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"Those who cannot remember the past are condemned to repeat it"
George Santayana

We would like to begin with a brief summary of the fund. The fund closed the 28th of June with a NAV of 114.66, representing a net return of 1.67% for the second quarter of the year, and therefore, making the total return for the year 6.1%. The fund was launched the 14th October of 2013, and since then, the return has been of 14.7%. The ISIN of the fund is LU0942882589.

The first half of the year has been positive for all the fixed income universe, having the credit spreads narrowed to historically low levels since the end of last year. Investment grade bonds (those BBB or higher) and those from emerging markets have behaved positively and in a very similar fashion to the high yield ones (which make up most of our portfolio), due mainly to a change in the discourse of central banks. The Bloomberg Barclays Global Credit IG index, which is a good indicator of performance of the investment grade universe, ended the first half of the year with a return of 5.08% (in Euros), whilst the Bloomberg Barclays Emerging Markets Corporates Total Return index (BEBGTREU), which shows the evolution of bonds from emerging markets, ended with a 10.44% yield. Lastly, our closest comparison in terms of asset class, the Bloomberg Barclays Global High Yield Total Return index (LG30TREH), concluded with a return of 8.1%.

Having said this, the returns generated in the fund throughout the first six months have been similar to the fixed income indices, but as later mentioned, with substantially lower risk, because our cash and equivalent position by the end of June was one of the highest of our history. The very high valuations, together with poor balance sheets and uncertain economic expectations have left us taking a more cautious approach to credit risk in general.

Now we will provide a summary of the first half of the year, how we generated our returns and how we are positioned for the rest of the year.

Summary of the first half of the year

The first half of the year has been very favourable for the fund's performance. The prices of the bonds within our portfolio have risen and, generally, have more than compensated for some of the losses stemming from a few individual positions, which we will comment on later. Due to this performance, we have recovered from the losses suffered last year, and moreover, we now have a portfolio of more liquid assets, but with a positive spread (in terms of yield to worst) of 2.5% compared to the US HY bond index.

The greatest contributors to the performance have been the preferreds of the GSEs (Fannie/Freddie), the Imperial Metals and Canbriam Energy bonds (which in both cases have been retired) as well as certain bonds from emerging countries, which have substantially narrowed their spreads and therefore we are no longer invested in (Sibanye, Tunas, Tupras, Kernel y MHP). The largest detractors of profitability have been some of our energy companies (Floatel and CRC) along with the HC2 bonds, which we will later comment on.

There have been two major changes in our portfolio during these months. The first is that, as the credit spreads have narrowed, our share of our cash and other liquid assets (short-term Treasury bonds and 3-6 month bills from reputable issuers such as CIE Automotive or Europac) have increased by the same proportion: if at the start of the year the percentage of our cash and equivalents was under 14%, by the end of June, the same percentage had grown to 27%. We are prepared to make use of this liquidity when the right investment opportunities arise. We are confident that it will not be long before these opportunities finally materialise.

Despite the high percentage of cash and equivalents and the short duration of the fund (1.8), the YTW of the fund was of 5% (fully hedged in euros) at the end of June, substantially higher than the 2.7% of indices such as the HYG. We truly believe that the fund presents a more attractive risk/reward proposition than most fixed-income indices or funds, and without taking into account the various investments we hold with huge optionality and limited downside risk. The second major change during these months has been the progressive incorporation of convertible bonds to our portfolio, representing around 8% by the end of June. Although most of these bonds are in situations with very limited credit risk, either because you are buying cheap optionality with low coupons (Polyus) or because there have been forced sellers after the fall of the price of the underlying asset (Ence), there are two convertible cases (Teekay and HC2) that have a more equity-like return profile. In either case, our estimated valuation of the underlying assets fully supports the value of such bonds.

Current positioning and comments on selected investments[1]

Looking ahead to the rest of 2019, as it stands, our portfolio has 41% of its assets in Europe, 44% in the US and Canada, 10% in emerging Europe and 5% in the rest of the world. Although Europe represents an important percentage of our investment portfolio, our presence in the "traditional" Europe (France, Germany and Italy) is very limited, because we still believe that valuations are absurdly expensive and that sooner or later that will change. Within Europe we focus on energy firms (Siccar, Enquest), convertible bonds for which there have been forced sellers (Ence), or small, local issues, where local knowledge have allowed us to buy these bonds at a discount (Ortiz, Copasa).

