FAIRTREE

Fairtree Global Flexible Income Plus Fund Quarterly Update Q2 2023

Market Dynamics

Global Risk

The global bull market that started at the end of the 3rd quarter 2022 continued through the 2nd quarter of 2023 with most risk indices printing positive returns during the period. With the exception of the FTSE 100, the majors showed a plethora of good returns with the NASDAQ taking the lead (again) amongst a domination by North American indices over their European counterparts. The NASDAQ was indeed the star of the show, delivering just over 13% to investors in USD whilst the broad-based S&P 500 also shone with a quite respectable 8.74%. What is quite interesting is that the Europeans produced "average" returns in their respective rankings over the past 16 years. Average in that the rank of the Dax was 32 out of 65 quarters, and still produced a positive 3.32%. When coupling this with annualised total returns, one sees the distribution negative skewness at play in that the median quarterly return is way higher than the average return.

Table 1 shows the performance of the major international equity indices as well as the European credit benchmark that we use as a yardstick for the fund performance. It is also interesting to note that the 2 x levered iTraxx Crossover Total Return Index, an index that produces similar levels of volatility as the European equity indices, produced outsized returns over the quarter on a like-for-like basis. The more vanilla iTraxx unlevered, a significantly lower volatility than equities also showed investors 3.40% over the quarter, a performance which has been buoyed by a rallying spread index, lower than expected default intensity as well as an ever-increasing base level of rates which, coupled together, has produced a favourable backdrop for the asset class.

Table 1: Major Index Q2 2023 Total Return and historic rankings Q2 2007 – Q1 2023

	Dow Jones	S&P 500	Nasdaq	Dax	FTSE	CAC40	SX5E	TOP40TR	iTraxx	iTraxx *2
Total Return	3,97%	8,74%	13,05%	3,32%	-0,42%	3,54%	4,25%	0,95%	3,40%	6,02%
Rank (65)	31	15	8	32	45	30	29	38	22	24

(Bloomberg. 30.06.23

When looking at the longer series of returns, we can quickly ascertain which indices have delivered the best risk adjusted return. Our dataset from the beginning of Q2 2007 to the end of Q2 2023 is shown in Table 2. What becomes apparent, again, is the domination of North American equities on a risk adjusted basis. When one divides the total return by the standard deviation of those returns, a good proxy for risk, we

generate comparable return coefficients. The highest risk adjusted return over that period is 0.62 which is generated by the NASDAQ. This number suggest that for every 1% of risk, 0.62% of return is generated. This should not be confused with a Sharpe Ratio, which considers excess return to a risk-free cash benchmark, but still gives some insight into where good risk adjusted returns were generated over the past 16 years. We have always suggested that investing is for the long term and with our dataset now at over 16 years, we could argue that the longer run is more represented as the dataset is elongated. Of course, what we will not contend is the outlook for the indices over the next 16 years as we only have 1 sampled point of the entire distribution in that regard. It has always remained a mystery as to how fund managers and analysts alike can make longer term predictions, using such curtailed information. Predicting any investment outcome requires representative sampling, how this can be achieved with such short historic datasets remains nothing short of baffling. Analysts and managers alike might be construed as being overly confident in their abilities to forecast future outcomes and perhaps fooled by the law of small numbers.

