GENERALI INVESTMENTS

Exploiting Credit Opportunities Through a Long/Short Approach

Q&A with Simon Thorp, CIO UK and Fund Manager of the Aperture Credit Opportunities Strategy

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Simon Thorp is the Chief Investment Officer, UK, based in Aperture's London office. Simon is a career credit investor, with over 30 years experience in fixed income markets as well as an investing track record spanning over 15 years, most recently serving as the CIO of KKR Credit. His experience spans broking, investment banking and fund management. Simon received his B.Sc in economics and politics from the University of Keele. He has received and been nominated for numerous honors throughout his career, including Hedge Fund of the Year in 2009, the 2005 Eurohedge runner-up for Credit Fund of the Year, and nominations for Credit Fund of the Year in both 2008 and 2009.

With the one year anniversary of the fund, can you provide insight on how it has performed thus far? How was it managed, which investment strategies worked and which didn't? What were the main contributors to the fund's success this year?

The fund launched in early August 2019 and it's fair to say that whilst the expected investing environment turned out to be quite different from our expectations, the performance of the fund was up 3.96% (I USD Cap share class as at end of August 2020) outperforming the Secured Overnight Financing Rate (SOFR) +2% benchmark by 2.28*%.

One area that I believe has been beneficial is the added value of having parallel investment teams in New York and London. We believe particularly in March, where we saw the peak of the meltdown and subsequent periods of volatility, having the information flow between the two teams being so close to the ground (both in terms of fundamentals and technicals) proved to be invaluable.

If we split the year into three periods we can see how our various strategies added to the overall performance.

The first 6 months was characterised by low volatility and credit compression. During this time the core longs and carry contributed most to performance whilst shorts and hedges tended to be a drag.

Then, when the market sold off sharply in late February and March, the reverse was true. Shorts (especially single names, which faced the worst of the COVID-19 headwinds), relative-value/negatively convex trade structures, index hedges and equity puts allowed us to hold many of our favoured positions as prices fell.

This helped us to limit our drawdowns to ~5% while global high yield markets were closer to -20%.

The third period has been one of recovery and here the main contributors have been core longs (corporates and financials), special situations and primary issuance. The latter category typically plays a minor part in performance attribution but the vast levels of particularly early supply, and much of it being investment grade, aimed to provide an attractive risk/reward opportunity, especially once the Fed had stepped into US credit markets.

The detractors over the period were almost exclusively our shorts. Out of the money equity puts and credit indexes (Itraxx and CDX) as portfolio hedges. Single name shorts (cash bonds and CDS) which rallied as the rising tide lifted all ships.

Where does credit stand and what are the main opportunities investors should look at?

Global credit markets continued to rally over the past three months driven by easing of lockdowns, liquidity injections by central banks and governments, and positive surprises from macro-economic data. This backdrop incentivized investors to continue allocating money to the asset class with strong mutual fund and ETF inflows especially towards US investment grade (IG) and high yield (HY) credit.

The rally has been led by higher quality names (both corporate and financial) whilst HY has tended to underperform, held back by the weaker sectors (travel and leisure) and the CCC segment. The US inflows were instrumental with US HY recording its strongest month this July since 2011.

*Source: data as of end of August 2020, for more information on the performance please refer to the sub-fund' factsheet.

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Meanwhile, European credit has tended to underperform a little with Emerging Markets (EM) bringing up the rear - mainly as a result of negative COVID effects in Africa, India, and LATAM. To illustrate the scale of the rally, CDX HY (US HY index) was trading at a spread of 300bps pre-COVID. It widened in March to 870bps and is currently back at 395bps. With real economic damage having been sustained globally and a heightened degree of uncertainty remaining, it is not obvious that credit markets retain much in the way of value at these levels.

So what opportunities are we seeing as we begin the run towards year-end? Decompression across credit markets have left some relative value in slight weaker segments of the market. For instance, BBs look attractive versus BBBs and Bs versus BBs. Assuming markets remain reasonably stable, we would expect to see compression as a key theme over the next 3-4 months. In weaker credits and those names where pricing has become overly optimistic, we like relative value trades (both negative basis and senior versus subordinate debt) as ways of generating positive returns as negative news appears whilst not incurring the full costs of naked shorts.

