AXIOM
ALTERNATIVE INVESTMENTS

Flash AXIOM AI - Subordinated Financial Debt positioning in the current crisis

- In the recent market correction, financial subordinated debt has fallen sharply in recent weeks to levels that we have not seen for a long time. Current spread levels are above 1000 bps on Legacy bonds and above 1400 bps on AT1/RT1[1] bonds (Solaxicc index) which is equivalent to a yield to maturity of over 7% in EUR.
- The current crisis is an economic crisis and not a banking crisis: never before have European banks approached a crisis so well capitalized.
- The exceptional measures announced by the BoE, the ECB and the SSM[2] are extremely positive for the banking sector and more specifically subordinated debt.
- In practice, in our view, banks are in a better place compared to corporates and are almost assured of not coming under significant pressure from the supervisory authorities if they were to face a stress scenario that would affect their capital.

1 Analysis of the current situation:

A. Exceptional measures

The ECB has announced **regulatory relief measures** that are extremely favourable for European banks (and very protective for holders of subordinated debt). We published a note on March 12 explaining most of these measures (accessible hereafter Flash Axiom AI - Outlook for the European banking sector March 2020).

In a nutshell:

- **Capital Measures:** A temporary suspension of the conservation buffers (2.5% of CET1)[3] and Pillar 2G [4] (variable by bank), reduction or elimination of countercyclical buffers. The ability for banks to fill Pillar 2 with AT1 and Tier 2 securities further reduces capital requirements. This measure also significantly reduces the risk of coupon non-payment by increasing the distance to the MDA.
- **Liquidity Measures:** Very accommodating access to liquidity (TLTRO 3) [5] and the possibility for banks to go below their Liquidity Coverage Ratio.
- **Asset quality measures:** A relaxation of the rules, in particular on NPL[6] accounting.
- **Postponement of 2020 stress tests**

The 2018 EBA stress test results are quite useful to assess and predict the impact of the current crisis. These tests assumed 8.3% GDP deviation to fall into negative territory for a longer period than 2008 (3 years). This is the most severe scenario in terms of GDP deviation from baseline levels compared with the previous two EBA exercises.

The average impact on banks' CET1 is a maximum drawdown of 4.1pts, which leaves the banks **with an average CET1 ratio above 10%**, a figure significantly above the AT1 conversion triggers (7% et 5.125%). That is why we believe that fundamentals have become so robust following the financial crisis and that **European banks have enough capital to absorb the shock of a recession**.

B. European banks remain solid

Despite the market downturn, banks continue to call [7] at par their Tier 1 securities which have become

unnecessary or too expensive.

- On March 15, ING announced the call of USD 1 bn AT1 and USD 700 million Legacy Tier 1.

- On March 18, SEB announced the call for USD 1.1 billion AT1.

Sources: Axiom , Bloomberg as at 19th March, Spreads are duration weighted
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The fact that the supervisor authorised ING and SEB to exercise these calls is a very strong signal of robustness in the current context, which reinforces our vision of the European banking sector.

2 Funds activity and investment opportunities

We approached the market correction with a **significant amount of liquidity** in our portfolios.

Overall, we have had few redemptions over the last two weeks in our opened-ended funds (less than 3% of assets under management).

This **defensive positioning** enabled us to act as a tactical buyer in order to benefit from **historically high levels of returns**.

Opportunities arise across our investment universe: from short dated calls like SEB 5.75 (trading around 90 before its call announcement), make-whole[8] bonds offering an attractive yield to worst, to high coupon step-up[9] legacy bonds trading close to par, subordinated bonds offer compelling yields above 10% without any credit risk or coupon risk.

Overall, we remain cautiously constructive until the peak of the epidemic is known, as volatility will remain high.

A) Axiom Optimal Fix

The fund fulfilled its defensive role, limiting its decline.

We approached the market correction with around 30% of cash/quasi-cash.

