which might be subject to early redemption due to free cash flow generation or company-specific corporate finance activities. On the short side, in addition to macro hedges, the investment team continues to seek opportunities in deteriorating companies which are over-levered and have weak credit ratings at a time of uncertain economic growth. With input costs still elevated in certain areas, the cost of capital increasing, and lending conditions tightening, some highly leveraged companies will likely struggle to meet their financial obligations, setting the stage for the potential for additional positive attribution from the short side of the portfolio.

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