March 31, 2022
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Aperture Credit Opportunities Fund
Q1 2022 Commentary

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Market Performance

We can safely say that what happened in the first quarter of 2022 was not in our year-end outlook. While financial markets have seen all forms of crazy events over the last few years, Russia's brutal attack on Ukraine on February 24th will quite likely be one of the most seminal events shaping the global world order in the next several years. We came into the year expecting central banks to start withdrawing monetary accommodation. The ECB conference at the beginning of February was the first marker for investors that the era of easy money was ending. The markets were weaker through February after listening to Ms. Lagarde, but the breakout of war towards the end of the month just sapped all risk sentiment. There were vicious rotation moves under the surface as portfolios de-risked in a fairly illiquid taper. Sixty years since the last flare-up, investors were dealing with the prospect of nuclear weapons being used by a major military power. While the human tragedy and suffering in Ukraine has only gotten worse every day since, the markets stabilized around the second week of March. By the time the FOMC meeting came about on March 16th, the market had imagined the worst in terms of accommodation removal and through various fits and starts, the markets recovered strongly through the rest of the month and quarter.

The S&P 500 punched in a -4.6% return for the first quarter of 2022 but not without a dizzying 14.6% drawdown from Jan to Feb 24th. As always there was also plenty of excitement under the surface. The drama around China tech companies' disclosure and delisting continued. In March, for example, the KWEB China Internet ETF had a 41% drawdown from Mar 1 through Mar 14th and rallied 41% on Mar 16th alone. It has been a long quarter.[1]

The rates market endured most of the shift in policy narrative as the US 10-year moved from 1.5% to 2.4% during the quarter. The 2s10s flattened a whopping 80 bps to finish the quarter near zero(!) Inflation is here. Does a recession follow?[2]

US credit returned -7.69% for the quarter and HY credit -4.8%. In Europe, overall credit returns were -5.3% and HY credit -4.1%. All considered, we would say that was a heroic effort by the market as spreads continue to be well anchored so far. [3]

Source: Bloomberg Finance L.P, as of March 31, 2022.

1. S&P 500 refers to SPX Index, EURO STOXX 50 refers to SX5E Index.

2. US 10-year refers to USGG10YR Index and US 2-year refers to USGG2YR Index.

3. US Credit: LUACTRUU Index; European Credit: LP05TREU Index; US High Yield: LF98TRUU Index; European High Yield: LP01TREU Index.

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Portfolio Performance (Net of Fees)

The Aperture Credit Opportunities Fund (Inst USD, Acc share class) (the "Fund") returned 0.19% in absolute terms in the first quarter. This was behind the SOFR +2% benchmark by 33bps. Whilst our aim is always to be ahead of the benchmark, we accept that during certain market conditions and over differing time periods this will not be the case.

RETURNS AS OF MARCH 31, 2022 (%, net of fees)

	Jan	Feb	Mar	Q1	2021	1-Year	Since Inception
Fund	0.36	0.16	-0.34	0.19	3.78	2.19	4.81
Benchmark	0.15	0.17	0.18	0.51	2.04	2.05	2.44
Relative Performance	0.21	-0.01	-0.52	-0.32	1.74	0.14	2.37

We came into the first quarter positioned defensively in rates, duration, credit quality, as well as sector positioning, with a view that fixed income yields could widen materially. The idea was to focus on catalyst driven alpha and portfolio concentrations that could detract materially from performance.

A few noteworthy portfolio component moves:

Contributors:

- Long position in a data centre REIT was made-whole as the company was sold to private equity and the capital structure refinanced entirely, as we had expected.
- Short position in an IT services company saw strong returns as the market came to our thesis view that cash flow generation was much poorer than the ratings would imply. We had positioned for a ratings downgrade event, but spreads reached our targets in the first quarter and we closed the position.
- Long position in a Spanish construction company performed well as market participants became aware of the increasing asset value of its real estate portfolio whilst its construction arm continued to win lucrative contracts in the Europe and the US.
- Short position in a French catering business generated strong alpha as the company announced poor results impacted by a post-Covid change in eating habits, much higher input prices and increased wages.