We deployed some of this cash opportunistically to build certain fixed to fixed bonds of strong banks, which constitute the core of the fund's portfolio. These are legacy, high-coupon securities that will lose their eligibility at the end of 2022 and will be called.

For example, BNP Fixed-to-Fixed (one of our largest positions) has a call spread close to 1000 bps (call date in 2021). The bond was trading at 94 of par on Friday March 18th.

In the last few days we have mainly reinforced the fixed-to-fixed pocket.

At the same time, we took advantage of the sharp rise on the 24th of March to sell quasi-cash securities under good conditions and thus be able to continue our purchases. The cash/quasi-cash position now represents 20% of the portfolio.

B) Groupama Axiom Legacy 21

The fund has a pocket of 8% cash, 9% quasi-cash (short-term or senior securities), and 14% legacy AT1 securities, which, in addition to low extension risk, benefit from the maintenance of high liquidity in the current market correction (execution capacity on dealer bids/offers).

We carried out some arbitrages and, despite the exceptional market conditions, maintained a high velocity level in managing the portfolio:

- We are selling off instruments whose call catalysts are far off and which we can therefore come back to later since they should rebound more slowly;
- We are buying instruments with near catalysts to capture quicker rebounds:
  - We strengthened our position on the SEB 5.75% bought at 91% on March 18 with the conviction that the call option would be exercised within 4 weeks. The bank announced the call at par the same evening. This bond was issued in 2014 with an annual coupon of 5.75%. The bond was trading with a yield to call of 72%.
  - We also strengthened our position on a bond with a similar profile issued by an Opco and losing its regulatory eligibility. We managed to source it at around 90%, offering a yield to its call in June of more than 50%.
  - We are also finding opportunities on Lloyds Opcos, with step-up in 2024 and a regulatory call in early 2022. These bonds are now close to par and offer a yield to call in 2024 of more than 11.6% and 11.3% at its regulatory call (in USD).

These examples highlight the distortion of the market which offers buying opportunities.

The spread on the fund is now above 700 bps. We are finding legacy securities with extremely attractive yields on investment grade issuers.

Despite the exceptional market conditions, we have seen some inflows in the fund sincethe beginning of the market correction.

C) Axiom Obligataire

The Fund holds a pocket of 28% cash/quasi-cash. We have very marginally and selectively strengthened the AT1 pocket after the sharp correction of the last few days (the AT1 pocket now represents 28% of the portfolio). We strengthened ING 6 7/8, CaixaBank 5 ¼ and AIB 5 ¼.

We are also positioned on a legacy bond from RBS offering a return of 8% in GBP. This bond loses its capital eligibility at the end of 2022.

D) Axiom Contingent Capital

Axiom Contingent Capital, our pure play CoCo fund, approached the current market sell-off with 30% cash and a relatively defensive portfolio (short calls with high backends).

During the decline we selectively bought securities that fell by around 30% deploying part of the cash.

Overall, the re-pricing of the asset class represents a very attractive entry point. Indeed, we have seen periods of significant declines in the asset class in the past (2016 and 2018). As the market recovers, these instruments tend to reprice rapidly in terms of yield to call, generating a significant upside for bondholders.

The upside of the current portfolio is 50% if prices return to February 21st levels.

E) Axiom European Financial Debt

Prior to the week of 24 February, the Fund had reduced its exposure in Liquid Relative Value and in Restructuring.

Since the start of the correction on 24 February, the Fund has realised gains on some hedges and redeployed marginally on seniors, Tier 2 bonds and selectively within the Restructuring bucket.

As the correction continued, and as at 9 March, the Fund remained liquid with more than 5% of cash and 14% of Liquid Relative Value instruments. The Fund's holding in AT1 was limited to 35%, of which 17% are liquid instruments. The Fund holds also a significant pocket of liquidity in the form of Senior bonds, Fixed-to-Fixed, as well as other Legacy Tier 1 instruments with no extension risk, amounting to 18% and short bond positions as credit hedges amounting to 3%.

