TwentyFour ASSET MANAGEMENT

TwentyFour Income Fund

Monthly Commentary | 31 March 2020

Market Commentary

Clearly the main driver of markets during March was COVID 19 and the response to measures put in place in an attempt to alleviate market stress. The UK was the first country to announce coordinated fiscal and monetary action, with the outgoing governor of the Bank of England calling an emergency meeting where he cut interest rates by 50bp to 25bp, and importantly for the banking sector, he reduced the countercyclical capital buffer to 0% freeing up capital to support and encourage banks to lend through the uncertainty and downturn ahead. The central bank meeting was quickly followed by the Chancellor announcing several fiscal measures to support the economy and country during the pandemic. Other countries were not far behind. The European Central Bank held its policy meeting as scheduled and although it did not cut interest rates (already at -0.5%), it did announce an increase in its asset purchase program and also reduced capital requirements for banks. However, the market was underwhelmed at the conference and the response was muted. With risk-on assets continuing to slide rapidly lower despite the various and vast measures announced to tackle the fallout of the coronavirus, the Fed stepped back in with several measures. Firstly, another emergency rate cut of 100bp took the range to 0-0.25% and more importantly, a liquidity programme that included buying government bonds, mortgage-backed securities and for the first time in the central bank's history, corporate debt and ETFs. Supporting this, a $2tr package of spending and tax breaks passed a vote in the Senate, which improved sentiment and led to a bounce in asset prices. Across the globe major economies announced very large scale supportive packages, with aid for businesses, tax breaks and support for the unemployed. The central banks continued with rate cuts, including one more from the Bank of England, as well as almost unlimited liquidity packages, including a new Term Funding Scheme with additional incentives for lending to SMEs (TFSME), to assist markets and encourage the banks to keep lending. The IMF also signalled it was ready with $1tr to support struggling countries. Adding fuel to the fire, another major headwind for markets was the collapse of Russia's alliance with OPEC and Saudi Arabia's subsequent response to open the taps, which led to the biggest fall in the price of oil since the Gulf War in 1991. The price fell by more than 50% to under $25 a barrel, adding to already heightened market volatility, especially in the US high yield market where there is a large number of energy companies. There was little recovery as the price war goes on and oil finished the month close to its lows. The European ABS market has also seen challenges, many of them similar to those of the global financial crisis, particularly around secondary market liquidity provided by investment bank trading desks. Pricing volatility increased sharply as dealers dropped their bid prices at the beginning of March, with limited appetite to add risk to trading desk balance sheets seen across all fixed income markets. Since the GFC enhanced regulatory measures such as higher RWA charges, no bank propriety trading desks, investment bank ring-fencing and overall smaller balance sheets has led to less liquidity being available across all fixed income bond markets, not just ABS. Also compounding liquidity issues has been the level of redemptions in credit and high yield ETF markets, which while designed to be liquid and doing an admiral job in stable markets, have proven to be completely the opposite in periods of stress, as a corresponding amount of the underlying credit bonds need to be sold per unit of these funds. The sharp drop in prices has also led to an increase in margin calls to leveraged accounts, and while the haircuts on these assets are much larger than during the GFC this has still led to some ABS bond sales, both in European and US ABS assets, across all assets classes and all parts of the capital structure. We believe that the banks involved have made margin calls on their financing exposure, which were covered either by client cash or line asset sales, but are now covered with assets marked at appropriate levels. The ABS market had enjoyed a strong supply-demand technical for the last few months, which had seen spreads in Prime AAA RMBS, as an example, move into the Sonia+50bp area. Since the virus outbreak these spreads had widened by the middle of March to around Sonia+250bp as a number of real money investors were forced to dispose of assets to meet fund redemptions. These AAA spreads typically tend to be the building blocks for establishing levels for other parts of the capital stack, and as bid-side support driven principally by very large investor demand for assets at such unwarranted wide levels emerged, they had made a strong recovery by the end of the month, retracing to around Sonia+130bp. In the latter part of the month selling became much less prevalent, with the demand side holding the balance of a much more stabilised market in the absence of any primary supply. Currently, spreads remain wider than the returns on most underlying assets can support, so there will be no new imminent supply, unlike wider credit markets which now have the benefit of pricing points for new issuance. Wider spreads can imply a material level of loan distress, but that is simply not present in the ABS market, and while we do now expect some asset performance deterioration in the near future, it will be nowhere near that implied by current spreads.