Table 2: Index Risk Adjusted Return Co-efficient

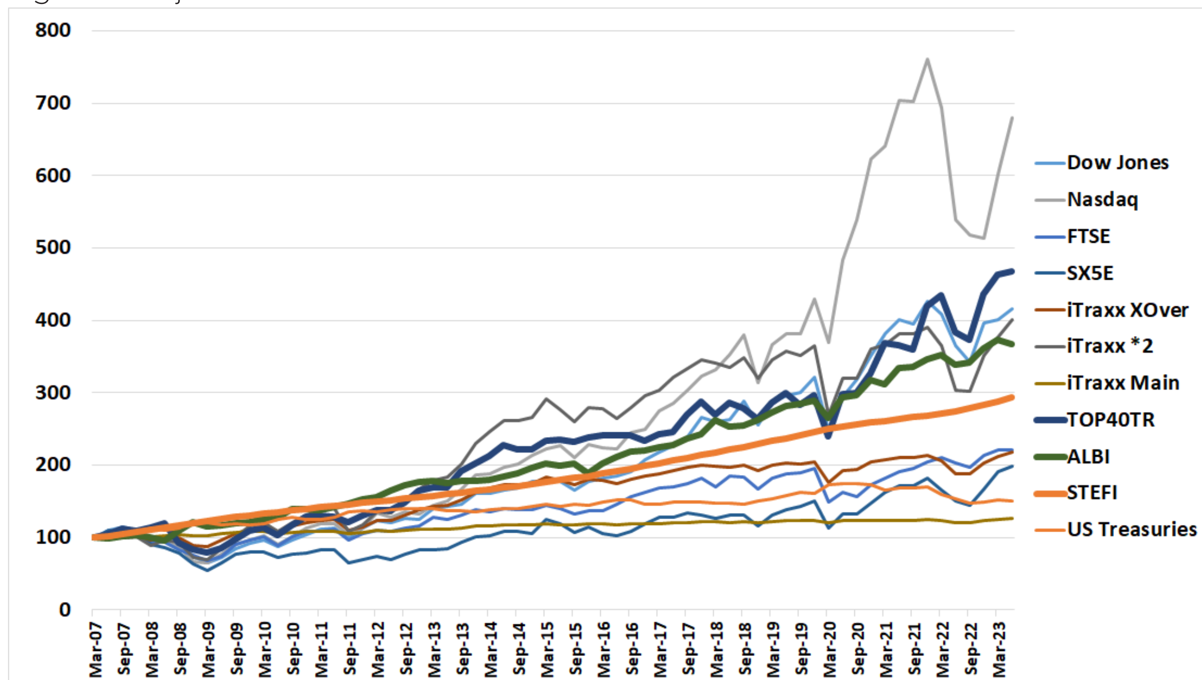
	Dow Jones	S&P 500	Nasdaq	Dax	FTSE	CAC40	SX5E	iTraxx	iTraxx *2
Annualised Return	9,17%	9,45%	12,52%	5,36%	4,99%	5,29%	4,31%	4,92%	8,91%
Annualised Risk	16,56%	17,51%	20,23%	21,18%	14,93%	19,57%	19,78%	9,57%	19,43%
Return coefficient	0,55	0,54	0,62	0,25	0,33	0,27	0,22	0,51	0,46

(Source: Bloomberg 30.06.23)

When looking at the risk and returns in a common basis (currency), one can finally perform a better inspection of the indices. The choice of basis is elementary and has no effects on the comparative outcome of any conclusions that one might arrive at, as long as all indices are convert to that same basis.

Figure 1, below, shows the cumulative return of the various indices in the currency of the particular index domicile. The various performance traces have been indexed to 100 at the beginning of the second quarter 2007, when we have the starting historic data for the iTraxx XOver total returns. As was highlighted last quarter, the outright domination of North American Equity indices has been tempered over the past 18 months, although the resurgence of the Nasdaq has been witnessed of late, primarily due to its great start to 2023 where it has delivered some 32.3% in USD.

