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Market Commentary

The undifferentiated bull market rally which started almost a decade ago was quite an extraordinary moment in time. ETFs and long-only funds generally ridiculed the performance of alternative strategies - for a much lower fee, ultimately questioning the *raison d'être* of the Hedge Fund industry.

However, those were truly supernatural times. Markets were distorted by the actions of central banks. The extraordinary amounts injected into financial markets created an environment of low dispersion, low volatility, and steady rise of risky assets. A world for beta and ETFs, not for selective pickers. A world somewhat at odds with the rules of capitalism, where selection and excellence mattered less than ever.

As much as the complacent central banks' policies helped foster this environment, the upcoming end of QE in Europe now implies the return of dispersion and volatility. Those are the conditions for alternative strategies to make sense again, putting in-depth analysis back at the centre of returns. Further to the volatility spike in Q1 2018, the recent widening of European credit indices highlights a clear change of regime in European markets.

In the meantime, several imbalances have been building up. The most dangerous of them might well be the liquidity mismatch, with some large daily liquidity funds investing into instruments whose liquidity was artificially sustained by the never-ending inflow of money in the financial system.

In January and February 2016, we witnessed a glimpse of market fragility. As global risk appetite deteriorated sharply, liquidity in the European credit market froze, and the value of credit assets collapsed, most notably CoCos. However, the ECB expanded its QE programme aggressively in March, muting fears and paving the way for a new period of a low volatility rally. The lesson was not learned.

Now, combined with the upcoming end of the ECB's QE program, we believe the return of volatility could trigger substantial fund outflows. This could create significant market turmoil, aggravated by the liquidity mismatch described above in the "liquid hedge fund" and UCITS universe. This time however, we believe the probability of a white knight saving the day is much more remote.

The magnitude of the downturn will primarily depend on the extent of outflows out of the "mismatched funds", as they would trigger an overhang in illiquid asset classes, and potentially, significant mark downs.

We believe attractive investment opportunities could soon be forming, and we are geared to gaining entry at the right levels (and with the right liquidity profile).

Could this scenario fail to materialise? Could there be an orderly reshaping of liquidity profiles? One reason why our analysis could be tested is that some of the "mismatched funds" have turned into brands and count their investors in the stickier part of the spectrum, such as private banking and advisor networks. Some UCITS funds consistently display bottom quartile performance over the short-to medium-term and yet command AuM in billions.

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Even if these funds resist outflows and manage their mismatches, markets have already started normalising out of the “Central Banks distortion”.

Regardless of market direction, the subsequent increase in dispersion shall play in favour of fund managers such as Chenavari, with trading-oriented strategies backed by a deep bench of fundamental research. Very recent and numerous examples, like the rise of Altice or the pressure on Softbank, again highlight the renewed importance of fundamental analysis, and the rising opportunities to generate alpha via long/short strategies.

To conclude, the Fund’s nimble and agnostic approach enables it to seize opportunities as they arise - without compromising the Fund’s liquidity profile. As Beta becomes less of a return driver, perhaps even a negative one, we believe this upcoming new cycle will be more exciting for alternative investment managers than we have seen in a long time, paving the way for real alpha generation.

Positioning of the Fund

Since the start of the year, the Lyxor/Chenavari Credit Fund is up 0.23% (class SI, USD to 5 June)¹. This performance in troubled markets highlights the focus on capital preservation of the Fund, and its nimble approach.

The UCITS Fund ranks within the Top 10 of Kepler’s league table YTD (Credit Funds, as at end of May 2018), and features within the 93rd percentile of its peer group over 1 Year according to Bloomberg (as at 5 June 2018).

In terms of evolution of the risk profile, we first started reducing risk by taking profits post the January rally; in February, we reduced risk further as the Italian elections approached. The sensitivity to a 20% widening of spreads was halved from -1.5% in February to -0.75% in mid-March (see Chart 1 below).

Over the past few weeks, in continuation of the overall risk reduction that took place earlier in the year, we focused primarily on:

- (i) increasing the fund’s convexity profile, and
- (ii) minimising basis risk by adding more bond shorts

We also increased cash levels from the low teens to high twenties, as market sentiment continued to deteriorate. In April, as fears of a US-China trade war intensified and European economic data slowed down, we reduced the long bias again. The exposure to a 20% spread widening scenario came to zero and was even positive towards the end of May.