Detractors:

- Long position in a healthcare REIT drew down due to general rates widening as well as resurgence of the virus in the first quarter.
- Long position in a North American pharmaceutical company detracted from returns as a worsening IPO environment delayed their planned spin-off of a large asset. The company also decided to take a litigation to trial that we were expecting them to settle. This was damaging to our thesis and we repositioned ourselves in the structure.
- Long position in the legacy Tier 1 paper of a large UK bank performed poorly as the bank decided against using the “make-whole” provisions to redeem the bond, preferring to wait as yields rose and the make-whole cost reduced. Discussions with the regulator are on-going and we hope to see some of the loss recovered in Q2 or Q3, perhaps post the business tendering for the bonds.

Outlook

While markets have recovered from their lows in March, we are not out of the woods yet. While there is no imminent cause for a crash, we simply do not believe investors are being paid enough spread for holding risky assets in passive form. Central banks are on the move. Chairman Powell was clear in his goal of tightening financial conditions to a point that aggregate demand falls below supply and inflation eases. Given how ineffective monetary policy is in dealing with supply side inflation, the Fed needs to use a blunt force instrument to deal with the problem. The more the market is stable, the faster policymakers will withdraw liquidity. Liquidity in global financial markets is the single biggest reason the markets have been so resilient so far. Slowly but surely, we will have to deal with the prospect of a coordinated global economic slowdown and receding liquidity. The US may or may not enter a recession, but global growth is slowing down, and we expect returns to be low and volatile from here.

Clients have asked us if stagflation or a global economic slowdown would make central bankers reverse course on quantitative tightening. We feel it really depends on when and where the slowdown shows up. Our current thinking is that Europe is looking at crippling inflation via energy and food prices. The resultant economic shock will likely make ECB bankers pause while the Fed continues undeterred. The Fed seems fairly confident that the economy will not only be able to withstand the tightening financial conditions and ensuing economic demand destruction but “thrive”. We will see. If economic growth recedes and risk assets sell off sharply, we are pretty sure the central bankers will try and jawbone the policy path. To be sure, the markets have a long way to fall before the central bankers change course.

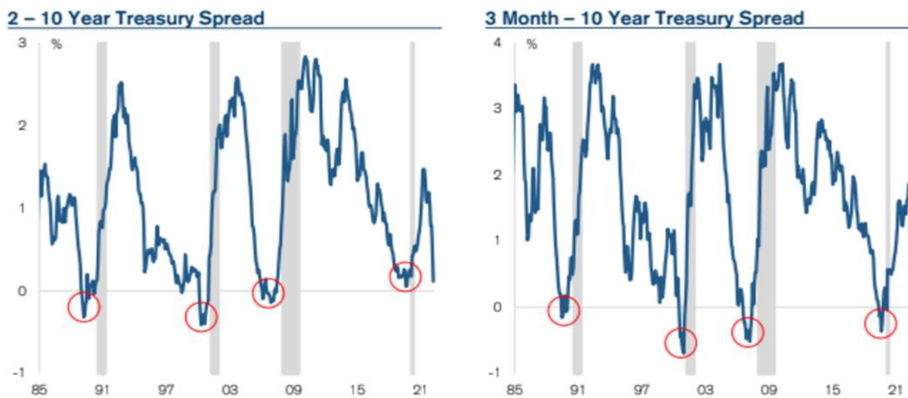
Considering the uncertain macro environment, we remain focused on catalyst-driven investments that are uncorrelated with the broad market. There is still a lot of capital markets activity – M & A, buyouts, refinancing, etc. We are setting up long and short investments that should benefit with such catalysts. The overall market volatility also leaves capital structures dislocated and we are finding more relative value opportunities in the market to try and capture uncorrelated alpha. As earnings season starts, we will get a glimpse into how companies are dealing with inflation and supply chain issues and a better sense of economic demand. We expect dislocations throughout this earnings season and are keeping the portfolio nimble to take advantage of these.

