. 14 may 2020 .

SILEX FUND

FLEXIBLE BOND

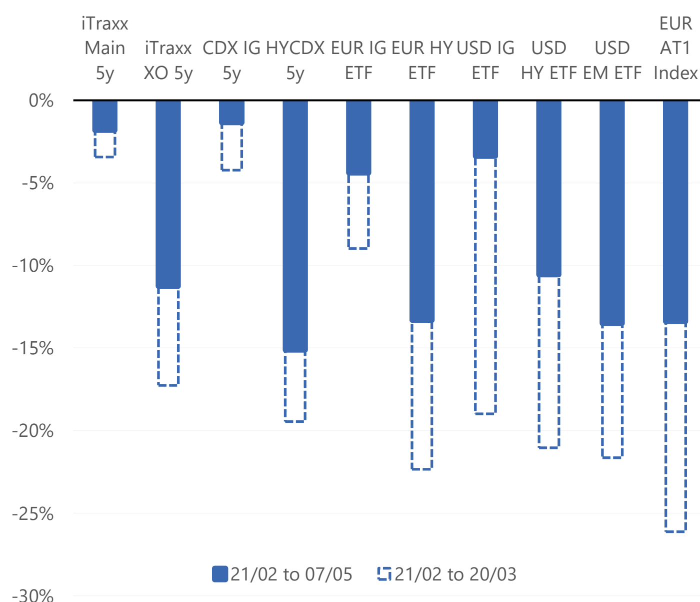
A sub-fund of SILEX Fund, Luxembourg SICAV approved by CSSF

UPDATE & OUTLOOK

Market Background_

Fixed income markets have been subject to extreme volatility since the beginning of the year and the Covid-19 outbreak. Credit spreads have widened at the fastest pace on record and are still left at very elevated levels despite the recent retracement. In March, **corporate bond portfolios experienced the most severe monthly drawdown in history.**

Figure 1_ Overview of recent drawdowns across credit markets (total return in %)



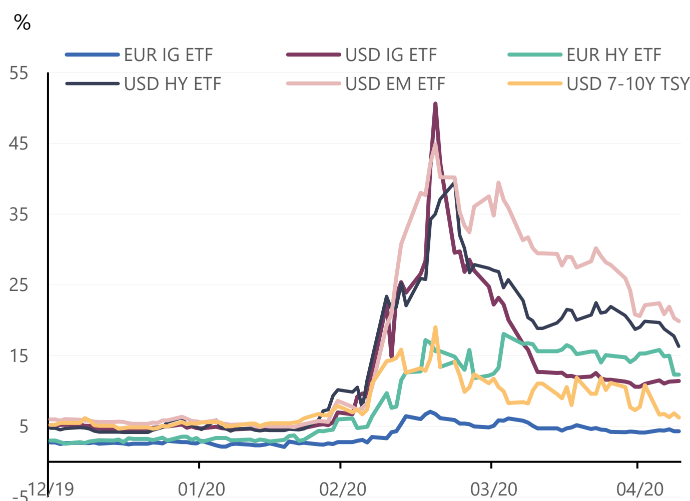
Source : SILEX, Bloomberg -12 may 2020

Bond ETFs' **implied and realised volatility rose to extreme levels before normalising** as Central Banks announced various bond buying programs, designed to reduce negative feedback loops. (Figure 2).

Government and corporate bond **liquidity conditions deteriorated sharply in March and have since normalised**, well underpinned by increased Central Bank buying flow and/or demand backstop..

Market and systemic risk have decreased materially. Central Banks have explicitly signalled the persistency of recent programmes and the high likelihood of further support. We are therefore confident that the levels of volatility observed in March are unlikely to be seen again for some time.

Figure 2_ YTD Bond ETF Implied Volatility



Source : SILEX, Bloomberg -12 may 2020

Sector and issuer risk remain elevated. As aggregate demand undergoes an extreme fall in H1 2020, many sectors/companies' top lines are falling heavily, implying heavy cash burn for various segments where a significant proportion of the cost base is fixed. This is leading to a very rapid rise in the volume of defaults in the most speculative parts of the market (e.g. HY energy and retail). In turn, many issuers facing challenging short-term liquidity conditions are able to access various government programmes, reducing the risk that companies with viable business models end up defaulting.

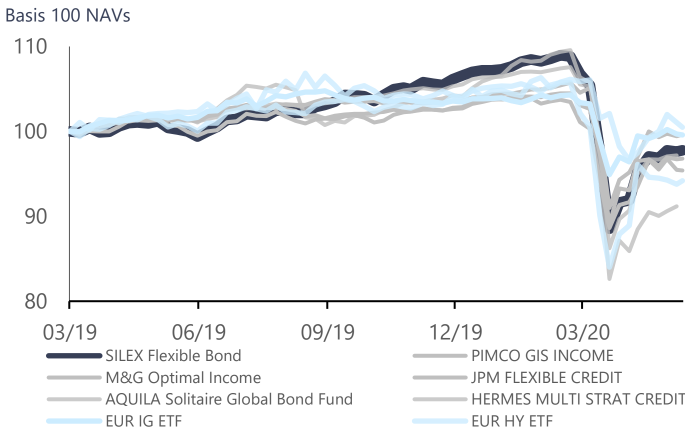
Interestingly, after freezing for a couple of weeks in March, primary markets have reopened and **April has set a new record for monthly USD IG issuance** by some margin.

