

Never catch a falling knife?

Executive Summary

- Recent spread widening and the index roll bring iTraxx Main 5Y to its widest level since the European Crisis.
- Sentiment remains very bearish but has started to stabilize at these depressed levels.
- Positioning remains at its shortest in iTraxx Main.
- Uncertainty remains; in addition to the themes outlined all summer, we now have to account for the UK's Fiscal plans.
- Are investments in credit via ETFs and bond portfolios better than synthetic?

“If one does not know to which port one is sailing, no wind is favorable” Seneca

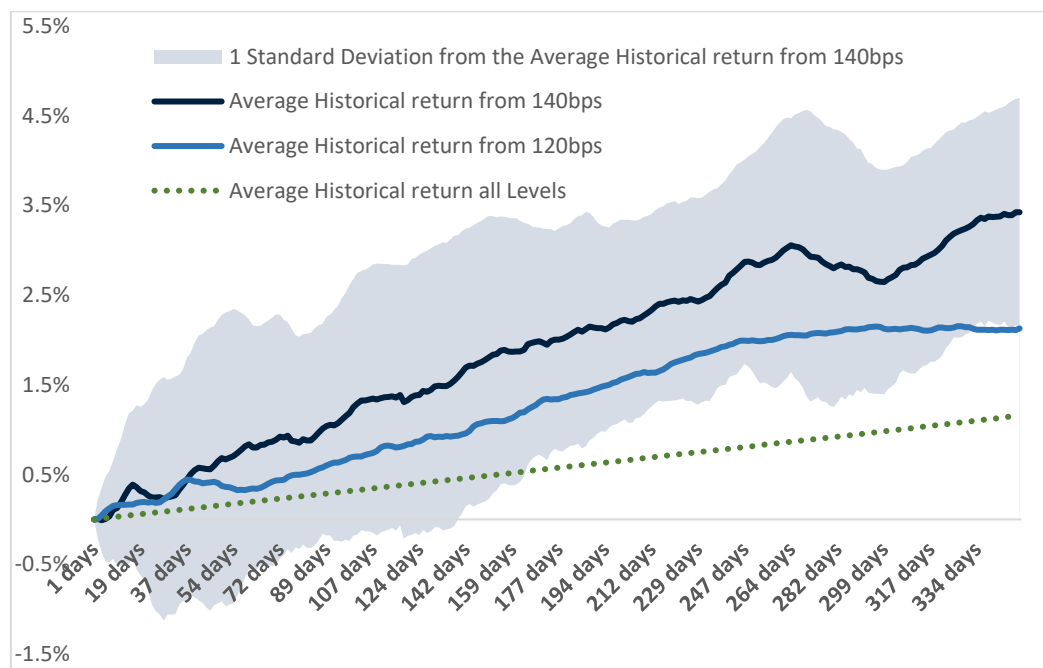
iTraxx Level is back to European Sovereign Crisis:

Fundamentally the return to a long position in iTraxx Main is positive long term as default risk is “over priced”. A Long term view is one thing though. The short term return may be very different. We continue to believe that **credit will remain choppy**, at least throughout the winter, thus investment timing is key. **Despite this belief, today's levels appear attractive** - carry alone currently covers you for around ~30bps of spread widening. But, **positioning and sentiment remain bearish** with asset prices implying expectations of a further deterioration from today's data.

We have now reached ~144bps¹ on the S38 series, a **level not seen since the Sept 2012** at the end of European government crisis. It is easy to say that this level is a good entry point, but **we should be conscious that we may also revisit 2011-2012 levels of around 200bps!**

Given the prevailing uncertainty we investigate the average subsequent return of entering into iTraxx when it is in the 140ish area. To provide some context for the potential return profile we also graph the one standard deviation return (both high and low) around the average. The average return from a ~120bps starting point provides further colour as to the potential return profile.

Fig. 1: Cumulative One Year Return from a 1x long iTraxx Main 5y² position from selected entry points



¹ As of 28/09/2022

² Using iTraxx Main On the Run indices since 2004 (ITD)

