Management Review

London - March 17th, 2020

H2O
Asset Management

On behalf of the whole H2O team, we would first like to extend to you and to your clients our sincere apologies for our risk-adjusted losses which have been particularly significant since early last week.

In terms of flows, we would also like to reassure you that our funds' net assets have so far proven much more stable than in 2019.

If 2008 was a liquidity crisis, 2011, a volatility crisis, and 2016, a convexity crisis, **2020 is a combination of the three previous shocks, which made:**

1. Our risk management much more difficult given the repeated market swings: as *an example, over the last 3 weeks, the S&P moved by more than 3% in either direction 12 times, a frequency seen only in the Great Financial Crisis and the Great Depression.* **Our funds have long-term investment horizons managed with relatively long risk matrices that tend to under-, then over-estimate their risk (volatility) budgets;**
2. No model could forecast and manage such repetitive shocks, and our earlier qualitative assessment of the crisis did not anticipate such an outcome. Also, our hedges did not work as expected, especially on currencies.

We now have to deal with sensitive markets that accelerate on the way down while doing the same on the way up. This pronounced convexity goes against our value management style; it may however offer investment opportunities at a later stage:

1. **Crises are ignited by different causes, but unfold along similar patterns:**
   - Volatility typically reaches its apex before the market hits its lowest point;
   - Volatility is a fire that needs to be stoked every day;
   - Contagion among assets starts at a local (Hubei), then regional, (China & SK) finally global level, to subside later going down the opposite route (global/regional/local);
   - Diversification alongside normalization of correlations spring back before assets rebound.

2. **Current stage of the crisis**: it is too early to make any sound prediction of the end of the current sanitary/health crisis and its final impact on the global economy, but what we can ascertain is that even though the end of the tunnel is not visible yet, **the lights have been turned on by central banks and governments.** Markets have been questioning the ability of the former to support the economy as the recent moves from both the Fed and the ECB have not yet stopped the sell-off on risky assets. However, we believe that markets underestimate the firepower of central banks in the coming weeks. Instruments which are not available today could become accessible, the People's Bank of China has not intervened massively yet, and the ECB could increase the self-imposed limit of 33% of total eligible assets to purchase per country.

In this environment, as the crisis is moving into a liquidity credit crisis, we should avoid assets which are not “protected” by central banks, and maintain those which are systematic and will be supported by them. This is the reason why, for example, we have no exposure to US High Yield and EM corporate credit, as the bulk of our exposure pertains to G10 sovereign bonds & currencies mainly. To be sure, the reversion of these liquid instruments back to their fair value is in general faster than that of other assets.

Through their massive fiscal and relief intervention, governments should also smooth the cost of the economic lock down.

3. **What happened to our funds**: the split between our long risk-on positions (under-valued and volatile assets) and our short risk-off stance (over-valued and less volatile assets) has widened: the former have turned less expensive while the latter have surged in value. For our global fixed income portfolios, the drop is roughly split equally between sovereign bonds and currencies.

Our main objective in this challenging environment was, and remains twofold:

1. **First and foremost to reduce the risks**: this is what we have done following the drop in the funds’ net assets, and the surge in the volatility and correlations of our positions. This risk cutting policy is conducted discretionarily, and preferably concerns the exposure to strategies whose immediate justification has subsided and investment horizon has lengthened;
2. **Also, to keep the rebound capacity of the funds as significant as possible**.

It is important to remember that correlations normalize before asset prices start appreciating, which will critical for the rebound of our relative value strategies as soon as the current crisis dissipates.

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