On the long side, we continue to like European bank subordinate debt and are screening the travel and leisure sectors for those names that might surprise the upside while currently trading at significant discounts. Overall, we continue to run long outright risk-adjusted exposure split fairly evenly between US and European credit, although we have reduced this net exposure by about one-third since the end of July. Our favoured hedges remain Out of the Money (OTM) equity puts as volatility declines and equity markets continue to push higher.

Why could a long/short credit strategy prove effective for institutional investors' portfolios?

Our strategy of being long and short in credit allows us to try to select the best opportunities for the long side of our portfolio i.e. names that are undervalued, that we believe to be improving in credits. On the short side we seek the mirror image of that i.e. overvalued names with a deteriorating profile. In that way we aim to protect invested capital, especially when we do have a big market move. This balance is why our strategy is attractive to institutional investors aiming to generate stable long terms returns in their portfolios.

The key, from a 360 degree view, is trying to be flattish on a risk-adjusted basis when markets begin to go down, maybe even a bit short, and then to undo some of those shorts as the markets begin to bottom out, to expose those long positions that can benefit from a rally.

Post the rally of the past five months, we believe credit markets to be at best fair value at current levels and, at worst, moving into overbought territory. Consequently, we see that the bulk of the beta trade has been had and some caution needs exercising. The best risk-adjusted returns are in parts of the market that remain mispriced. These are often best expressed as relative value (RV) trades (pairs, basis, or capital structure arbitrage) and are the mainstay of credit long/short strategies.

We also look to build convexity into the portfolios (positive and negative) and the current credit market environment is one where we see abundant opportunity in this regard. On the long side of the balance sheet, we aim to add credits where we see limited downside, but with an emerging positive story that will result in significant price appreciation (spread tightening) and the news is assimilated by the market. For shorts, the opposite is the case. We identify credits where we see some potentially negative news likely to appear in the short term but where the market has been overly optimistic and/or complacent in its pricing. Shorting names with limited upside but plenty of scope for price falls (spread widening) leverages off the asymmetric risk profile that is a key element inherent in all credit markets

Scouting opportunities in credit: the powerful mix of experience, coverage and research

Our philosophy is to protect investors' capital. We seek opportunities that do not come around often, we do deep fundamental work, understand if something seems to be misunderstood or mis-priced by the markets, and then buy (or sell) in a relatively concentrated manner. Over time we also tap cheap insurance to protect the portfolio because no one knows when the next move is going to happen.

We are set up to protect investors' capital in a bear market. In a bull market our philosophy is to target Alpha through the selections that we make, with a smaller amount of our return being Beta. We don't run 100% of our money in long only (we're normally running 25-30% long on a risk-adjusted basis).

As a long short fund we can use leverage, we can short single names and we can use indices, options, and ETFs to hedge and increase the amount of exposure. We have numerous tools to try to optimize our portfolio.

Our approach to single names is informed by the top-down themes we look at. We use quantitative models to find the names that we think can best perform if a theme is correct. Analysts then dig in. This is a top-down approach followed by bottom-up analysis. Other times we'll start with an individual credit idea.

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Fund in focus
Aperture Credit Opportunities

In those cases we look at the specific name, do the work, and see whether it can fit in the portfolio and has the correct risk reward profile.

In active management there is no substitution for experience. We've been doing this a long time: I set up one of Europe's first long short funds over twenty years ago and so we have seen a few cycles. The majority of our team has been intricately involved in credit markets for more than 12-14 years. Additionally, our NYC and European-based teams mean that we are covering ~95% of the global liquid credit markets. Real time information is passed between the two teams throughout each day to help one another.

US credit markets are three times the size of Europe. Many occurrences in the US tend to follow through to Europe and the rest of the world. It is the combination of experience, having this twin-centre approach, and operating a hybrid approach to investing, that sets us up for success in our portfolio.

AuM	$592 M (as of 31st August 2020)
ISIN	LU1958553239 (I EUR-H Acc.) LU1958553072(I USD Acc.)
Launch of sub-fund	05/08/2019
Benchmark	Secured Overnight Financing Rate (SOFR) +2%
Fund Currency	USD
Domicile	Luxemburg
Management fees	0,39%
Performance fees	30% > benchmark
Management Company and Investment Manager	The management company is Generali Investments Luxembourg S.A. who appointed Aperture Investors as investment manager

To find out more on the strategy
CLICK HERE

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