Source : JP, Selwood AM

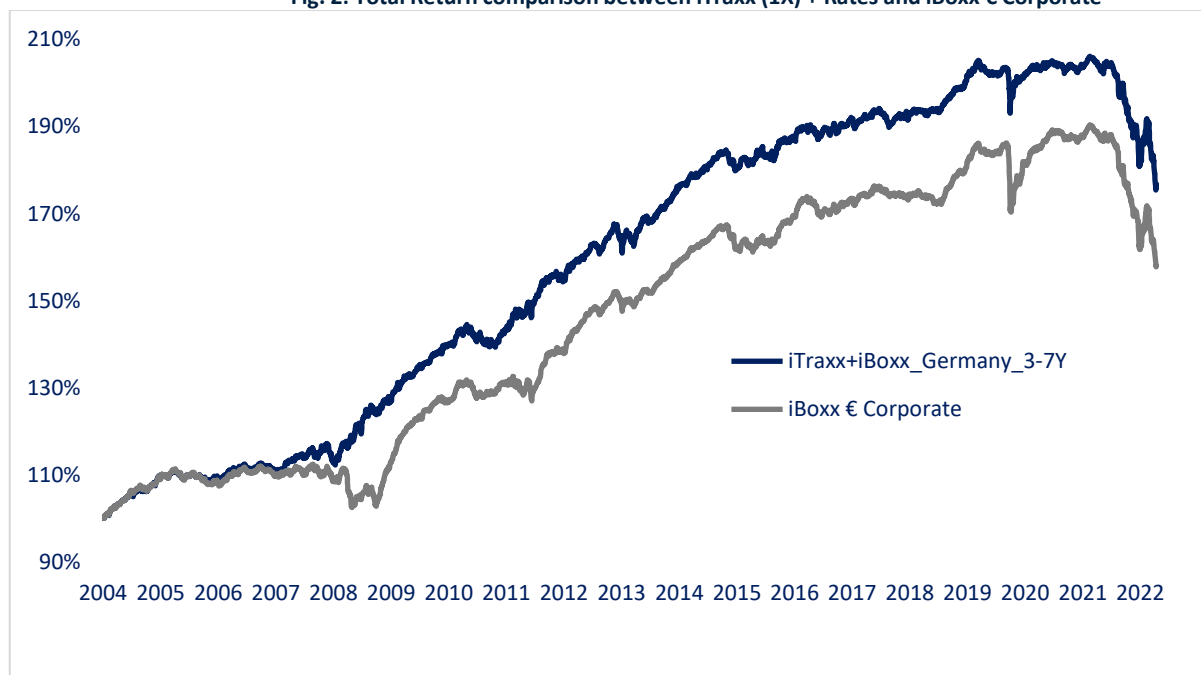
The average return (represented by the green dot) shows the fundamental positive return from taking a long in iTraxx. **Entering a long in the index at the 140ish area however significantly skews the return profile in your favour. Returns after one year, when entered at these elevated levels, result in an average return that is three times the typical return.** At an entry level of ~140bps even a return that is one standard deviation worse than expected represents a return that is 2x the normal average. The average return when starting from around ~120bps area, as opposed to today's levels, shows a return that is "only" double the average. Note also that after a five month holding period this extrapolates to around a ~68% chance of recording a positive return.

iTraxx or a traditional corporate bond portfolio?

If we agree that today's levels represent an attractive entry point then we need to also consider which instruments to choose. **iTraxx has multiple advantages:**

- **Liquidity:** iTraxx Main 5y is currently trading more than €10bn a day with a bid-offer less than 0.1bps. This stands in marked contrast to cash bonds that are more difficult to find in secondary markets, and have larger bid-offers. We also demonstrate that iTraxx tends to be more liquid in stressed environments, while bonds' bid-offer increase.
- **Financial Strength:** Trading on-the-run series allows an investor to limit their chance of default as the portfolio is reset every six months by Markit.
- **Level:** today the **bond portfolio equivalent to iTraxx Main trades ~40bps tighter (richer) than iTraxx.** We have here a very good buffer of performance if markets normalize. Note that in previous crisis, at extreme points, bonds traded up to ~50bps cheaper (as in 2008 and 2020).
- **Recovery:** There is typically a **shorter recovery time for a strategy utilising iTraxx as opposed to a bond portfolio.** This was particularly true during the credit crisis (2008), the Asian crisis (2016) and Covid (2020), see Fig.2.
- Trading iTraxx and Govies, allow you much more flexibility in terms of maturity and rebalancing, while you keep your spread exposure on 5Y on the run CDS Index.