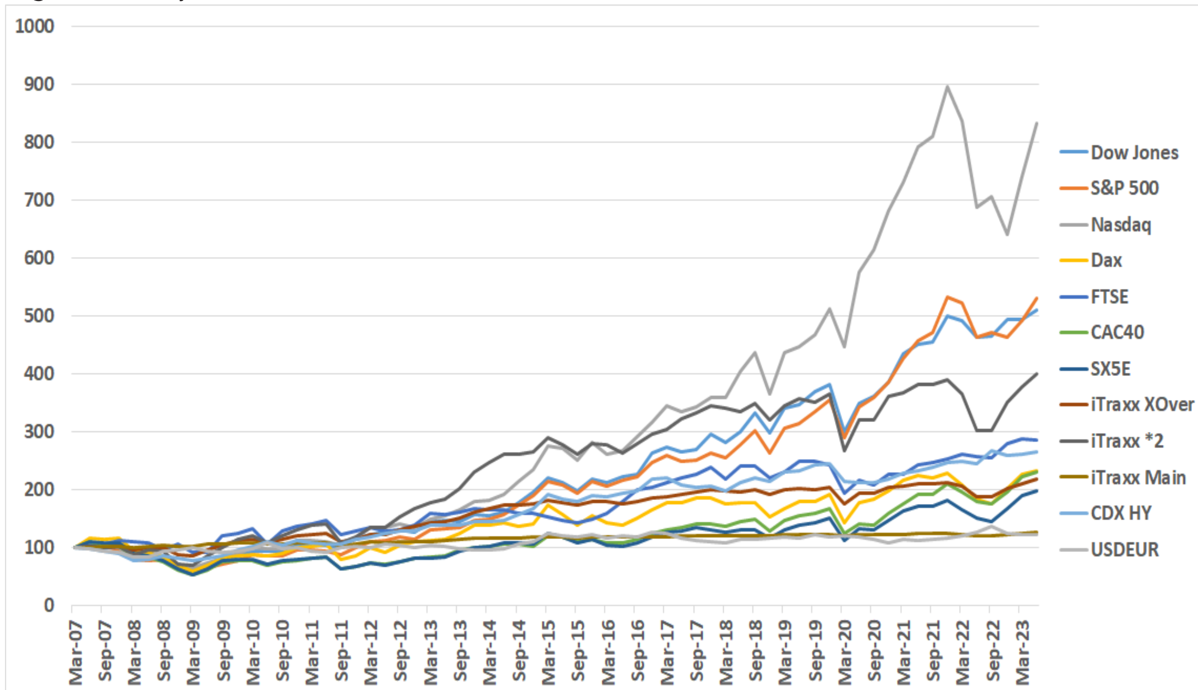
Figure 1: Major Index Total Return Q2 2007 – Q2 2023



(Source: Bloomberg 30.06.23)

Of course, the above figure show returns in local currency which neglects any currency affect. As was previously stated, translating the indices to a common currency – a common basis – allows for direct comparison and shows what investors would have realised, albeit on an unhedged basis. A fuller picture of what has been delivered is now witnessed as all indices are comparable to 100 units of Euro exposure being invested in the different indices then translated back to Euro at the end of each quarter. Obviously, these returns have no fees associated with them and investors may not have realised such giddy numbers. But the bottom line is that the NASDAQ has delivered returns in excess of 8x your original investment back in 2007, which underpins again that investing is indeed for the longer term, and trading in and out of stocks forgoes the possibility of generating these sorts of returns. It is also interesting to note that those returns have been generated amidst the backdrop of the Global Final Crisis, the Greek Crisis, the COVID 19 pandemic as well as the onset of the first major European conflict since World War 2. The other interesting fact to point out is that iTraxx XOver levered has delivered returns in EUR that have dwarfed the performance of European equities – as proxied by the Euro Stoxx 50 Total Return Index. Figure 2 shows the indices as well as the translation effects of EURUSD.

Figure 2: Major Index Total Return in EUR Q2 2007 – Q2 2023



(Bloomberg 30.06.23)

Table 3 converts the traces shown in Figure 2 to numbers that can be more easily compared in tabular form. The other more obvious point to make is that iTraxx Main, an index compromised of 125 equally weighted global investment grade names, remains a non-viable investment alternative to most European investors. The annual returns do not even match the European Central Bank's inflation target of 2%. One would argue that the "Risk Free" nature of the well diversified investment grade index has come at a price to investors, and that price has been paid in low realised returns. Our preferred iTraxx XOver x2 has performed exceptionally well as far as European risk assets are concerned.

Table 3: Index Total Returns and Risk in EUR Q2 2007–Q2 2023

	Dow Jones	S&P 500	Nasdaq	Dax	FTSE	CAC40	SX5E	iTraxx XOver	iTraxx *2	iTraxx Main	CDX HY	US Treasuries	EURUSD
CAGR	10,5%	10,8%	13,9%	5,4%	6,7%	5,3%	4,3%	4,9%	8,9%	1,5%	6,2%	3,8%	1,3%
STDEV	17,3%	18,1%	21,3%	23,6%	17,9%	21,6%	21,9%	10,0%	21,5%	2,4%	11,1%	11,3%	9,9%

(Source: Bloomberg 30.06.23)

We as supporters of the asset class and proponents of the thesis that well diversified credit portfolios could provide the cornerstone to any balanced fund, find it interesting that although investors tend to avoid credit, they seem to do so in spite of the diversification and return benefits of the said asset class. interest rates have kept excess depreciation in check over the long run. It is important to note that this in itself is a distribution of outcomes and although the Euro has come under severe pressure of late, the longer run should mean reverting.

