THE DRIVE YOU DEMAND

U ACCESS (IRL) NEXTHERA UCITS

Quarterly Comment | Q4 2018

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Markets

- Global equity markets were down -13.42% during the fourth quarter, bringing the YTD performance to -8.71%, as measured by the MSCI Daily TR Net World Index. The final quarter of 2018 was not good for equity markets. Investors had to contend with rising US central bank interest rates, a sharp slowdown in Eurozone business confidence, weaker Chinese growth and rising geopolitical concerns (including Brexit, Italian politics and the ongoing trade conflict between the US and China). This all proved an indigestible cocktail for investors. The biggest challenge for markets is that global growth is slowing at the same time as the Central Banks are winding down quantitative easing.
- In contrast to the first three quarters of 2018, Developed Markets underperformed global markets in Q4. In the US, markets were dominated by fears of further rate hikes and that the US is late in its economic cycle, driving the S&P 500 down by -13.97%. The MSCI Europe declined by -11.32% over the quarter, with all underlying county indices being down meaningfully. The Nikkei 225 also saw a strong decline (-17.02%).
- Emerging Market (EM) equities also declined meaningfully in Q4 but did relatively better than Developed Markets, the MSCI EM being down -7.47% in Q4. The prospects of a Chinese stimulus and a slower pace of interest rates hikes in the US, as well as lower equity valuation were supportive factors. On a YTD basis, Emerging Markets still underperformed Developed markets, on aggregate, with the MSCI Emerging Markets being down -14.58% in 2018.
- In light of the market sell off, volatility increased sharply during this fourth quarter, closing the year much higher than in 2017. The regime change that we started to witness in February continues to be valid, as markets seem more focused on fears like slower growth, trade tensions or higher interest rates. The VIX closed Q4 at around 25, versus close to 12 at the end of Q3.
- After rising during most of 2018, US and European bond yields decreased in Q4. After initially moving higher in the first part of the quarter, yields sharply reversed from mid-November as increased geopolitical tensions and question marks about the strength of the global economy drove equities lower, with investors selling equities and buying treasuries, in a classic risk-off trade. Monetary policy continues to tighten, although the Fed has lately been more dovish than during most of the year.
- In light of policy shifts progressing in the major economies, the increased volatility within all markets, including equities, is inducing allocators to look for alternatives or complements to their long-only equity allocation. We strongly believe that one efficient way to improve the risk-return profile of a traditional long-only equity portfolio is to favour Long/Short sector specialists like U Access (IRL) NEXTHERA UCITS. Indeed, this strategy is today characterised by significant innovation and regulatory changes, which should provide many long and short investment opportunities across the healthcare area.

Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

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Performance Review

- U Access (IRL) NEXTHERA UCITS had a negative return of -22.26% (Class C USD, net of fees) during the third quarter of the year, bringing the YTD net performance to -18.61%. As a comparison, the NYSE Arca Pharma TR Index (large cap pharma) posted a negative quarter at -4.18%, while the NASDAQ Biotech TR Index (large cap biotech) suffered a -20.65% loss over the same period.
- Within the long portfolio, much greater-than-expected declines have unfortunately been seen in both large capitalisation companies, as well as mid-cap de-risked biotechnology companies, which have sold off aggressively in the recent market drawdown. The investment team does not believe these moves are related to any negative fundamental developments at these companies, nor to any specific concerns about the therapeutics sector in particular, but rather to a continued de-risking in a macro-driven environment. It also believes that, for most of 2018, the lack of sustained M&A in mid-cap therapeutics (a trend they thought was likely) has eroded valuations across the board after a December 2017 / January 2018 spate of M&A totaling some $27 billion. Even recently, three mid-cap M&A transactions have failed to create any valuation support in the anticipation of further transactions.
- While the short hedges in single stocks, ETFs, put options and custom baskets have mitigated a substantial amount of the declines on the long side, they have not sufficiently offset such losses.
- The top 3 detractors over Q4 were long positions in Audentes Therapeutics Inc, Immunomedics, and Takeda Parmaceutical Co. Audentes shares were under pressure in a de-risking biotech tape, including after the company raised ~$151mm in a surprise secondary offering at $29/share, which had a ~14% dilution to shareholders. There was no specific event around Immunomedics during the quarter, but the stock suffered along with the biotech sector. Being one of the largest holdings in the portfolio, it had a larger impact than most other positions. Another top laggard was a long position in Takeda Pharmaceutical, as shares remained volatile ahead of a shareholder vote to approve the Shire acquisition. The investment team trimmed the investment ahead of this vote, as the upward re-rating they expected post the deal announcement-related sell-off failed to materialise.
- On the positive side, the top 3 performers during Q4 were a long position in Endocyte, as well as short positions in the S&P Biotechnology Select Industry Index and the Nasdaq Biotechnology Index. On October 18th, Novartis announced its acquisition of Endocyte for $24/share in cash, or ~$2.1B in total equity value, at a 54% premium to the prior close. This followed last month’s positive regulatory development in which the FDA accepted radiological progression free survival (“rPFS”) as an alternative primary endpoint for the company’s Phase 3 VISION trial in prostate cancer.