Fund performance and positioning_

After a very strong relative performance during the first year, the Flexible Bond fund experienced a larger-than-expected drawdown in March, in line with bond market performance and its allocation mix. A higher cash balance or exposure to Treasuries would have reduced the drawdown somewhat.

Nevertheless, about half of the drawdown has been recovered over recent weeks as credit spreads retraced a portion of their widening. The fund has taken advantage of highly attractive conditions in the primary market, with new issues contributing well to recent performance.

Figure 3_ SILEX Flexible Bond YTD performance (EUR I Share class)



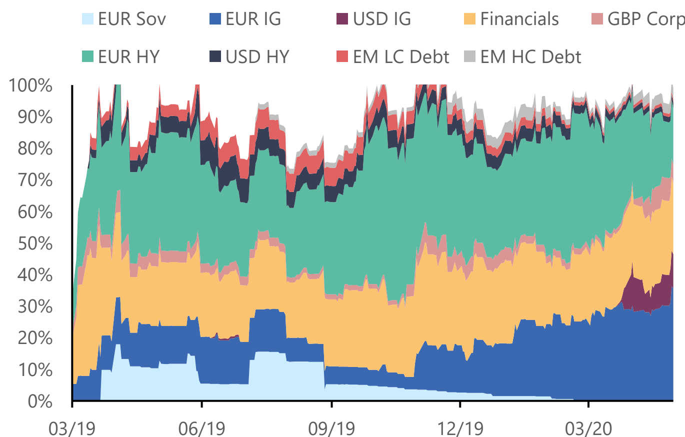
Source : SILEX, Bloomberg -12 may 2020
Past performance is not necessarily indicative of future performance

The allocation mix has evolved towards a more defensive positioning **as we reduced exposure to HY when the opportunity cost of doing so was low.** HY issuers now represent just over 20% of fund NAV, with single-B rated issuers at less than 3% and focused on food retail.

In turn, **EUR and USD IG allocations increased materially** as parts of these segments present superior risk/reward profiles. Indeed, new issues are attractively priced and with stronger terms than anything seen in recent years. They present a very compelling opportunity as they benefit from higher liquidity in secondary markets whilst the issuer is able to strengthen its liquidity position and prove market access.

The fund is positioned in the segments which we view as most likely to benefit from strong policy support and therefore superior technical factors.

Figure 4_ Historical allocation mix



Source : SILEX, Bloomberg -12 mai 2020

We continue to maintain a strong non-cyclical bias towards sector exposure. However, we have started to increase exposure to cyclical sectors via issuers with very strong balance sheets and best-in class operations in their sectors, often via primary markets (e.g. BMW and VW recent USD new issues). We maintain a healthy allocation to financials where default risk remains remote. Legacy subordinated debt remains our preferred way to express our views on the sector.

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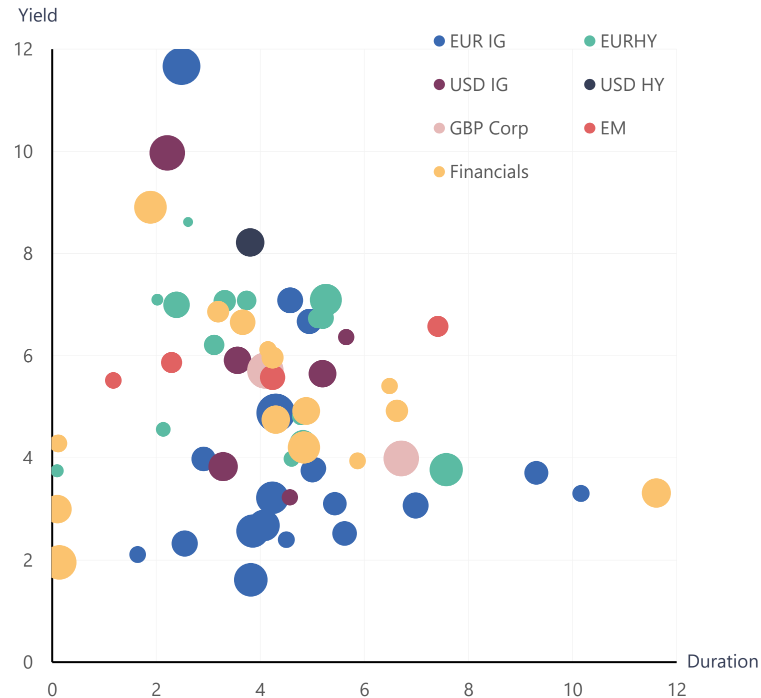
Portfolio stats:

- Median issuer/issue ratings: BBB/BBB-
- Average EUR yield ~5%
- Average gross/net duration 4+/3+
- Largest industry exposures: banks, REITS, TMT, food retail

Figure 5 Yield / Duration & weight distribution



Source : SILEX, Bloomberg -12 may 2020

The current market environment is a fantastic ground for actively managed bond funds with the right size as there are healthy liquidity conditions, enough volatility and dispersion (i.e. numerous compelling rebalancing opportunities). The fund has therefore been particularly active in recent weeks, with a significant portion of the excess turnover coming from participation in new issues.

Outlook_

Attractive valuations, strong policy support and reduced economic downside all support elevated expected returns for corporate bonds. After a significant capitulation from bond ETFs and fund investors in March, the market structure is now healthy and opportunities abound.

This puts us in a good position to recover the full drawdown in due course and get back to the prior annualised return pace.

We aim to achieve this with the lowest possible level of risk – we are constantly monitoring the portfolio's risk/reward distribution and opportunities to improve it.

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