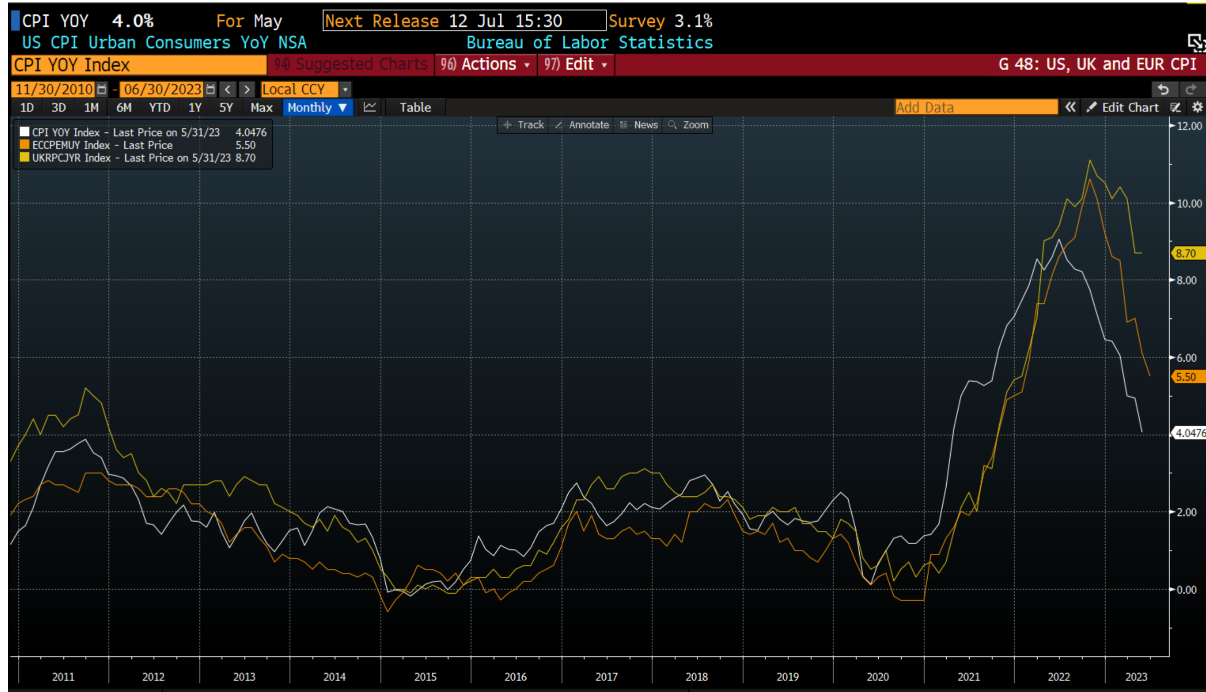
Local Interest Rates

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) met once during the second quarter of 2023 and raised the short-term Repo rate by a further 50 bps to 8.25%. We highlighted in the last quarterly report that the heretofore diffusion administered rates opened up the possibility of another 50 bps increase in this hiking cycle, we felt that rates would have had to be nearer the top of the cycle. There is no doubt that this has come to pass and that current rates, although these may still need to be raised by a further 25-50 bps, are close to the terminal rate ceteris Paribas. The "ceteris Paribas" part is that should the Fed see the need to raise by more than 50 bps to reach their terminal rate, we feel that the Reserve Bank will have to raise rates in excess of the 50 bps that we have pencilled in.

The global "bogeyman" remains the inflation prognosis, and as long as inflation remains at elevated levels, Central Banks will be forced to tune their reaction functions to the stickiness of that said inflation. Rates might need to remain higher for longer than what the market is pricing in. Cycles should be slow moving at the extremes unless they are driven by supply side shocks. The conundrum is that Russia's "Special Operation" in the Ukraine has developed a supply side shock, but the general underlying problem was initially fuelled by excess liquidity and exceptionally cheap money provided by those same Central Banks in response to the Global Pandemic in 2019.

