SphereInvest | GROUP

SPHEREINVEST GLOBAL CREDIT STRATEGIES (UCITS) FUND

Weekly Performance Period: 27th June to 31st July 2014

Class F (USD): MTD return: -0.20% YTD 2014 return: 6.05% NAV per Share: 120.63

Class D (EUR): MTD return: -0.21% YTD 2014 return: 5.96% NAV per Share: 119.84

Portfolio and Market Commentary:

Having struggled during much of the month, credit markets sold off the last week of July, an episode of weakness, which has so far extended into August. Although the sell-off appears to have been triggered by EM and Developed Europe-centric developments, US HY markets underperformed considerably during the first phase, seemingly after Fed Chair Yellen reminded investors that "valuations metrics in some sectors [appeared] stretched", sparking large outflows and ETF liquidations; for the month, US HY returned -1.32%. EM HY appeared more resilient at first before sharply weakening during the last days of the month, returning -0.32%. Finally, European high yield markets were buffeted by the failure of Portuguese lender Banco Espirito Santo (BES) and returned -0.57% (1).

Credit markets appear to have cracked primarily under the accumulation of various and largely uncorrelated events, from the collapse of BES, conflicts in Ukraine, Gaza, and Iraq, to the default of Argentina. In isolation, none of those developments may have made much of an impact on global markets. Investors had indeed proved able– or been complacent enough – to climb similar "walls of worry" in previous months. The fact they did not this time around probably reflects the "accumulation effect" of too many bad news events at once, a seasonal effect (as liquidity thins during the Summer, amplifying market movements), and most importantly, valuations which no longer provide a cushion against any bad news at all.

On July's two most important developments for credit markets, the failure of BES, and the deepening crisis in Ukraine:

- BES failed in early August after its exposure to insolvent related parties pushed its capitalization ratios below regulatory minimums, prompting the Regulator to step in and force its recapitalization. The relative rapid intervention and split of BES between a "good bank" and a "bad bank" was, in our view, the most benign outcome European credit investors could hope for, with the bail-out of BES' senior bondholders, however unsatisfactory from other perspectives, limiting obvious systemic risks, given the fragile investor confidence in Portuguese lenders and the adequacy of their supervision. Investing in European subordinated financial bonds has, for several years now, been a consensus trade among credit investors, on the assumptions that banks were deleveraging, safer than "before 2008" and therefore inherently "creditor friendly" propositions. The BES debacle is a reminder that performing relevant credit analysis on a bank remains a challenging, indeed almost futile, exercise given the information gap investors will always suffer from at the time when information matters most: when a bank gets into trouble.

- Russian assets sold off considerably during July, with the BofA-ML Russian IG index falling 5.1% after the US and the European Union announced sanctions notably aimed at limiting the access of State-owned Russian borrowers to international capital markets. We do not pretend to have a better understanding of the crisis than derived from the general press and have for some months already wondered about what other credit markets participants, largely people educated in analysing financial statements and business models, could base their investment thesis on, while it was already obvious that the main, if not sole, drivers for Russian assets would be geopolitical developments. We admit any fixed income asset will reach a valuation when the rationale for holding it becomes solely a judgment on default probability or recovery, but we mentioned in previous letters that Russian Eurobonds never reached that point. The severity of the renewed sell-off reflects the fundamental challenges facing the Russian economy and its increasing isolation from global financial and trade markets, but also the fact investors once again wrongly assumed political actors think and behave as economically rationale financial actors. From the European debt crisis to the debt ceiling debacle in the US, that assumption has been consistently challenged, and has once again proved wrong this time, leaving investors essentially without bearings.

Despite renewed talks about credit markets being “at a crossroad” between an exhausted bull run and an uncertain future, we believe there remains considerable investor appetite for the asset class – although not at current valuations. This does not imply the current correction should necessarily be mild: valuations may have some way to correct to entice investors back after recent record outflows. We would however be surprised if markets overshoot on the downside. In contrast with other recent sell-offs, including the short-lived EM scare of January, we do not see real fundamental drivers behind this episode; in our view current geopolitical tensions remain unlikely to have an impact on the global recovery, although they will undoubtedly leave losers as well as winners, both at regional and company levels; July’s batch of macro data continued to paint a picture of slow and uneven global recovery, with positive developments in China offset by growing concerns that the European recovery is faltering – although this is consistent with investors’ expectations that monetary policy in Europe will remain extremely loose for the foreseeable future. In the near term, two developments could make us more pessimistic:

- Extraordinary amounts of debt have been issued year-to-date, in particular in Euro HY, and we are particularly wary of contagion effects if any credit among the recent vintage of first-time issuers, less well researched and with sometimes questionable outlooks, turned sour.

- Global high yield markets remain hostage to the performance of equity markets in the near term; we remain sanguine on the outlook for the asset class partly on the premise risk premiums are compressed across asset classes; any further cheapening in equity risk premiums will necessarily continue to drag credit yields up too, in our view.