A Few More Things...

Consumer strength

While we are not experts in economics by any means, not a day goes by right now where we do not discuss the probability of a recession. Since this is an important component of our portfolio construction, we thought we would share our current thinking on the topic. The bears argue that tightening financial conditions will translate into demand destruction and then a recession. The Ukraine war and resurgence of the BA.2 variant will put further pressure on supply chains, exacerbating the Fed's inflation problem. These investors can produce charts showing that historically recessions have quickly followed the inversion of the rates curve.

Chart 1: Rates Curve Spreads



Source: Federal Reserve, Bloomberg Finance L.P., Credit Suisse as of April 2022.

The bulls, on the other hand, argue that the consumer is strong and household balance sheets have never been in better shape. With 1.7 jobs available for every worker, consumer confidence is robust, and the economy will not only survive but thrive despite the tightening.

Chart 2: Openings per Unemployed Worker

Note: Unemployment figures adjusted to account for workers misclassified as employed. Data is seasonally adjusted. Source: US Labor Department, The New York Times, April 2022.

Furthermore, the participation rate is finally on the move up and the "lost workers" are coming back. This will avoid the wage-price spiral that the bears are worried about.

Chart 3: Civilian Labor Force Participation Rate, seasonally adjusted

Note: Shaded areas represents recession, as determined by the National Bureau of Economic Research. Persons whose ethnicity is identified as Hispanic, or Latino may be of any race. Source: US Bureau of Labor Statistics, April 2022.

No matter how the debate resolves, we expect some tough sledding for low-income families and their consumption basket even if broad macro consumption (dominated by the affluent) remains intact. There will be societal and corporate haves and have nots over the next few quarters.

Management teams' commentary

Comments that our team has collected from corporate management teams fall broadly into two distinct categories:

- "Cost inflation pressures are real, getting worse, and we are trying to pass the cost on to the consumer. So far, so good."
- "Demand is very strong, and we are having difficulty fulfilling the order book due to supply chain issues."

Both of these are consistent with the ongoing debate on the strength of the consumer we discussed above, so the only reason we mention them separately is to bring attention to the fact that corporate management teams have a mixed record of predicting earnings in periods of high macroeconomic uncertainty. Beyond visibility on the immediate order book, management teams are often no better informed about the future than investors. Furthermore, barring a few cases (high contractual protections), most consumer facing order books can evaporate quite quickly as typically there are no cancellation penalties for consumers. When evaluating investments, we are trying to avoid false precision in our analysis.

This time it's different (with oil) …

There has been much fanfare around higher oil prices in recent months. This is a remarkable turn of events, given that just 2 years ago oil was trading at a negative value, and many had left the sector for dead. Today, we see quite the opposite - oil prices are well over $100 and it seems to us that investors now expect that this will continue for a period of many years. The general thesis seems to be that underinvestment has constrained supplies and demand will continue to grow. We have grown increasingly worried about this narrative in recent months and believe there is material downside risk to it.

While many are focused on short term oil supply and demand factors, we look across the value chain and are much more concerned about less noticed energy transition factors. Multiple data points continue to show a much quicker adoption of clean energy than previously expected. This is only being accelerated with $100 oil and the Russia-Ukraine war. The net effect of this, in our estimation, is a sharp pull-forward of the point at which oil demand will flatten and then begin declining. We are extremely focused on this point, as it is the point at which the world must begin structurally reducing oil production for the first time ever. In our opinion, the only way to force this is for oil prices to be below the cost of the marginal barrel of production. This "clearing price" is far below current oil prices, which represents the downside in price at that point in time.

In the short term, imbalances may keep oil prices elevated over the coming quarters, but we expect the market to become much more balanced at some point. The downward adjustment in assets in the space should be as sharp as the up move has been. As with all things in investing, timing this will be difficult but potentially quite profitable.

