



Monthly Commentary | 31 December 2020

Market Commentary

2020 was a year like no other as COVID-19 brought most major economies to a standstill and threw financial markets into turmoil, with the speed and magnitude of the sell-off on a scale not even seen during the global financial crisis. However, the unprecedented intervention from central banks and governments spurred a strong recovery in asset prices with high quality assets leading the charge. December is typically a benign period for markets as borrowers and investors gradually wind down towards year-end vacations. This year was different with investor appetite for risk assets very much in evidence throughout the month, resulting in a strong finish for credit markets as euphoria over the release of a number of vaccines outweighed the announcement of new COVID variants that appear more infectious than the original. 2020 also finally brought an end to the Brexit saga, and thus the removal of one big market uncertainty. While there are still a couple of topics to be ratified, the agreement has removed a key tail risk and prevented a no-deal Brexit, which looked likely at several points in December.

In the US, President Trump signed a bill allowing \$900bn of COVID-19 relief to be released after many lost unemployment benefits over the holiday period. He also demanded that Congress increase the amount per individual from \$600 to \$2000, in line with what the Democrats have been requesting, but as expected Republican hardliners helped scupper the deal. The ECB had its final meeting of 2020 and announced further stimulus, most significantly expanding the PEPP up to €1.85tr (an increase of €500bn) and extending the duration for another nine months until at least March 2022. The Fed and the BoE meetings followed but there were no changes from either. In the ABS market activity gradually faded into year-end, as expected, with just a handful of small deals pricing. Total primary ABS issuance volume finished the year at around €70bn, around 30% lower than 2019's post-crisis record, but under the circumstances this represented a reasonably strong recovery. Following a strong Q1, supply volumes fell away quite quickly in Q2 due to the significant pandemic-driven volatility but rebounded quite quickly in Q3 and Q4 as the backdrop became more positive, added to the strong market technical driven partly by various government and extended fiscal support mechanisms. Net supply for 2020 was negative at minus €8bn, but issuance is expected to bounce back in 2021 with a fairly wide consensus of opinion from market participants of around €85-100bn in total issuance. Issuance by collateral type saw the European and UK RMBS sector accounting for 36% of 2020 supply, followed by CLOs and Autos at 22% each. CLO issuance surprised on the upside, finishing the year strongly despite the wider negative speculation in the financial press at the onset of the disruption in Q2. The UK accounted for the largest sector by jurisdiction at 47% and was followed, away from CLOs, by the Netherlands at 12%, Spain on 6%, Germany 5% and France 3% respectively, with Italy and Switzerland accounting for the tail. The breakdown by currency was more balanced with euro issuance at 52%, surpassing sterling at 46%. In terms of price performance, and following a volatile 2019, Q1 2020 saw strong spread contraction across all asset classes which came to an abrupt halt in Q2 with the onset of the pandemic, with spreads then rapidly retracing to multi-year wides not seen since the crisis, though this was relatively short-lived in the more liquid ABS sectors. Strong investor demand and constrained primary issuance defined the balance of the year as spreads steadily retraced across the majority of asset classes, good levels of market liquidity via BVWICs and trading desks also delivering a normalisation in spreads. Having lagged wider credit markets in the latter part of the year, European ABS markets look well positioned moving into 2021.

Portfolio Commentary

As is generally the case in December, primary and secondary market activity tailed off mid-month with low levels of traded volume observed in the market. However, the portfolio managers added several positions during the month. The Fund added two mezzanine UK Non-conforming bonds, which have been fairly hard to come by in the last few months, at attractive spreads in the three-year duration period. Further small secondary additions were made in non-investment grade CLOs to existing positions from preferred managers, which continue to offer good relative value as an asset class, particularly with the intrinsic value benefit of the Euribor floor. In the primary market the Fund also added non-investment grade CLO bonds from a top tier manager, which rounded off primary CLO investments for the year. Given the strong performance of the CLO market over the last

quarter, the portfolio managers hedged a proportion of the non-investment grade CLO exposure via XTRAX Xover in order to lock in that performance in the event of market volatility in the run up to year-end and the conclusion of Brexit negotiations, with the intention of taking this off again early in the New Year. While there was no requirement for liquidity during December, secondary market prices were well supported by trading desks as there continued to be strong investor appetite throughout the month. The portfolio managers will maintain appropriate levels of liquidity and balanced positioning across rating and sector in the Fund. Fundamentals in the ABS market remain robust, with investment grade ABS continuing to benefit from strong subordination levels and the team will continue to maintain high levels of due diligence on the underlying portfolio.