Fig. 2: Total Return comparison between iTraxx (1X) + Rates and iBoxx € Corporate

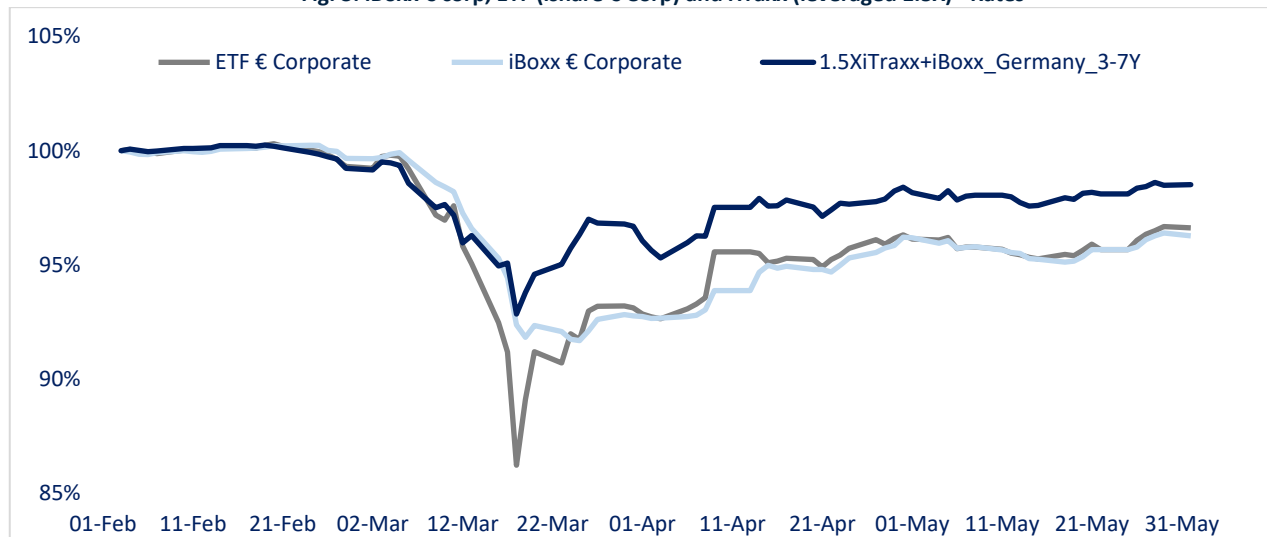


Source : JP, Selwood AM

Traditional Corporate bond portfolio and its ETF:

Asset Managers are offering ETF on traditional credit cash portfolios; the liquidity is much better in ETF rather than in a TRS on cash Index (like iBoxx € Corp), probably much better than trading bonds for large size.

Fig. 3: iBoxx € corp, ETF (ishare € Corp) and iTraxx (leveraged 1.5X) +Rates



Source : JP, Bloomberg, Selwood AM

As shown on fig.3. **ETFs tend to be more volatile than the underlying cash index**, as marks on **bonds are typically smoother** than those on liquid instruments. In addition, ETFs are considered as more liquid³ and can easily be used for hedging purposes. This leads them to overreact, **underperforming in bear markets and outperform in bull markets**.

If you look at the height of COVID (18/03/2020) the ETF € Corporate hit its lows, while iTraxx reached its peak. The **iBoxx cash bond index lagged** by one day. This period also clearly illustrates that while in the long term the ETF and the cash index converge **in specific stressed environments, marks can dramatically differ (this iBoxx ETF was ~6.15% lower at the height of COVID !)**.

Conclusion:

The opportunity set as it stands today **shows a good risk/reward ratio**. While there is always the potential for further deterioration, **the carry and roll down offered on credit index instruments, at these levels, provides a sizeable buffer**. To take advantage of today's levels and to position yourself opportunistically, various alternatives are offered (Corporate Bonds, ETF, Synthetic). We **definitely prefer being positioned via liquid instruments, especially in those uncertain times**. This liquidity provides us the ability to proactively and swiftly rebalance positions and are very easy to trade in large volumes in volatile environments.

Mathieu Labelle and Thibault Brohard, 03.10.2022

This material is not intended to be relied upon as a forecast, research, or investment advice and is not a recommendation offer or solicitation to buy or sell any securities or to adopt any investment strategy.

Selwood Asset Management France,

If you wish to know more about our **#ESG Credit Abs return (Article 8), #Tail Hedge, #Long Only and #Solvency II Solutions**

³ At peak of the Covid Crisis, IEAC (one key EUR IG ETF) Traded around ~€800MM/day. iTraxx was trading over ~€9bn/day – Source SFDR, BNP and Bloomberg.

Please feel free to contact us for any further information at paris@selwoodam.com

DISCLAIMER

Monthly Letter. Selwood Asset Management France SAS ("Selwood") is providing this monthly commentary solely at the request of and for the exclusive use of the recipient (the "Recipient") in its capacity as the investment manager.

Purpose and Non-Reliance. The monthly letter is provided to the Recipients who are sophisticated investors, being professional clients, eligible counterparties, accredited investors or qualified purchasers. The monthly letter is provided to the Recipient for the limited purpose of providing the Recipient with information relating to the performance and the risk profile of the Fund as at the date specified therein and/or for the purposes of discussion with Selwood only. The monthly letter is not intended to provide and should not be relied upon as any form of accounting, legal or tax advice or investment recommendations. The Recipient should consult its own tax, legal, accounting or other advisors about the issues contained herein. The Recipient should refer to the risk factors set out in the Fund's prospectus and supplement.