Portfolio Activity

- U Access (IRL) NEXTHERA UCITS focuses on therapeutics solely, and more specifically on pharma and biotech companies. Four segments make up the investment universe: (i) Large cap pharma companies with low multiple, high dividend paying, and strong revenue growth; (ii) Revenue generating biotech companies that would be accretive on day 1 for an acquirer and would be under the radar and not discounted for M&A; (iii) Clinically de-risked biotech companies which are innovative M&A target companies post Phase 3 about to commercialise their drugs; and (iv) Highly innovative companies which have passed the proof of concept (Phase 2) and are going through pivotal trial (Phase 3) with a high likelihood of clinical success, although their individual allocation in the overall portfolio would remain limited.

- Coming into the fourth quarter, the investment team maintained its positioning of being long a select group of larger-capitalisation pharmaceutical and specialty pharmaceutical companies and a group of core de-risked mid-cap biotechnology companies, while hedging through larger capitalisation single-stock shorts, biotech ETF shorts and option strategies on these biotech ETFs. This positioning has been consistent since early 2017 and in line with the team's generally bullish thematic view on the potential for strong underlying fundamentals – particularly on the scientific front – to help drive value creation.
- During the second half of December and in order to preserve capital amidst a market dominated by macro concerns, the Nexthera team reduced both the gross and net exposures, to finally end the quarter at 115% and 10% respectively. The team decided to maintain a low gross and net exposure until they feel the market has stabilised and that valuations have sufficiently reset so that they can resume investing according to their fundamental views. This started to be the case towards in the middle of January 2019.
- While M&A and BD activity was quieter than what the team would have expected in 2018, capital markets activity has been robust, with healthy primary issuance and some M&A transactions seen towards the end of the year. The team continues to expect M&A to accelerate in the next 6-12 months for de-risked, innovative companies. With a now clearer consensus on no price increases for the remainder of the year and potentially beyond, global biopharma companies shall continue to need external activity to bolster pipelines. With valuations having now reset for a number of these biotechs, the investment team finds these valuations more compelling and continues to look for attractive investments.
- Looking at specific positions during Q4, a long position in Novartis was initiated. The investment team believes that corporate activity, with the spin-off of Alcon and the likely selling of a large part of their generics business, represents now a good catalyst for improving the efficiency of the company and create shareholder value. In addition, progress made on two of their promising drugs should drive sales growth in the coming quarters. Novartis was the largest holding in the portfolio at the end of the year.
- At the end of December, the portfolio was built around 21 positions, 17 on the long side and 4 on the short side. Biotech has been the largest subsector allocation during Q4, while the US remains the highest regional exposure.

Outlook & Positioning

- Despite the recent extreme volatility in markets, the Fund's general outlook remains similar to last quarter. However and as we look back to 2018 and enter 2019, the investment team has a few observations about the therapeutics landscape, which should drive the portfolio's tactical positioning in the weeks or months to come.
- First, there is increasing competitive intensity across therapeutic areas. The substantial inflow of capital into private and now public biotechnology companies over the last ten years, which has funded the ongoing innovation wave and has produced such meaningful improvements in clinical outcomes has, unsurprisingly, created heightened competition in practically every therapeutic area. Second, the wave of enthusiasm for innovation as well as investors' desire to access it at earlier stages of development have allowed the public markets to receive an ever-increasing number of early-stage IPOs. Hence, the innovation cycle that has delivered the types of meaningful clinical improvements we have been discussing for some time now has also lured less mature companies into the public markets, including some of lower quality and/or higher risk.

- The implication of these phenomena, namely (i) increasing competitive intensity, (ii) the inefficiency and opportunity created by a sizable suite of newly public and investable companies, and (iii) the volatility that ensues, as the public markets have to digest earlier and sometimes higher-risk companies, create a very fertile environment for the Fund’s Long/Short Equity approach, based on fundamental, scientific and rigorous valuation analysis.
- As mentioned above, the investment team decided to reduce exposure during the second half of December in order to preserve capital during an extremely volatile market environment. With things stabilising by mid-January, the team decided to add risk back to the book. On the political front, further to the mid-term election results, the risk of drug pricing overhaul has stabilised, although, the team still expects House Democrats to introduce and push for drug pricing reforms that ultimately should fail to pass in the context of a Republican Senate and President.
- The U Access (IRL) NEXTHERA UCITS portfolio’s net exposure is currently made of two-thirds coming in a core basket of de-risked late stage biotech stocks and one-third in value pharma names like Allergan, AstraZeneca and Takeda. These two baskets of growth and value have been historically relatively uncorrelated.