ASG Capital Perspectives for the Second Half of 2017

In the summer of 2016, ASG Capital published a review outlining the strong potential of the subordinated asset class on which the ASG investment strategy is focused. As a reminder, we argued at that time that three main forces would drive the future performance of this market:

1. Continued world Central Bank monetary injections (notably from the Bank of Japan, and the European Central bank) would keep crowding out Bond investors from their traditional fixed income markets into alternative bond investment solutions, which included the subordinated debt asset class.
2. Continued need for yield from investors in a historically low interest rate environment, would make assets with 4 to 6% carried return, such a subordinated bonds, an attractive investment solution.
3. Improving issuer financial results and deleveraging would translate into stronger Balance sheets underpinning subordinated debt instruments, thereby reducing the traditional risks normally associated with this asset class.

Our foresight at that time has translated into strong performance results for our flagship fund with over +13% return year-on-year basis, and +7% since 1st January 2017. Even though this is a very satisfactory result, ASG is focused on looking ahead to continue to create value for its investors.

Perspectives

In our view, one of the main areas to focus on in the coming months will be world Central Bank monetary policy, notably that of the Federal Reserve. Since 2009, this institution has led the way for world Central Bank intervention, which has had a profound impact on Fixed Income markets. Fast forward to 2017, the proposed policy changes announced by different Federal Reserve officials could potentially have the same significant repercussions as was the case back in 2009. What are these proposals? :

a. Normalization of interest policy, with a reversal back to historical norms,
b. Reduction of the Central Bank balance sheet, in other words a Quantitative Easing policy in reverse.

The effect of a monetary intervention of this kind will be dependent on the time horizon for its implementation, whether the Federal Reserve actually goes through with these changes or not, as well as the policy reaction other world Central banks which could sterilize the full impact of this process. On paper, Fixed Income markets could be affected in four main areas:

1. ***Capital Bond Flows.*** Seeking returns in a low interest rate environment, speculative investment bond flows have tended to chase capital gains rather than carried yield returns to generate performance. World Quantitative Easing policy has provided a certain visibility for market participants as to the positive potential that Bond instruments could provide, in terms of Capital gain. Therefore, investors have positioned themselves accordingly, sometimes using leverage to enhance results. As a result, the demand for bonds has been strong. In the case of a more normalized interest rates scenario, this visibility would not be so clear. Faced with potential Capital losses in a rising interest rate environment, these same investors would most probably hold off from investing or using leverage to the same extent as in the past. The demand notably for low yielding quality bond instruments, which are more sensitive to Capital gains or losses due interest rate changes, would likely be affected the most.
2. ***Crowding out.*** The Quantitative Easing policy of the last few years has had the effect of crowding out some investors of their traditional bond markets. This trend has pushed capital flows into alternative Fixed Income investments such as the High Yield and Emerging debt markets, to lesser extent the subordinated debt market. As the Federal Reserve moves to normalize interest rates, with the European Central Bank eventually looking to do the same, this crowding out effect could work in reverse. Investors would seek to return to more familiar investment pastures where they would now find greater bond availability as well as higher yield returns. This could take demand away from the alternative bond investment space, notably High Yield and Emerging debt markets which have been the prime beneficiaries of this past trend up to now.
3. ***Predominant Central Bank action.*** Since 2009, bond markets have become totally dependent on Central Bank intervention. Natural price discovery and volatility have given way to monthly asset purchases from these institutions. As Federal Reserve policy moves to less interventionist approach in the biggest world bond market, participants are not quite sure how the financial industry will react. One thing is very clear: low interest rates, increased regulation and deleveraging of bank balance sheets have reduced the number of participants animating world bond markets. In effect by changing their policy to a 'laissez faire' approach, the Federal Reserve policy could create a sort of trading void, which in turn

could lead to dysfunctional bond markets.

4. ***Higher overall Private and Public debt.*** Since the start of the financial crisis in 2007, overall Private and Public debt has increased. Therefore, any substantial interest rate rise could have a significant impact on financial and macro-economic activity. Since 2009, the world has moved into a 'new normal' of low growth notably for advanced economies principally due to a large private debt overhang that had been built up at that time. The Federal Reserve needs to show restraint when rising interest rates in order to reach a level that is serviceable by today's economic environment. Therefore, there is a delicate fine-tuning balance that needs to be achieved.

Faced with potential head winds, ASG has chosen the following approach. With an underlying theme of flexibility in the face of a changing environment, ASG has positioned itself in the following four main areas, to be able to benefit from possible outcomes:

a. ***Short Modified Duration.*** By keeping a short modified duration, ASG reduces its sensitivity to future interest rate changes, and their potential impact on asset valuations in the portfolio.
b. ***Re-investment option***. With uncertainty ahead, ASG has chosen to increase its allocation to bonds with a short-term or potential short-term maturity. The advantage of holding such instruments is that as market conditions change ASG will have the option to use its re-investment capability to fully benefit from future investment opportunities.
c. ***Stay away from the herd***. Larger Fixed Income funds have pilled into very similar trades in search of investment volume. Some of these bond assets are now looking over priced. ASG seeks to stay away from these movements focusing on investments that make economic and financial sense, to achieve a balanced risk/reward mix.
d. ***Diversify the coupon structure.*** With uncertainty on future interest rates, it makes investment sense to keep all options open. ASG has opted for a variety of bonds with different coupon structures, which the subordinated asset class is one of the few to provide. These include variable, fixed, and fixed to variable rate bonds. Two main advantages exist in this approach. Firstly for bonds that are correctly exposed to interest changes, these will perform well as this scenario materializes. Secondly, the increase in current general uncertainty has also raised the optional value of subordinated instruments where the carried yield of 4 to 6% gives a return protection to the investor who is paid to wait to see how the future unfolds.

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