(1) Source: Bank of America Merrill Lynch Indices EMHB, HP00 and H0A0

Portfolio Composition:

SphereInvest Global Credit Strategies	Average Rating	Market Value (%)	Price	Mod. Dur.	Yield	Carry	Z-Spread	PnL Contrib.
	BB-	100 %	104.2	3.6	5.3 %	6.0 %	403	100 %
Largest 5 Positions								
	B+	19 %	103.1	6.5	8.0 %	8.7 %	617	14 %
Regions								
Cash & cash equivalents	AA	26 %						0 %
Latin America	BB-	25 %	102.4	5.8	7.1 %	8.0 %	505	41 %
Developed Europe	B+	18 %	106.5	4.5	7.2 %	8.2 %	556	11 %
Asia ex-Japan	B+	15 %	104.7	4.7	7.4 %	8.4 %	569	29 %
Eastern Europe / CIS	B+	8 %	105.6	3.6	6.3 %	7.8 %	531	15 %
North America	B	5 %	103.7	4.5	7.8 %	8.4 %	585	4 %
Middle East / Africa	B	3 %	99.8	4.0	8.4 %	8.4 %	663	0 %
Corporates/Financials								
Corps	B+	59 %	103.2	5.2	7.4 %	8.2 %	569	75 %
Cash & cash equivalents	AA	26 %						0 %
Financials	BB-	15 %	108.0	3.6	6.4 %	8.1 %	460	25 %
Sectors								
Cash & cash equivalents	AA	26 %						0 %
Real Estate Management & Development	BB-	16 %	104.4	5.3	7.4 %	8.2 %	583	23 %
Telecommunications	B	10 %	106.5	4.5	6.9 %	7.8 %	486	2 %
Consumer Finance	BB-	9 %	107.3	3.9	7.2 %	8.4 %	525	11 %
Commercial Banks	BB-	6 %	109.0	3.2	5.1 %	7.5 %	366	14 %
Food Products	B	6 %	106.3	3.5	7.4 %	9.2 %	588	6 %
IT Services	B-	5 %	107.5	4.1	7.9 %	9.0 %	698	1 %
Communications Equipment	B+	4 %	100.7	4.0	7.8 %	7.9 %	602	0 %
Airlines	B-	4 %	85.8	9.5	10.2 %	10.2 %	746	9 %
Transportation Infrastructure	B	3 %	106.3	3.6	8.3 %	9.4 %	666	3 %
Media	BB-	3 %	106.7	3.3	5.5 %	7.0 %	405	13 %
Beverages	BB+	3 %	93.5	5.8	7.6 %	7.0 %	530	8 %
Utilities	-	2 %	104.5	12.5	7.1 %	7.2 %	406	4 %
Gaming	B+	2 %	100.5	5.4	5.8 %	6.0 %	494	-1 %
Diversified Financial Services	BB-	1 %	98.7	4.2	6.6 %	6.3 %	475	-1 %
Oil, Gas & Consumable Fuels	-	0 %						2 %
Machinery	-	0 %						6 %
Ratings								
AA	AA	26 %						0 %
BB-	BB-	17 %	107.1	3.6	6.6 %	7.9 %	487	27 %
B	B	15 %	104.9	3.3	8.0 %	9.3 %	650	25 %
BB	BB	14 %	105.1	5.6	6.6 %	7.6 %	496	15 %
B+	B+	10 %	103.5	4.4	6.6 %	7.2 %	498	7 %
B-	B-	9 %	98.5	6.8	8.3 %	8.8 %	583	6 %
CCC+	CCC+	4 %	108.9	4.1	7.8 %	9.1 %	711	-1 %
BB+	BB+	3 %	93.5	5.8	7.6 %	7.0 %	530	17 %
NR	-	2 %	104.5	12.5	7.1 %	7.2 %	406	4 %
Currencies								
USD	B+	76 %	102.9	3.6	5.2 %	5.9 %	390	92 %
EUR	B+	15 %	105.1	3.1	4.5 %	5.0 %	396	12 %
GBP	B+	9 %	110.4	4.0	7.2 %	8.8 %	511	-4 %

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Performance Table since Inception:

Class F (USD)

	Jan	Feb	Mar	April	May	Jun	July	Aug	Sep	Oct	Nov	Dec	YTD
2012							0.15%	0.72%	0.78%	2.11%	1.24%	1.72%	**6.90%**
2013	0.97%	0.11%	0.54%	1.64%	-0.04%	-2.16%	1.11%	-0.06%	1.70%	1.66%	0.14%	0.67%	**6.40%**
2014	0.84%	1.08%	0.84%	1.10%	1.20%	1.04%	-0.20%						**6.05%**

Class D (Euro)

	Jan	Feb	Mar	April	May	Jun	July	Aug	Sep	Oct	Nov	Dec	YTD
2012							0.20%	0.66%	0.70%	2.04%	1.20%	1.62%	**6.59%**
2013	0.87%	0.12%	0.54%	1.54%	-0.06%	-2.21%	1.16%	-0.07%	1.67%	1.66%	0.13%	0.65%	**6.11%**
2014	0.85%	1.06%	0.77%	1.09%	1.25%	1.01%	-0.21%						**5.96%**

Past Performance is no guarantee of future results.
Performance figures are net of all fees.

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