U ACCESS (IRL) CHEYNE ARBITRAGE UCITS

Quarterly Comment | Q2 2019

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

Markets

- Global equity markets were up +3.23% during the second quarter of 2019 and stand at +15.90% YTD, as measured by the MSCI AC World Daily TR Net Index. After a very strong first quarter, Q2 was more volatile with two main elements influencing markets: trade war rhetoric, which initially escalated and then dampened further to the G20 meeting, and central banks, which have been intensifying their dovish stance, signalling possible rate cuts. In short, the market has been willing to ignore the weaker economic data in the hope that central bank stimulus will help avoid a recession.
- Developed Markets (DM) performed strongly in Q2, outperforming global markets on aggregate, with the notable exception of Japan. The S&P 500 TR ended the quarter up +4.30%, while the MSCI Europe gained +4.48%. In terms of styles, growth was once again the winner during Q2, while value and small cap underperformed global markets. Looking at sectors, Financials and IT were the strongest contributors. On the other hand, Energy was the laggard.
- Emerging Market (EM) equities were flattish during this second quarter of the year, with the MSCI EM TR Index being up +0.12%. As US interest rates decrease, a better environment for this asset class could emerge.
- Volatility increased slightly during Q2 but remained at a low level as of June-end (15.08) compared to the last nine months. It briefly topped the 20 mark during the month of May but came back down in June as markets rallied.
- After a very strong Q1, oil contracted somewhat between April and June (-2.78%). Q2 saw a revival in the price of Gold, as weak economic data increased fears of an economic downturn and demand for safe haven assets.
- Markets have been pricing in Fed rate cuts and the potential for further ECB quantitative easing (QE), all of which should be supportive of DM government bonds. However, and although global equities rebounded sharply in June and are off a very good start YTD, there are still a few headwinds that seem to be overlooked by markets so far, among which: (i) the on-going US-China geopolitical tension, (ii) slowing manufacturing data, (iii) early signs of a faltering American consumer, and (iv) a “whatever it takes” monetary policy easing that might not be sufficient to reverse the on-going global slowdown, all this leaving investors overly cautious at this juncture.
- In that context, we believe expanding asymmetric exposure through alternative solutions ahead of rising volatility prospects is a smart asset allocation move today. Indeed, an increased market uncertainty and volatility should provide a fertile ground for our U Access (IRL) Cheyne Arbitrage UCITS fund, which is an arbitrage strategy with a yield component extracted from both Merger Arbitrage and Mixed Arbitrage opportunities. This solution offers then alternative sources of yield to traditional bonds with limited duration and a low correlation to traditional asset classes.

Performance Review

- U Access (IRL) Cheyne Arbitrage UCITS posted a negative -1.48% during Q2 (Class C EUR, net of fees). The Fund's net performance in EUR since the beginning of the year is now +0.79%, which remains a valide case compared to traditional, EUR-denominated fixed income instruments like government bonds and IG corporates.
- On the positive side, the top three contributors during the quarter were WellCare Health Plans, Red Hat and Interparfums. The portfolio's Merger Arbitrage position in WellCare paid off as Centene shareholders voted to support the combination with the managed care provider.
- Another top performer was the Red Hat Merger Arbitrage position. The investment team held the view that the transaction was unlikely to be challenged by the antitrust authorities on the basis of vertical integration. Furthermore and during the quarter, the acquirer received the nod from the different regulators in the US, Europe, South Africa and Brazil. These regulatory clearances triggered a narrowing of the spread from 4.3% to less than 1%, which benefitted the portfolio.
- The third largest contributor was a Mixed Arbitrage position in Interparfums. Going into the second quarter results, the US holding was reflecting unreasonable expectations, trading at a 20% premium to its European subsidiaries. As the earnings and the subsequent downgrades forced the North American investor base to adjust down the contribution of the French listed subsidiaries, the investment team took advantage of this adjustment, by being short spread positioned.
- On the negative side, the top three detractors over the quarter were Latour, Celgene and Lindt. The Latour Mixed Arbitrage spread widened by 6% during Q2, which negatively impacted the portfolio. Following a 40% rally triggered by the inclusion of the company in the Scandinavian benchmark index, the holding company now trades at a 15% premium to its NAV and a 56% valuation premium to its reference index. Assuming a progressive normalisation of the holding discount in the coming quarters, this investment could yield a 25% IRR for a 5% realised volatility. Hence the corresponding prospective Sharpe Ratio continues to make the Latour holding spread one of the portfolio's core holdings within Mixed Arbitrage.
- The Merger Arbitrage position in Celgene detracted to the quarter's return, as Bristol-Myers (BMY) announced their intention to divest Otezla to comply with FTC demands. From a procedural standpoint, once a buyer has been found for the asset, the seller need to enter a consent decree with the regulator. Depending how advance BMY are in the negotiations, it could extend the deal time line by 4 to 6months. The change in the investment team's working assumptions should have impacted the spread by 1.2%; instead the spread went from 0.7% to 4.2%. The team finds the reaction overdone and expects that the spread will tighten again in the coming weeks.
- Finally, a short position in the Lindt Share Class spread contributed negatively to the performance, as the spread narrowed over the quarter. Trading flows were disturbed by the lapse of Swiss equivalence. Due to the limited time that was given to market participants to prepare for the change, adjustments were made promptly and created dislocation in some of the capital structure. The Lindt position was maintained as the manager would expect the spread to normalise once the adjustments flows have stabilised. The team continues to monitor the situation and will not set-up new positions until they have seen evidence that the trading has normalised.

