SphereInvest | GROUP

SPHEREINVEST GLOBAL CREDIT STRATEGIES (UCITS) FUND

Weekly Performance Period: 1st May to 29th May 2014

Class F (USD): MTD return: 1.20% YTD 2014 return: 5.17% NAV per Share: 119.63

Class D (EUR): MTD return: 1.25% YTD 2014 return: 5.12% NAV per Share: 118.89

Portfolio and Market Commentary:

Credit markets continued performing well during May, led by EM corporate bonds: in high yield, spreads tightened by 46bps, to return +2.4% for the month (5.6% year-to-date) while IG spreads declined 21bps, to return 2.2% (5.5% year-to-date). In contrast with the previous three months, spread tightening across developed markets stalled, although very strong treasuries and carry ensured a solid performance for US and European high yield markets, which returned 0.9% and 0.7% for the month (4.6% and 4.1% year-to-date, respectively) (1).

While all individual positions performed well during May, the performance of the fund was primarily explained by three investment decisions, which we review in turn below.

We significantly reduced our exposure to European High Yield during May, since we believe pending monetary easing by the ECB is unlikely to provide the expected trigger for spread tightening, leaving the asset class vulnerable to profit-taking and negative shocks, in our view. ECB president Draghi all but tied his hands on May 8th when he declared that the Governing Council was “comfortable” with acting at the June meeting – making a cut in rates and a package of measures to support SME lending a done deal in our view. We believe that European credit markets had priced in such limited monetary easing even prior to May 8th, leaving the balance of risks very much balanced between two equally unlikely outcomes : no action on the one hand, and asset purchases on the other hand. At the same time, the return of volatility in European Sovereign during the third week of the month provided both a reminder about the lack of liquidity in credit markets, and put to rest any belief that periphery Sovereign bonds were again trading as “rate products” without credit risk. In the event, the episode of volatility proved short-lived but should, in our view, provide a floor to corporate spreads.

The second factor explaining the performance of the fund was our absence of exposure to Russian risk. May saw a dramatic rally in Russian assets, with the benchmark equity index rallying 9.6% and hard currency Eurobonds returning 6% (+1.1% year-to-date (2)), as investors cheered the “de-escalation” of tensions between Ukraine and Russia. We broadly believe that both their sell-off and subsequent rally reflected a fair assessment by investors of the balance of risks for Russian Eurobonds: the crisis never seriously threatened the actual ability of large Russian companies such as Gazprom or Sberbank to service their external obligations, as reflected in their

Eurobond spreads which peaked around 400bps (3) in early May, or approximately the spread at which BB credits trade in EM. The higher risk premium assigned to those credits, in other words, did not reflect a deterioration in credit worthiness as much as an attempt to price in "geopolitical risks" : in this particular case, the interplay between President Putin's still obscure end-game and Western powers' conflicting political and economic priorities. With spreads having largely normalized, our focus is likely to remain on the deterioration of the macro outlook in Russia and its possible impact on Russian issuers. While we do not rule out taking positions in Russia (indeed, the fund opened a small position in Borets, the Russian electric submersible pump producer, during May) our bias remains negative.

Finally, our view that the treasury rally since the start of the year was largely explained by technical factors, notably crowded positioning, wrong-way shorts and pension funds rotation, has certainly been challenged by the persistent decline in yields across the curve. While we are aware of several theories which could provide a fundamental explanation for the rates decline, including the possibility that neutral Fed fund rates could have permanently declined, we remain wary of justifying every short-term market move with structural theories: the 50bps rally in 10-year treasuries experienced since the start of the year, while significant, is by no means extraordinary (indeed, we counted 17 such episodes over the past 20 years) and just about every level in treasury rates can be rationalized ex-post (4). We therefore do not believe that there is an investment case (albeit possibly a trading one, since our stance remains in the consensus) to extend duration at this point. We also believe that investors calling for a further rally in treasuries would be better served taking a direct exposure in core rates rather than through corporate bonds, since the implications of a further decline in rates for credit spreads are far from certain.