Carry. Any references to "carry" are intended to refer to a specific performance computation. Carry and theta would correspond to expected performance in a 12 months' period. Certain assumptions are used to calculate "carry", such as no trading and all market parameters staying intact, which may have inherent limitations. Accordingly, the estimated carry and performance is not reliable, is not exhaustive and represents subjective views of Selwood. Please also refer to the Risk Factors listed in the Fund's prospectus and the supplement. Note also that any estimates are gross and do not include the deduction of fees and trading costs.

Accuracy of Information. The figures, estimated figures, projections, views, charts, calculations and other information (the "Information") contained in the monthly letter is indicative only and are provided as at the date specified therein.

Information related to any net estimated returns is based on unaudited, internally prepared assessments of the performance of the Fund's portfolio by Selwood and have not been independently verified or confirmed. The net estimated returns are subject to adjustment as a result of items such as changes or delays in Selwood's or the Fund's administrator's calculation of the profit and loss of the portfolio in whole or in part and/or Selwood's assessment of the month-end value of any one or more of the financial instruments in the Fund's portfolio. Any such adjustments could have a material impact on the estimated net returns, including a change from a positive monthly net return or year to date performance estimate to a negative monthly net return or year to date performance estimate.

Market views presented herein, including any forward-looking statements, are reasonably held by Selwood as at the date hereof but are subjective and have not been independently verified. Market pricings assume. These are not intended to and do not constitute financial or investment advice.

Selwood is not under any obligation to update or revise this monthly letter or any specific Information (including, without limitation, the estimated net returns or carry) contained therein or to correct any inaccuracies, whether as a result of new information, future events or otherwise.

No representation, warranty or undertaking, express or implied, is given as to the fairness, correctness, accuracy or completeness of the Information or the models used in preparing such, opinions or any forward-looking statements contained in the monthly letter by any of Selwood, or its respective members, employees or affiliates (together "Selwood Parties") and no liability is accepted by such persons for the accuracy or completeness of any such information or opinions, and nothing contained herein shall be relied upon as a promise or representation whether as to past or future performance.

Use of Models and Simulations. Certain information contained herein is derived from simulations or models. Methodologies and models used by Selwood are just some among alternative other methodologies that could be used and such can produce different results. Neither the simulations, nor the models have been independently verified. The derived information is therefore based on certain assumptions which may be subjective and may not necessarily be reflective of reality.

Distribution and Non-Solicitation. The monthly letter is not intended, and must not be construed, as an offer of, or a solicitation of an offer to purchase, any investments in any jurisdiction where such offer or solicitation would be unlawful. The distribution of the monthly letter may be restricted in certain jurisdictions. It is the responsibility of any person or persons in possession of this monthly letter to inform themselves of, and to observe, all applicable laws and regulations of any relevant jurisdiction. Please refer to the country-specific disclaimers in the prospectus and the supplements of the Fund.

External Market Conditions. The current global market conditions are exceedingly impacted by the Russia/Ukraine conflict and the continuing uncertainty around COVID-19 which creates unprecedented volatility and could last for an extended period thus adversely affecting the Fund's performance and liquidity.

Solvency II (SCR). No representations or guarantees as to compliance with Solvency II are being made by Selwood. Prospective and existing investors need to complete their own analysis of Solvency II requirements.

Confidentiality. Selwood is distributing this monthly letter to the Recipient only. The monthly letter is strictly confidential and may contain proprietary information of Selwood. It may not be reproduced, distributed or published by any Recipient for any purpose without the prior written consent of Selwood.

Selwood. Nothing contained herein shall be deemed to create any obligations or commitment on the part of Selwood or any of the Selwood Parties. Selwood is acting solely as an arm's length contractual counterparty to the Fund and not as the Recipient's financial advisor or fiduciary. To the maximum extent permitted by law, none of the Selwood Parties shall be liable (including in negligence) for any direct, indirect or consequential losses, damages, costs or expenses arising out of or in connection with the use of or reliance on the monthly letter. By accepting a copy of the monthly letter, the Recipient agrees to be bound by the foregoing limitations and conditions.

Selwood Asset Management (France) SAS is registered in France (884 339 839 RCS) with its registered office at 106 Boulevard Haussmann – 75008 – Paris; and is authorised and regulated by the Autorité des marchés financiers (AMF) (GP- 21000006).

© Copyright 2022 Selwood Asset Management (France) SAS. All rights reserved.