Portfolio Activity

- U Access (IRL) Cheyne Arbitrage UCITS focuses on Merger Arbitrage and Mixed Arbitrage. At portfolio level, the arbitrage exposure at the end of June was 166% long/AUM, as the investment team progressively re-initiated short spreads positions and increased the exposure to Mixed Arbitrage.
- Half of the portfolio's exposure continues to be comprised of Merger Arbitrage, to be seen as the yield book. The other half is invested in Mixed Arbitrage, which is more of a bear market proposition, as it tends to produce outsized gains in falling markets despite being structured in a market neutral way.
- Looking at Merger Arbitrage dynamics, the investment team expects to see continued M&A activity in the sectors that are currently active. Consolidation cycles are normally long cycles once they have been initiated, and they alter the competitive forces and trigger further concentration in an iterative manner. European and US deals should then continue to be the driving forces behind global M&A trends. Going into the second half of the year, the dampening of the volatility witnessed in the last two quarters allowed for an increase in the number of announced transactions.
- The team expects the US deal flow to pick-up considerably once the market will get clarity on the Brexit outcome and crucially when the trade tensions with China abate. For that matter, the resolution does not have to be final and the materialisation of a path for the talks would be enough to trigger a raft of new announcements. This is particularly true for technology companies with a substantial part of their sales or assets in Asia. Finally, the team believes that 2019 will be another busy year for technology companies' M&A.
- Looking at Mixed Arbitrage, spreads within this strategy are typically "short volatility". As the Mixed Arbitrage portfolio is mainly made of short spread investments, the investment team thinks they could do well in a normalising market exhibiting a higher degree of volatility. Indeed, while the Mixed Arbitrage bucket alone is meant to return 0-2% per annum in a bull market environment, it could generate 6-8% returns in a bear market, being therefore a cheap option in the event of a significant market unravelling.
- At the end of June, there were 33 active Arbitrage strategies in the portfolio. 14 positions composed the Merger Arbitrage book, while the Mixed Arbitrage allocation was structured around 19 positions. The portfolio's exposure was increased by 35% during Q2 following a raft of new investment opportunities in Mixed Arbitrage.

Outlook & Positioning

- The portfolio currently offers a yield-to-maturity of 2.75% in EUR with an associated duration of 4.7 months, this representing a potential 7.02% yield in EUR on an annual forward-looking basis. The weighting of the Merger Arbitrage book bore the greatest part of the reduction in terms of gross exposure, as large market dislocations could affect spreads temporarily.
- Moreover, the investment team believes that it is tactically advantageous to continue to keep some reseve in the current trading conditions. Despite some improvements in the Merger Arbitrage opportunity set, deals are priced very aggressively and in many instances the spread does not reflect the appropriate level of risk. Given this positioning, any "scare" can have a disproportionate effect on the spread and can create attractive entry levels.
- Given where we stand in the cycle, Merger Arbitrage should continue to constitute a key allocation of the investment strategy. However, the team is also of the opinion that the ongoing normalisation of the market conditions should continue to generate new opportunuties in Mixed Arbitrage.

Therefore, the investment team is currently growing the Mixed Arbitrage component of the overall portfolio. To summarise and given the current set of opportunities, the team anticipates that the Merger and Mixed Arbitrage strategies should continue to have an equal weighting in the portfolio in the short to medium term.

- Geopolitical tensions should continue to be an obvious risk aggregate. The team closely monitors US transactions exposed to Chinese approvals (15% overall exposure), but also the exposure of other transactions to looming trade wars.
- Another topic of concern is a bill in preparation in Brussels that would introduce a double taxation for internet companies. If voted by the member states, it would easily constitute a Material Adverse Effect event for any ongoing transactions. The team therefore stays clear of all transactions in the sector, as the directive should be put to the vote in the coming months.