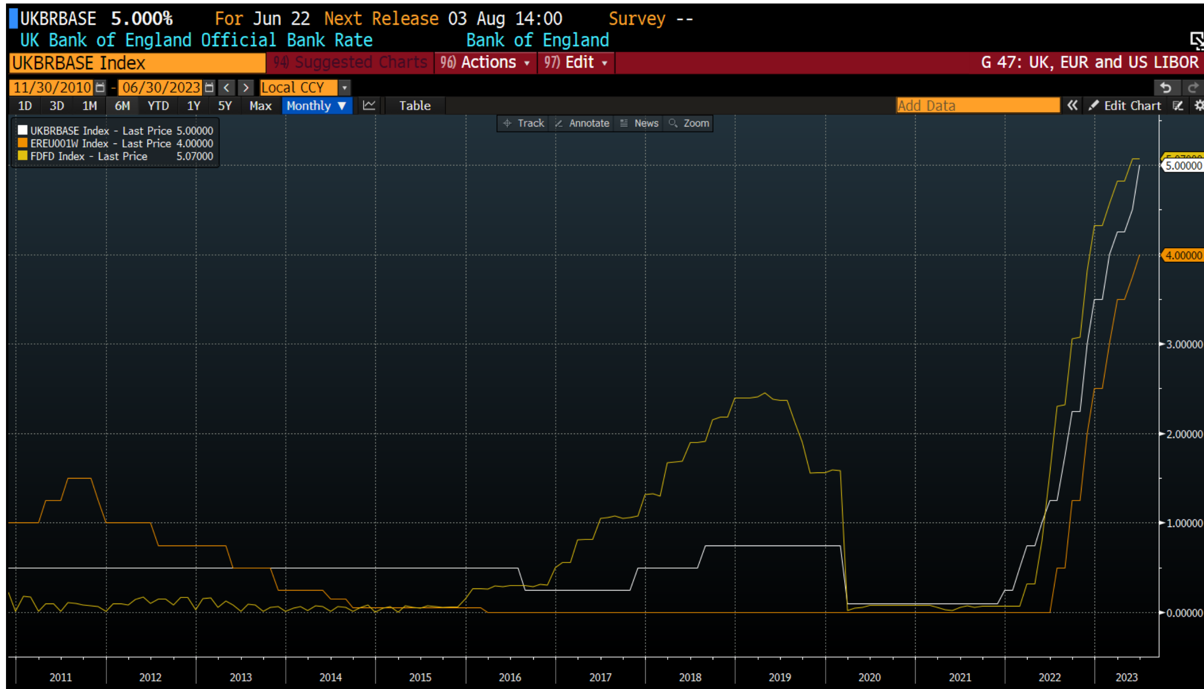
Figure 3 shows the annual change in the US, European and UK Consumer Price Index (CPI) which is commonly known as headline inflation. In looking at the figure, two things become apparent, the first is that inflation has rolled over already, as all the traces are well below their peaks that were experienced in 2022. We can also see that the US inflation experience has led that of their European and UK counterparts. The US seems to lead whilst the others merely follow what has already happened the period quarter in the US.

Figure 3: 1 year %age changes in US, European ad UK CPI



(Source: Bloomberg 30.06.23)

When analysing the Central Bank response to this increase in global inflation it is again interesting to note that the US Federal Reserve has certainly been the most aggressive, in spite of the fact that their inflation is currently the lowest out of the 3 regions. Monetarists will point out that it is probably because of this aggressive interest rate response that inflation has swiftly declined, although one might argue that the US, unhindered by strong social tendencies, might be able to respond to increasing prices on a broad-based front. Labour unions have not had the leverage to enable them to monetise the inflation shock which cannot be said for the more recent experience in the UK. One only needs to look at the new proposed, and accepted, protection offered to homeowners to realise that the Bank of England may have lost its teeth. We currently have the BoE trying to curtail excess demand, whilst the fiscus is providing for this demand. It could be seen as the classic case of arm wrestling with yourself.