(1) Source: Bank of America Merrill Lynch Indices EMHB, EMIB, H0A0, HEAD.
(2) MICEX and Bank of America Merrill Lynch ERUH Index
(3) Benchmark US$, 10-year Eurobond
(4) Investors may remember in early 2011, while UST 10 year rates were hovering at 3.3%, the consultancy McKinsey was calling for permanently higher rates in the next decade, noting "the long-term trends in global saving and investment that contributed to low rates in the past will reverse [as] developing economies are embarking on one of the biggest building booms in history. [...] The world may therefore be entering a new era in which the desire to invest exceeds the willingness to save, pushing real interest rates up. "

Portfolio Composition:

	Average Rating	Market Value (%)	Price	Mod. Dur.	Yield	Carry	Z-Spread	PnL Contrib.
SphereInvest Global Credit Strategies								
	BB-	100 %	105.0	4.1	5.5 %	6.2 %	421	100 %
Largest 5 Positions								
	B+	19 %	108.5	5.7	7.0 %	8.1 %	555	11 %
Regions								
Latin America	BB-	26 %	104.1	5.4	6.9 %	7.8 %	512	42 %
Developed Europe	B	21 %	108.5	4.9	6.6 %	7.7 %	503	13 %
Eastern Europe / CIS	B+	13 %	106.0	4.6	6.5 %	7.2 %	537	12 %
Treasury Bills	AAA	11 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Cash	AA	10 %						0 %
Asia ex-Japan	B+	9 %	104.1	5.2	8.5 %	9.1 %	698	12 %
North America	B+	8 %	105.6	5.5	7.0 %	7.6 %	506	12 %
Middle East / Africa	B+	2 %	102.8	5.1	6.1 %	6.4 %	423	8 %
Corporates/Financials								
Corps	B+	54 %	105.3	5.5	7.2 %	8.0 %	563	76 %
Financials	BB-	25 %	106.7	4.2	6.3 %	7.5 %	473	24 %
Treasury Bills	AAA	11 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Cash	AA	10 %						0 %
Sectors								
Consumer Finance	BB-	15 %	105.9	4.5	6.6 %	7.5 %	488	12 %
Media	BB-	13 %	107.1	5.5	5.9 %	6.7 %	445	15 %
Real Estate Management & Development	BB-	12 %	104.4	5.8	8.0 %	8.5 %	655	7 %
Treasury Bills	AAA	11 %	100.0	0.1	0.0 %	0.0 %	0	0 %
Cash	AA	10 %						0 %
Telecommunications	B	10 %	107.5	4.7	6.8 %	7.7 %	495	20 %
Commercial Banks	BB	9 %	108.1	3.7	5.7 %	7.5 %	438	12 %
IT Services	CCC+	4 %	111.0	4.3	7.4 %	8.9 %	660	0 %
Food Products	B	4 %	109.4	5.0	7.5 %	8.7 %	566	11 %
Transportation Infrastructure	B	3 %	106.3	3.7	8.4 %	9.4 %	696	4 %
Machinery	BB-	3 %	97.9	3.6	8.2 %	7.8 %	691	1 %
Airlines	B-	2 %	83.7	9.2	10.5 %	10.5 %	785	1 %
Utilities	-	2 %	103.6	12.6	7.2 %	7.2 %	421	7 %
Oil, Gas & Consumable Fuels	B+	2 %	102.8	5.1	6.1 %	6.4 %	423	10 %

	Average Rating	Market Value (%)	Price	Mod. Dur.	Yield	Carry	Z-Spread	PnL Contrib.
Ratings								
BB-	BB-	20 %	105.7	4.2	6.5 %	7.5 %	509	14 %
B	B	17 %	105.8	4.5	7.7 %	8.4 %	632	23 %
BB	BB	15 %	105.9	5.6	6.5 %	7.6 %	496	20 %
AAA	AAA	11 %	100.0	0.1	0.0 %	0.0 %	0	0 %
AA	AA	10 %						0 %
B-	B-	8 %	102.2	6.3	7.7 %	8.5 %	543	6 %
B+	B+	7 %	105.2	4.5	6.7 %	7.4 %	493	17 %
BB+	BB+	6 %	107.5	5.8	6.1 %	6.9 %	404	9 %
CCC+	CCC+	4 %	111.0	4.3	7.4 %	8.9 %	660	0 %
NR	-	2 %	103.6	12.6	7.2 %	7.2 %	421	3 %
BBB-	-	0 %						5 %
BBB	-	0 %						3 %
Currencies								
USD	BB+	71 %	103.6	3.7	5.1 %	5.7 %	390	81 %
EUR	B+	18 %	106.5	5.2	6.2 %	7.0 %	517	12 %
GBP	B+	11 %	110.3	4.4	6.8 %	8.3 %	480	7 %

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%								**5.17%**

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%								**5.12%**

Past Performance is no guarantee of future results.

Performance figures are net of all fees.