SphereInvest | GROUP

SPHEREINVEST GLOBAL CREDIT STRATEGIES (UCITS) FUND

Weekly Performance Period: 31st May to 27th June 2013

Class F (USD): MTD return: -2.16% YTD 2013 return: 1.02% NAV per Share: $108.00

Class D (EUR): MTD return: -2.21% YTD 2013 return: 0.77% NAV per Share: $107.41

Portfolio and Market Commentary:

June was a very volatile and weak month for bond and credit markets. In high yield credit, EM, European and US markets returned -4.85%, -2.49% and -3% respectively, dragging down total returns for the first half of the year to -3.19%, 1.25% and 2.15%. Global investment grade spreads widened 21bps, representing a negative excess return of 1.21% over treasuries (1). With global investors and financial commentators in thrall to the growing likelihood that the Federal Reserve will “taper” its quantitative easing programme by the end of the year, we believe readers of our letter will be well aware of the events which led to the sell-off in bond markets during June. We will therefore focus our letter on reviewing the fund’s strategy so far and any adjustment we will make in light of the recent development in credit markets.

Since the sell-off in June was largely a rates event, duration was the single most important factor explaining the performance of corporate credit. By and large, we believe the fund was adequately positioned with regard to that risk. As explained in our previous letters, we had kept a negative bias towards spread products since the start of the year, and we had already cut most of our investment grade positions by the end of February. In addition, we had substantially raised the fund’s cash position by the third week of May, largely because we believed valuations had reached unattractive levels, but this also had the benefit of materially reducing the fund’s duration, to 2.6 years at the end of May.

Contrary to our expectations, the fund’s focus on non investment grade credit provided no cushion against rising rates during June. To the contrary, spreads widened materially, by as much as 129bps in the case of EM credit. The combined rise of treasury yields and corporate spreads is a rare occurrence. In an empirical study published earlier this year, which we can make available on demand to interested investors (2), analysts at Deutsche Bank looked into the behaviour of credit spreads in previous episodes of rising rates, going back to 1919, and found little correlation between rates and spreads, and no evidence of rising rates causing wider spreads. Insofar as leveraged credits are more sensitive to improving underlying economic conditions and trade at a higher spread than higher quality credits, we do expect high yield to outperform investment grade bonds when rates rise, once adjusted for the difference of duration (high yield bonds tend to have a lower duration than investment grade bonds). This wasn’t the case during June. Deteriorating liquidity in secondary markets

and higher volatility played a role, as did fundamental concerns stemming from the feedback impact of rising rates on more marginal issuers. Global default rates have been kept very low by the ease with which companies have been able to refinance their debt. They might now pick-up, in particular if rates volatility remains elevated and continues to constrain access to the primary market. In our view, however, corporate spreads widened during June simply because they had compressed too much during the previous months. June was, therefore, a continuation of the correction which started during May.

The fund primarily focuses on Emerging Market corporates, while June was marked by a sharp worsening of sentiment towards all EM assets. Some of the drivers of that deterioration have been apparent for several months already, and are not cyclical. Many EM countries need to adjust their models to the ongoing transition of China towards a less capital intensive economy. The growth potential of countries reliant on commodities exports, in particular, may have structurally shifted downwards, and may only improve again if those countries are able to find new drivers of growth. However, the commodity boom of the past decade and ultra loose credit conditions since 2009 appears to have fed policy complacency and delayed structural adjustments in some of the largest EM countries – most notably Brazil. In addition to those structural concerns, Emerging Markets are also perceived as most vulnerable in an environment of tighter global liquidity, with the risk of a “sudden stop” of capital flows threatening both liquidity (if EM economies are unable to roll over their short-term external debt) and solvency (as currency pressures expose sovereign and corporate FX balance sheet mismatches).

Below, we review in turn the fund’s current strategy with regard to duration, credit quality, and regional exposures.