(Source: Bloomberg 30.06.23)

Moving back to the more mainstream fixed income indicators, the European swap curve sold off and flattened during the 2nd quarter of the year. 3m Euribor followed movements from the European Central Bank (ECB) – who hiked twice by 25 bps in May and June – whilst the longer dated maturities basically marked time over the period. I would argue that this underpins the credibility of the ECB in that investors feel reassured that inflation over the long run will average around 2% - as per the ECB's mandate. Arguably it's a similar story in the 1-year changes where the curve has sold off and flattened. Volatility has been transferred from the long end of the yield curve to the short end as is the thesis within an inflation targeting environment.

Table 4 European Swap Yield Movements (bps)

	3m EURIBOR	2Y Swap	5Y Swap	10Y Swap	20Y Swap	30Y Swap
Year on Year	377	251	147	84	55	55
Q2 2023	54	46	22	5	-1	4

(Bloomberg 30.06.23)

Fund Performance

	Fund	Benchmark
1 Month	0.94%	2.01%
1 Year	12.96%	16.35%
3 Years	4.77%	4.20%
Since Inception	2.39%	2.51%
Highest rolling 1 year	20.32%	17.19%
Lowest rolling 1 year	-12.84%	-11.56%

All performance figures are net if fees
Inception date: January 2019
Returns from 1 year are annualised as of 30 June 2023

The strategy of the fund is to provide slow and steady excess income accrual to investors at low realised volatility relative to the benchmark. The benchmark performance over the more recent history has been rather pleasing with the iTraxx XOver producing some 2.01% during June 2023 and a last burst of 0.47% on the last trading day of the quarter. The performance numbers of the benchmark, the levered benchmark as well as the European Government Bond Index are shown in Table 4. Obviously, the fund itself was only launched in 2019, but the underlying benchmark returns should be generated over the longer term.

As far as the second quarter was concerned, the fund underperformed the benchmark by some 1.07% driven by the last day's movement in iTraxx XOver as well as the fact that the fund is not at full risk. The managers to date have been running quite short relative to the index and this more conservative approach has cost the fund in terms of performance. The fund has not risked up fully and therefore has underperformed the benchmark into the bull-run which has transpired over the past 9 months.

Table 5 shows the top 10 performers in the fund over the quarter in local currency. It is interesting to note that more than half of the top performers are "off benchmark" positions that have added performance on a relative basis. It is also interesting to note that there are some 45 instruments in the fund and 23 of the instruments outperformed the benchmark with a skewed positive distribution. But the cost of the outsized cash and margin accounts have cost the fund dearly over the quarter. The fund will be forced to deploy the majority of that capital in due course in order to avoid this inevitable cash drag that occurs when one opts for high levels of liquidity. This obviously protects capital during periods of distress, but we give away positive returns when the market rallies.

Table 8: Top 10 performers in the Fairtree Global Flexible Income Plus Fund Q2 2023

Name	Description	Total Return
XS2070055095	Schoeller Packaging	22,08%
XS2440849078	iTraxx XOver S36	9,18%
XS1405136364	Banco de Sabadell	6,98%
XS2336345140	CT Investments	6,86%
XS2613506968	iTraxx XOver S39	6,63%
XS1554299765	iTraxx XOver Total Return	6,02%
XS2326497802	Douglas GMBH	5,61%
XS2399700959	Albion Financing	5,43%
XS2035742829	iTraxx XOver Total Return	5,26%
XS1941755230	iTraxx XOver Total Return	5,00%
USG91237AA87	Tullow Oil PLC	4,89%

(Source: Prescient, internal 30.06.23)

Looking to the 3rd quarter it will all be about the timing of the so called "Fed pivot", that is when the hiking cycle comes to its timely end and global Central Banks' next major move will be deemed to be the onset of the cutting cycle. We believe that such a call is currently premature and that rates might have to remain higher for longer. Paradoxically this backdrop is favourable for the fund as the fund returns increase during periods with high base rates – obviously assuming low realised defaults.

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The Fairtree Global Flexible Income Plus Fund is registered and approved by the FSCA under section 65 of CISCA.

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