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Investors should note the specific risk warnings:

Interest Rate Risk - The performance of the strategy may be influenced by changes in the general level of interest rates. Generally, the value of fixed income instrument will change inversely with changes in interest rates: when interest rates rise, the value of fixed income instruments generally can be expected to fall and vice versa. Fixed income securities with longer-term maturities tend to be more sensitive to interest rate changes than shorter-term securities. In accordance with its investment objective and policy, the strategy may attempt to hedge or reduce interest rate risk, generally through the use of interest rate futures or other derivatives. However, it may not be possible or practical to hedge or reduce such risk at all times.

Credit Risk - Investing in fixed income instruments will be exposed to the creditworthiness of the issuers of the instruments and their ability to make principal and interest payments when due in accordance with the terms and conditions of the instruments. The creditworthiness or perceived creditworthiness of an issuer may affect the market value of fixed income instruments. Issuers with higher credit risk typically offer higher yields for this added risk, whereas issuers with lower credit risk typically offer lower yields. Generally, government debt is considered to be the safest in terms of credit risk, while corporate debt involves a higher credit risk. Related to that is the risk of downgrade by a rating agency. Rating agencies are private undertakings providing ratings for a variety of fixed income instruments based on the creditworthiness of their issuers. The agencies may change the rating of issuers or instruments from time to time due to financial, economic, political, or other factors, which, if the change represents a downgrade, can adversely impact the market value of the affected instruments.

Distressed Securities Risk - The strategy may directly or indirectly purchase securities and other obligations of securities and other obligations of companies that are experiencing significant financial or business distress, including companies involved in bankruptcy, insolvency or other reorganization and liquidation proceedings ("Distressed Companies"). Although such purchases may result in significant returns, they involve a substantial degree of risk and may not show any return for a considerable period of time or any return at all. Evaluating investments in Distressed Companies is highly complex and there is no assurance that Aperture will correctly evaluate the nature and magnitude of the various factors that could affect the prospects for a successful reorganization or similar action. In any reorganization or liquidation proceeding relating to a Distressed Company in which the strategy invests, such strategy may lose its entire investment or may be required to accept cash or securities with a value less than its original investment. In addition, distressed investments may require active participation of the strategy and/or its representatives and this may expose the strategy to litigation risks or restrict its ability to dispose of its investments. Under such circumstances, the returns generated from the strategy's investments may not compensate investors adequately for the risks assumed. There are a number of significant risks when investing in Distressed Companies that are or may be involved in bankruptcy or insolvency proceedings, including adverse and permanent effects on an issuer, such as the loss of its market position and key personnel, otherwise becoming incapable of restoring itself as a viable entity and, if converted to a liquidation, a possible liquidation value of the company that is less than the value that was believed to exist at the time of the investment. Many events in a bankruptcy or insolvency are the product of contested matters and adversary proceedings that are beyond the control of the creditors. Bankruptcy or insolvency proceedings are often lengthy and difficult to predict and could adversely impact a creditor's return on investment. The bankruptcy and insolvency courts have extensive power and, under some circumstances, may alter contractual obligations of a bankrupt company. Shareholders, creditors, and other interested parties are all entitled to participate in bankruptcy or insolvency proceedings and will attempt to influence the outcome for their own benefit. Administrative costs relating to bankruptcy or insolvency proceedings will be paid out of the debtor's estate prior to any returns to creditors. Also, certain claims, such as for taxes, may have priority by law over the claims of certain creditors.

High-Yield Risk - Investments in fixed-income securities with sub-investment grade ratings may involve greater risks of loss of income and principal than rated or higher-rated securities and are more speculative in nature. Although they may offer higher yields than do higher-rated securities, they generally involve greater price volatility and greater risk of default in payment of principal and income due to factors including corporate developments, negative perceptions of high-yield instruments generally and decreased secondary market liquidity.