The fund returned 1.51% for the month with 3yr annualised monthly volatility at 11.36%.

Market Outlook and Strategy

In terms of ABS fundamentals, 2020 saw broadly correlated pan-European policies rolled out to support household wages, jobs and also businesses, nuanced by country specifics and repeatedly extended. The impact on jobs has varied across the demographics of European society, with lower wage workers and specific sectors such as retail bearing the brunt. The same is true of the most exposed corporate sectors like food and retail, and more challenging trading environments for smaller business often forced to shut.

However you cut it, these schemes are unprecedented in scale and will provide a safety net for ABS pool performance well into 2021. European ABS tends to have a lower correlation to these most exposed workers or businesses, considering for example that home buyers tend to be older with longer credit histories, though pool performance is expected to weaken in 2021 in particular as unemployment reaches peak levels towards the end of the year. It is important to note that all scenarios envisioned sit comfortably within acceptable stress levels for European ABS. Again we expect ABS to outperform European corporate credit markets for upgrade/downgrades and defaults in 2021. The current foreclosure moratorium widely used across Europe will likely end during 2021 and may cause legal logjams, but we feel policy will continue to favour forbearance over foreclosure, and indeed there is regulatory pressure that this be the case. We expect a fast pace for European ABS spreads in Q1 as an early end to the year by many participants will create some Q4 catch up. Issuance will once again surprise forecasters, this time to the upside given underestimated borrowing needs, desire from banks to expand their balance sheets and improved ABS cost of funding for issuers. We feel issuance will be close to reaching €100bn, the high watermark in recent years and out of kilter with corporate markets where bumper 2020 issuance levels will lead to a slight reverse.

CLO issuance is expected to be very active, with a solid €25bn of new issuance but with tens of billions more in refinancings as a result of both aging deals and expensive 2020 offerings entering callable periods. Important to this is the cost of European AAA CLOs, which are cheap to the US and other parts of fixed income and increasingly well bid. Tiering across CLO managers and vintages is set to continue and value can be found at the start of a new cycle even through underperforming managers. Away from CLOs, improved funding costs will also continue to provide us with more interesting call opportunities from legacy ABS. We saw Paragon clean up pre-2008 deals utilising bank deposits and central bank support, and more compelling refinancing opportunities for all sponsors will exist. Capital relief focused ABS deals will regain traction, potentially helped by the introduction of a new synthetic STS label, but primarily driven by bank capital optimisation and for the first time an urgency for 'real' credit risk mitigation. The balance between investors chasing income and issuers looking to move credit risk has the potential to create poor risk-adjusted investments, so caution is warranted in the early stages of a new cycle. Spread will continue to be an attraction of European ABS in 2021, and while capital weightings remain an impediment for the attraction of new insurance buyers, the technical from stable issuance levels remains a dominant factor. With yield curves low, and with ongoing concerns around reflation driven by increased fiscal support, we view credit spreads as being the most reliable source of positive returns in 2021. As a result there is an expectation that spreads will continue to compress across fixed income, many parts of the broader investment universe can ill afford to have performance adjusted further for defaults, particularly passive indexed funds. European ABS investors carry forward little concern about nasty default surprises and this will be important in 2021 when considering total returns.

Rolling Performance	31/12/2019 - 31/12/2020	31/12/2018 - 31/12/2019	29/12/2017 - 31/12/2018	30/12/2016 - 29/12/2017	31/12/2015 - 30/12/2016
NAV per share inc. dividends	5.97%	5.04%	2.39%	13.51%	4.28%

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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