¹ Source: Bloomberg

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Chart 1: Flattening the book over the course of the year (theoretical reaction of the book to an overnight widening of spreads by 20%)



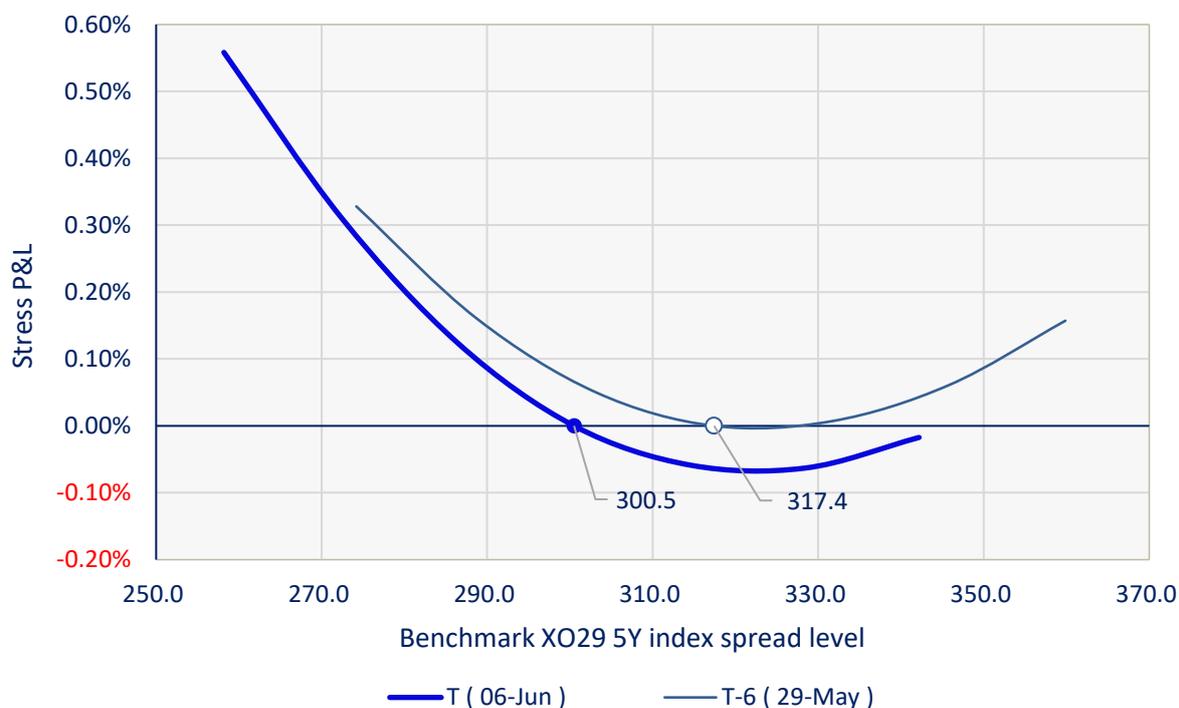
Source: Chenavari, estimated and unaudited as at 6 June 2018. **PLEASE REVIEW IMPORTANT HYPOTHETICAL DISCLAIMER AT THE END OF THIS DOCUMENT.**

More recently, as signs of a possible populist coalition between M5S and Lega in Italy emerged, we reduced the exposure to the Financials sector. In particular, we cut the net exposure to CoCos (AT1) to mid-single digits.

Finally, the Fund's risk profile has greatly benefited from convexity/gamma realisation in the credit and rate derivative hedging portfolio, as well as tactical shorts on targeted credits such as Italian corporates, insurers and low reset AT1s.

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Chart 2: Protecting capital: Lyxor/Chenavari Fund's convex profile on 29 May and 6 June versus iTraxx Crossover index



Source: Bloomberg and Chenavari, estimated and unaudited as at 6 June 2018. **PLEASE REVIEW IMPORTANT HYPOTHETICAL DISCLAIMER AT THE END OF THIS DOCUMENT.**

With our best regards,

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