We continue to believe duration is unattractive. Our focus is therefore likely to remain on non-investment grade, relatively short-dated corporates. We acknowledge the possibility that rates may have overshot, and expect Fed officials to maintain ambiguity about the timing of QE tapering, which could set the stage for a duration rally in the coming weeks. Following any broad market sell-off, higher quality bonds also tend to look more attractively priced, and any subsequent credit rally therefore tends to start with investment grade bonds before extending to high yield bonds. However, since May and June’s sell-off was not driven by credit concerns, we believe the case for reducing credit risk at the expense of duration risk looks weaker this time. We also believe high rates volatility may continue leading to high spread volatility, which means capturing the cheapness of IG spreads is likely to remain very challenging. We are likely to continue looking for opportunities to increase the average credit quality of the fund without extending duration, however. This was, for instance, our rationale for adding low IG and crossover positions since the end of June and the first week of July, such as Gazpromneft’s Euro-denominated bonds maturing in 2018, or Mol’s US$ 2019 bonds.

We are still in the process of reviewing the fund’s strategy with regard to its regional exposures, notably the balance of risks and rewards of US$-denominated EM bonds vs. Euro and Sterling credits. We believe the trade-off between both asset classes is currently one of valuation, which favours EM in our view, vs. lower volatility and better near-term technicals, which may favour European credit.

In EM, we believe it is important to differentiate between the tail risk of massive capital outflows on the one hand, and disappointing growth, structural policy challenges, or social unrest such as recently seen in Turkey or Brazil, on the other. The former could threaten the liquidity or solvency of the more vulnerable EM sovereigns and undermine the investment case for all EM corporates. The latter is essentially a valuation issue, in our view, and simply calls for more differentiation between relatively stronger countries and companies, and more vulnerable ones. To assess the actual risk of a "sudden stop" in EM, it is worth reviewing the factors which brought large capital inflows to EM in the first place. Some of those portfolio inflows were "pushed out" of Developed markets by the hunt for yield. We would expect a partial unwinding of those inflows as rates normalize from their rock bottom levels in the US - if not in other large DM economies, since the BoJ, BoE and ECB are all committed to keeping monetary conditions loose for the foreseeable future. Some of the inflows were "pulled" to EM by better debt positions and dynamics, and the large underweight allocation of global allocators to developing economies, relative to their weight in the global output. We believe those inflows were structural rather than motivated by the search for yield. The current challenges faced by EM countries are unlikely to lead to their reversal and talks of a sudden stop therefore look overdone to us.

In Europe, the short-term demand for credit currently looks more favourable than for US$-denominated credit. With EM and US high yield funds and ETFs experiencing record outflows, European credit has acquired a rather ironical "safe haven" halo for investors looking for some stability. On the one hand, we note the improvement (or bottoming out) of economic conditions in the UK and the Eurozone as well as the continued success of the ECB in dampening the volatility caused by developments in the Periphery (such as the ongoing political crisis in Portugal). On the other hand, debt levels across the Eurozone have barely adjusted since the financial crisis, which leaves much of its periphery particularly vulnerable to a sustained rise in government bond yields. Investors cheered at the ECB and BOE's recent shift to a forward guidance regime, but that forceful response was also an acknowledgement of the risks to the Eurozone and the UK of a premature, exogenous tightening of monetary conditions.

(1) Source: Bank of America Merrill Lynch indexes G0BC, HP00, H0A0, and EMHB.

(2) "Should credit investors worry about higher yields?", Deutsche Bank, 25 February 2013

Portfolio Composition:

	Average Rating	Market Value (%)	Price	Mod. Dur.	Yield	Carry	Z-Spread	PnL Contrib.
SphereInvest Global Credit Strategies								
	BB-	100 %	101.2	3.4	5.9 %	6.1 %	473	100 %
Largest 5 Positions								
	B+	17 %	104.2	4.1	8.3 %	9.0 %	689	30 %
Strategies								
Low Vol Portfolio	B+	41 %	101.8	4.2	8.1 %	8.4 %	661	66 %
High Vol Portfolio	BB-	31 %	101.0	5.3	8.3 %	8.6 %	651	34 %
Treasury Bills	AAA	18 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Cash	AA	10 %						0 %
Regions								
Latin America	B+	21 %	102.5	5.3	8.2 %	8.8 %	648	35 %
Eastern Europe / CIS	B+	21 %	99.4	4.4	8.7 %	8.6 %	720	31 %
Developed Europe	BB-	19 %	102.6	4.4	7.9 %	8.5 %	626	23 %
Treasury Bills	AAA	18 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Cash	AA	10 %						0 %
Asia ex-Japan	B+	5 %	96.4	3.7	8.3 %	7.6 %	694	8 %
North America	B	4 %	104.2	3.7	6.1 %	7.0 %	484	3 %
Middle East	B-	2 %	107.6	5.3	8.5 %	9.2 %	642	-1 %
Africa	-	0 %						1 %
Corporates/Financials								
Corps	B+	56 %	100.3	5.0	8.0 %	8.1 %	631	75 %
Treasury Bills	AAA	18 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Financials	B+	16 %	105.5	3.6	8.8 %	10.0 %	746	25 %
Cash	AA	10 %						0 %
Sectors								
Treasury Bills	AAA	18 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Consumer Finance	B+	12 %	106.9	3.6	8.8 %	10.1 %	744	17 %
Telecommunications	B+	12 %	98.4	5.0	7.9 %	7.7 %	612	11 %
Cash	AA	10 %						0 %
Oil, Gas & Consumable Fuels	B	10 %	101.5	4.1	7.2 %	7.4 %	567	3 %
Real Estate Management & Development	BB	5 %	97.9	8.6	8.2 %	7.9 %	581	14 %
Commercial Banks	B+	4 %	101.4	3.6	8.9 %	9.6 %	753	8 %
Media	B	3 %	106.8	4.9	7.7 %	8.5 %	586	8 %
Air Freight & Logistics	BB-	3 %	100.2	4.7	9.2 %	9.2 %	736	11 %
Transportation Infrastructure	BB-	3 %	92.9	3.8	9.9 %	8.6 %	845	6 %
Building Products	B+	3 %	106.1	2.9	7.5 %	9.0 %	650	0 %

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	Average Rating	Market Value (%)	Price	Mod. Dur.	Yield	Carry	Z-Spread	PnL Contrib.
Sectors (cont'd)								
Road & Rail	B	3 %	103.5	1.9	8.8 %	10.1 %	814	0 %
Auto Components	B+	3 %	98.5	3.7	8.1 %	7.9 %	678	0 %
Chemicals	BB-	3 %	96.6	5.1	8.5 %	8.2 %	655	7 %
Food Products	B	2 %	105.5	4.8	8.0 %	8.7 %	659	0 %
Metals & Mining	BB	2 %	100.7	10.9	8.6 %	8.6 %	553	1 %
Paper & Forest Products	BB	2 %	102.0	5.1	6.9 %	7.1 %	540	1 %
Environmental Services	B	2 %	98.4	4.9	7.6 %	7.4 %	611	4 %
Hotels, Restaurants & Leisure	-	0 %						2 %
Machinery	-	0 %						1 %
Beverages	-	0 %						4 %
Gaming	-	0 %						1 %
Utilities	-	0 %						1 %
Ratings								
AAA	AAA	18 %	100.0	0.1	0.0 %	0.0 %	0	0 %
BB-	BB-	16 %	100.4	4.3	8.7 %	8.6 %	702	28 %
BB	BB	16 %	98.2	6.9	7.8 %	7.7 %	565	35 %
B	B	15 %	102.7	3.8	7.5 %	8.0 %	622	10 %
B-	B-	14 %	104.0	4.3	9.3 %	9.9 %	780	18 %
AA	AA	11 %						0 %
B+	B+	7 %	101.6	3.7	7.9 %	8.3 %	653	2 %
NR	-	2 %	100.6	3.8	8.3 %	8.4 %	691	0 %
BB+	BB+	1 %	114.4	1.8	4.2 %	10.1 %	354	5 %
CCC+	-	0 %						3 %
BBB-	-	0 %						-1 %
Currencies								
USD	BBB-	74 %	100.6	3.3	5.7 %	5.9 %	458	79 %
EUR	B+	18 %	101.7	3.2	5.3 %	5.8 %	439	18 %
GBP	B+	8 %	105.6	4.6	8.5 %	9.2 %	671	3 %

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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%							**1.02%**

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%							**0.77%**

Past Performance is no guarantee of future results.

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