Securitized Debt Risk - The strategy may have exposure to a wide range of ABS (including asset pools in credit card loans, auto loans, residential and commercial mortgage loans, collateralized mortgage obligations and collateralized debt obligations), agency mortgage pass-through securities and covered bonds. The obligations associated with these securities may be subject to greater credit, liquidity and interest rate risk compared to other fixed income securities such as government issued bonds. ABS and MBS are often exposed to extension and prepayment risks that may have a substantial impact on the timing and size of the cash flows paid by the securities and may negatively impact the returns of the securities. The average life of each individual security may be affected by a large number of factors such as the existence and frequency of exercise of any optional redemption and mandatory prepayment, the prevailing level of interest rates, the actual default rate of the underlying assets, the timing of recoveries and the level of rotation in the underlying assets. In certain circumstances investments in ABS and MBS may become less liquid making it difficult to dispose of them. As a result, the strategy's ability to respond to market events may be impaired and the strategy may experience adverse price movements upon disposal of such investments. In addition, the market price for MBS has, in the past, been volatile and difficult to ascertain, and it is possible that similar market conditions may occur in the future. MBS that are issued by government-sponsored enterprises are known as Agency MBS. Such government-sponsored enterprises guarantee payments on Agency MBS. Non-agency MBS are typically supported solely by the underlying mortgage loans and do not carry the guarantee of any institution, and therefore carry a greater degree of credit/default risk in addition to extension and prepayment risk. The list above refers to the most frequently encountered risks and is not an exhaustive list of all the potential risks.

Slide 8

TS0 is this the updated fee language?
Thomas Spadaccini, 2022-04-18T21:52:45.947

Credit Default Swaps ("CDS") Risk - A CDS is a bilateral financial contract in which one counterpart (the protection buyer) pays a periodic fee in return for a contingent payment by the protection seller following a credit event of a reference issuer. The protection buyer must either sell particular obligations, issued by the reference issuer at their par value (or some other designated reference or strike price) when a credit event occurs or receive a cash settlement based on the difference between the market price and such reference or strike price. A credit event is commonly defined as bankruptcy, insolvency, receivership, material adverse restructuring of debt, or failure to meet payment obligations when due. The ISDA has produced standardized documentation for these transactions under the umbrella of its ISDA Master Agreement. As protection seller, the strategy will seek a specific credit exposure to the reference issuer – selling protection (by mitigating the counterparty risk) is economically equivalent to buying a maturity matching floating rate note on the same reference entity. As protection buyer, the strategy may seek either to hedge a specific credit risk of some issuers in the portfolio or to exploit a negative view on a given reference entity. When these transactions are used in order to eliminate a credit risk in respect of the issuer of a security, they imply that the strategy bears a counterparty risk in respect of the protection seller. This risk is, however, mitigated by the fact that the strategy will only enter into CDS transactions with highly rated financial institutions. CDS used for a purpose other than hedging, such as for efficient portfolio management purposes or if disclosed in relation to the strategy, as part of the principal investment policy, may present a risk of liquidity if the position must be liquidated before its maturity for any reason. The strategy will mitigate this risk by limiting in an appropriate manner the use of this type of transaction. Furthermore, the valuation of CDS may give rise to difficulties which traditionally occur in connection with the valuation of OTC contracts. Insofar as the strategy uses CDS for efficient portfolio management or hedging purposes, investors should note that such instruments are designed to transfer credit exposure of fixed income products between the buyer and seller. The strategy would typically buy a CDS to protect against the risk of default of an underlying investment, known as the reference entity and would typically sell a CDS for which it receives payment for effectively guaranteeing the creditworthiness of the reference entity to the buyer. In the latter case, the strategy would incur exposure to the creditworthiness of the reference entity but without any legal recourse to such reference entity. In addition, as with all OTC derivatives, CDS expose the buyer and seller to counterparty risk and the strategy may suffer losses in the event of a default by the counterparty of its obligations under the transaction and/or disputes as to whether a credit event has occurred, which could mean the strategy cannot realize the full value of the CDS.