Portfolio Commentary

March proved to be a fairly active month for the portfolio managers. The portfolio had been set up for expensive markets, having seen spreads gradually grinding in across all asset classes throughout 2019 with volatility at very low levels, and a likely gradual cheapening of risk. It is unlikely that any fixed income portfolio was positioned for the sharp sell-off in bond prices that we witnessed and which was a lot faster than anything seen during the GFC. That said and on the positive side, the portfolio went into this crisis holding a reasonable allocation of cash and AAA liquidity assets together with its lowest level of credit duration. Currently European ABS bonds represent outstanding value and indeed, we are actively adding selectively and in a measured way to existing holdings at extremely attractive yields. In the months running up to the end of February we had been gradually increasing liquidity and shortening credit duration by increasing AAA liquidity bonds. The portfolio managers initially sold several of liquidity assets at the very beginning of the month including very short dated RMBS bonds together with several positions in mezzanine CLOs to provide additional liquidity. Market illiquidity proved to be challenging into the middle part of the month as bond prices began to bottom out and wider market sentiment started to improve as stimulus packages were unveiled. In the second part of the month the fund started to add assets to existing positions in high conviction bonds at extremely attractive yields in mezzanine RMBS. These were funded from sales that were executed earlier in the month. Investors will recall when the fund added capital last year the mandate was changed to incorporate the use of Repo financing. This was deployed in March financing investment grade RMBS for 5% of the fund NAV, versus a limit of 25%, to take advantage of stressed market pricing which is exactly what it was set up for. Fundamentals in ABS remain robust and the team will be maintaining high levels of due diligence on underlying portfolios and the portfolio managers will maintain elevated levels of liquidity. The fund returned -15.76% NAV Per share for the month with 3yr volatility at 9.63%.

Market Outlook and Strategy

For the time being stability has returned to the ABS market following the initial sell-off. The strong technical demand from investors for AAA Prime RMBS and AAA CLOs saw retracement in spreads of over 100bp from the wides of mid-month and we expect this demand in senior bonds to continue. The mezzanine part of the market continues to establish clearing levels and understandably does not see anything like the flow volume seen in senior bonds. We expect this will continue to develop via a slower trading process as bid-offer prices compress to acceptable levels for sellers and buyers. The portfolio managers will continue to add selectively in a much more orderly market at elevated yields as opportunities present themselves but also maintaining appropriate levels of liquidity. It is unlikely we will see any publicly placed primary RMBS or ABS issues in the coming weeks, as is typical in these periods of volatility, and this usually contributes to a recovery in spreads. The supply-demand technical will continue to prevail from a diminishing pool of available assets and prices will recover over time, though there will be periods of volatility ahead of us in wider macro markets that ABS will not be immune from. It is time to recognise the outstanding value the asset class currently offers, particularly in high conviction bonds that we own in our portfolios. Lastly, we have identified three likely trends relating to the economy and employment from a mortgage performance point of view. Firstly, arrears. Disruption to everyday lives and unemployment will likely cause some borrowers to miss payments. Most of these will likely be those indirectly impacted by COVID-19 but directly impacted by the economic fallout from it. Bank support here is critical for mortgagors and measures are being put in place to alleviate some pressure. Secondly, and as a consequence of support being offered – specifically that payment holidays are not debt forgiveness – the interest payment is merely delayed, and we would not expect to see a high proportion of these arrears translate into defaults. Finally, monetary policy will feed into mortgage interest rates reducing the payment burden over time, albeit the quantum of this boost is limited given the low starting point for rates. As regular readers will know we published a blog during March addressing the robustness of Asset-Backed Securities together with three blogs around different themes within the CLO market. These are available on our website or available on request.

Rolling Performance	31/03/2020 - 29/03/2019	29/03/2019 - 30/03/2018	30/03/2018 - 31/03/2017	31/03/2017 - 31/03/2016	31/03/2016 - 31/03/2015
NAV per share inc. dividends	-12.03%	1.57%	10.33%	14.88%	-6.42%

The performance figures shown are in GBP on a mid-to-mid basis inclusive of net reinvested income and, with the exception of share price performance figures, net of all fund expenses. Past performance is not a reliable indicator of future performance. Performance data does not take into account any commissions and costs charged when shares of the portfolio are purchased and disposed of.

Fund Managers

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Key Risks

- **All financial investment involves risk. The value of your investment isn't guaranteed, and its value and income will rise and fall. Investors may not get back the full amount invested.**
- Past performance is not a reliable indicator of future performance, and the Fund may not achieve its investment objective.
- The Fund invests in structured credit products or asset-backed securities (ABS). The issuer of such products may not receive the full amounts owed to them by underlying borrowers, which would affect the value of the Fund. Credit and prepayment risks also vary by tranche which may affect the Fund's performance.
- The Fund has the ability to use derivatives, including but not limited to FX forwards, for hedging only (EPM). This may magnify gains or losses.
- Typically, sub-investment grade securities will have a higher risk of issuer default, and are generally considered to be more illiquid than investment grade securities.

Further Information

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For definitions of the investment terminology used within this document please see glossary at: https://twentyfouram.com/glossary

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