In these unprecedented market conditions, the closed-end structure should prove to be a very efficient format to absorb the price volatility in the underlying portfolio and we as investment manager remain confident in our ability to capitalise on opportunities in the subordinated financial debt universe.

3 Our Business Continuity Policy

Axiom activated its Business Continuity Policy (BCP) on Friday, March 13. All teams (research, portfolio management, middle office, internal control, risk control, marketing and sales) have access to all their usual tools via our remote access system.

Regular conference call meetings between teams are organized to ensure proper coordination of operations.

We did not observe any incidents. The management of the funds is carried out as usual.

The sales team is at your entire disposal and can be reached by email or by phone on our usual numbers.

4 Risks specific to subordinated debt

Credit risk

Since the introduction of the Bank Recovery and Resolution Directive (BRRD), the risk of a bank being resolved is the greatest risk for a long-term investment in subordinated debt. In the event of resolution, default or deterioration of the credit quality of the issuers (for example, if their rating is downgraded by credit rating agencies), the bonds in which the fund is invested will decline in value resulting in a lower net asset value.

Coupon

It is possible that the coupon will not be paid (apart from any resolution scenarios).

Subordinated debt entitles holders to receive coupon payments at a specified frequency. In some cases, the issuer may cancel coupon payment(s). The non-payment of a coupon is irrevocable, at the discretion of the issuer or by bond (in cases related to rules restricting coupon payments based on regulatory capital levels).

Extension

It is possible that a bond issuer will fail to redeem a bond when expected. The initially promised maturity date may be extended. As a result, investors might recoup their capital at a later time than initially scheduled.

Interest rate risk

Investors are exposed to interest rate risk, meaning when market interest rates rise, the prices of bonds fall, thus lowering the fund’s net asset value.

For an overview of the risks associated with investing in the Axiom funds, consult the “Risk Profile” section of the respective prospectuses.

5 Glossary

1. **AT1 and RT1 -** Additional Tier 1 and Restricted Tier 1 bonds are a new deeply subordinated debt format eligible for regulatory capital requirements/purposes under Basel 3 and Solvency 2. The instruments are designed to absorb losses in two ways: the first is via partial or complete suspension of coupon payment at the discretion of the issuer and the second is via either a (full or partial/temporary or permanent) principal write down or a (full or partial) conversion of the nominal amount into equity of the institution. The latter is triggered by a so-called quantitative capital trigger event with a predetermined regulatory capital ratio.

2. **SSM** - The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities of the participating countries.

3. **CET1 - (Common Equity Tier 1**) – Under Basel 3[10], Common Equity Tier 1 is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.

4. **Pillar 2 -** This pillar requires banks to develop their risk management beyond the minimum requirements set out in Pillar 1. Additional types of risk such as interest rate risk should be incorporated into this more comprehensive risk management system. Pillar 2 can be divided into two major components: (i) for institutions, where they should establish sound, effective and comprehensive strategies and processes for assessing and maintaining, on an ongoing basis, the amounts, types and distribution of capital corresponding to their risk profiles (ICAAP) and (II) Supervisory Review and Evaluation Process (SREP).

5. **TLTRO3** - Targeted Longer-Term Refinancing Operations - The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions. By offering banks long-term funding at attractive conditions they preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy.

6. **NPLs** - A non-performing loan is a loan that is in default or close to being in default. Many loans become non-performing after being in default for 90 days, but this can depend on the contract terms

7. **Calls** -capacity for the issuer the redeem a bond before maturity, usually – but not always – at par. Calls can either have a specific date or be triggered by regulatory, credit or tax events

8. **Make-whole** - make-whole corresponds to a calculation of compensation ("make-whole") which corresponds to the discounting of future payments (coupon and principal) that the investor would have expected.

9. **Step-up** – Step-up bonds are investment securities that pay an initial interest rate but also have a feature where set rate increases happen at periodic intervals.

10. **Bâle 1, 2, 3** - Under Basel 3, Common Equity Tier 1 is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.

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