Contingent Capital Securities (CoCos) Risk - In the framework of new banking regulations, banking institutions are required to increase their capital buffers and have therefore issued certain types of financial instrument known as subordinated contingent capital securities (often referred to as "CoCo" or "CoCos"). The main feature of a CoCo is its ability to absorb losses as required by banking regulations, but other corporate entities may also choose to issue them. Under the terms of a CoCo, the instruments become loss absorbing upon certain triggering events, including events under the control of the management of the CoCo issuer which could cause the permanent write-down to zero of principal investment and/or accrued interest, or a conversion to equity. These triggering events may include (i) a deduction in the issuing bank's capital ratio below a pre-set limit, (ii) a regulatory authority making a subjective determination that an institution is "non-viable" or (iii) a national authority deciding to inject capital. Furthermore, the trigger event calculations may also be affected by changes in applicable accounting rules, the accounting policies of the issuer or its group and the application of these policies. Any such changes, including changes over which the issuer or its group has a discretion, may have a material adverse impact on its reported financial position and accordingly may give rise to the occurrence of a trigger event in circumstances where such a trigger event may not otherwise have occurred, notwithstanding the adverse impact this will have on the position of holders of the CoCos. Upon such occurrence, there is a risk of a partial or total loss in nominal value or conversion into the common stock of the issuer which may cause the strategy as a CoCo bondholder to suffer losses (i) before both equity investors and other debt holders which may rank pari passu or junior to CoCo investors and (ii) in circumstances where the bank remains a going concern. The value of such instrument may be impacted by the mechanism through which the instruments are converted into equity or written down which may vary across different securities which may have varying structures and terms. CoCo structures may be complex, and terms may vary from issuer to issuer and bond to bond. CoCos are valued relative to other debt securities in the issuer's capital structure, as well as equity, with an additional premium for the risk of conversion or write-down. The relative riskiness of different CoCos will depend on the distance between the current capital ratio and the effective trigger level, which once reached would result in the CoCo being automatically written down or converted into equity. CoCos may trade differently to other subordinated debt of an issuer which does not include a write-down or equity conversion feature which may result in a decline in value or liquidity in certain scenarios. It is possible in certain circumstances for interest payments on certain CoCos to be cancelled in full or in part by the issuer, without prior notice to bondholders. Therefore, there can be no assurance that investors will receive payments of interest in respect of CoCos. Unpaid interest may not be cumulative or payable at any time thereafter, and bondholders shall accordingly have no right to claim the payment of any foregone interest which may impact the value of the strategy. Notwithstanding that interest not being paid or being paid only in part in respect of CoCos or the principal value of such instruments may be written down to zero, there may be no restriction on the issuer paying dividends on its ordinary shares or making pecuniary or other distributions to the holders of its ordinary shares or making payments on securities ranking pari passu with the CoCos resulting in other securities by the same issuer potentially performing better than CoCos. Coupon cancellation may be at the option of the issuer or its regulator but may also be mandatory under certain European directives and related applicable laws and regulations. This mandatory deferral may be at the same time that equity dividends and bonuses may also restricted, but some CoCo structures allow the bank at least in theory to keep on paying dividends whilst not paying CoCo holders. Mandatory deferral is dependent on the amount of required capital buffers a bank is asked to hold by regulators. CoCos generally rank senior to common stock in an issuer's capital structure and are consequently higher quality and entail less risk than the issuer's common stock; however, the risk involved in such securities is correlated to the solvency and/or the access of the issuer to liquidity of the issuing financial institution. The structure of CoCos is yet to be tested and there is some uncertainty as to how they may perform in a stressed environment. Depending on how the market views certain triggering events, as outlined above, there is the potential for price contagion and volatility across the entire asset class. Furthermore, this risk may be increased depending on the level of underlying instrument arbitrage and in an illiquid market, price formation may be increasingly difficult.

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