To give our investors a better idea of the scale of overvaluation as to which these European debt markets are trading, we would like to simply point out that only twice in the history of modern Europe (after the 17th century, which could be considered the start of fixed income markets in the modern sense of the word and especially after the "financial revolution" in England of 1688, and which witnessed the foundation of the Bank of England in 1694) have interest rates been so low. The first era, which was in the middle of the eighteenth century, was an era characterised by great economic growth and by easy money, culminated by the issuance of Britain´s first perpetual debt in 1751 at 3%, the famous *consols*.[2] At the end of the 19th century we encounter the second era, which coincided with the heyday of the gold standard, marked by deflation, given that the global discoveries of gold at the time, in general, did not keep up with global economic activity. As can be seen, low rates have existed both in times of prosperity, as well as in uncertain times. Although these periods and institutional configurations are different (for example, liquid corporate debt markets did not exist until well into the 19th century, without taking into account that the HY debt market was only created by the end of the 20th century), we believe that this comparison is instructive, and that in any rate, the risk/return proposition of the European HY is clearly very unfavourable. Our *bottom-up s*election process of European bonds that we know very well (but which are currently pricey) has led us to very similar conclusions.

On the other hand, the breakdown of our portfolio by ratings is: investment grade 9%, BB 13%, B 28%, CCC 2% and unrated 48%.

At a sectoral level, the breakdown of our portfolio is as follows: industry 20%, energy 18%, financial (including real-estate firms and companies with activities in other areas, but whose issuance is carried out by a financial company registered for this purpose) 13%, and basic materials 8%. At a sectoral level, we still believe that the divergence in terms of valuations between the energy sector and other cyclical sectors (e.g. chemicals or automotive) is unjustified. Such a divergence, together with a positive view on the oil industry (especially the supply-side dynamics) leads us to be overweighed in these companies.

Finally, in terms of individual credits, we think it could be worthwhile to share the following remarks about the main developments that have happened over the last few months:

[1] Unless otherwise stated, all the figures are as of 28th June.
[2] Homer, S. & Sylla, R. (2005); *A History of Interest Rates*, p.153, 4th edition, John Wiley & Sons.

- ***Oil companies:*** We have made limited changes to our energy positions since we explained the rationale for our stance in our November letter. Since then, we have reduced our exposure to service companies, ending our investments in EnscoRowan and Bristow; although the losses in the latter were limited, it proved to be a hasty investment due to the hard-to-grasp dynamics of the helicopter industry. In the rest of our portfolio, Floatel´s bonds (the only remaining service company in our portfolio), has kept depreciating to historic lows, due to both the unpredictability of oil prices and the uncertainty of order backlogs, despite the fact that many of the regions in which Floatel operates in are experiencing high utilization rates (especially the UK and Norway). The announcement of the merger with Prosafe would create the largest offshore accommodation company in the world, with a fleet total of sixteen semis, a dominant position in their main market (the North Sea), controlling thus 15 out of the 18 semis that can operate in that region and with the potential to rationalise the supply if conditions do not improve (Prosafe´s fleet is much older than Floatel´s and we see clear very-old candidates to be scrapped). In the rest of the portfolio, the Athabasca bonds have rapidly recovered with the measures taken by the Alberta government to restrict oil production. However, the price of the bonds is still below par, which along with the high coupon, make the bonds still a highly attractive investment. On the other hand, CRC bonds have been amongst the biggest detractors: although the results have been slightly disappointing, we believe that the market is over-penalising the company and fearing for the refinancing of the first important tranche of the debt (the TL 2016, with a hefty coupon above 10%) that matures in two years. In the coming months, we believe that we will see how CRC monetises additional assets, both as it has done through JVs in the past and through the sale of royalties (unlike fracking companies, CRC´s main field, Elk Hills is under the complete ownership of CRC, without royalties or any other similar charges). This will allow it to refinance the debts at more attractive rates and materialise the value of those assets. Finally, we have increased our position in Siccar, an oil-producing company operating in the North Sea, for two reasons: i) the company presents a healthy balance sheet with low production costs, and also ii) there has recently been great interest for independent operators in the North Sea and we believe that Siccar may be a potential target due to this interest. Last year, one of our companies from the North Sea, Point Resources, was purchased in similar circumstances by ENI, increasing the price of the bonds from par to 113. In such a scenario, we believe that the revaluation potential for our Siccar bonds could be similar.

- ***HC2:*** HC2 is our main position within the portfolio, which is divided in two tranches: the first tranche, a first lien bond that we acquired on the day of its issuance in November 2018, the second, a convertible junior tranche which we acquired in the first half of 2019. In both cases, the current prices are substantially lower than the prices at which we initiate our positions, with yields to maturity (in euros) both being over 13%. In addition to the inevitable holding discount that the market applies to these situations (due to the uncertainty that comes with upstreaming money to a holding company, or being structurally subordinated to the debt of subsidiaries, etc.), the HC2 bond has been punished for two reasons: i) the time of its issuance in November 2018 was not the most ideal (due to them having to refinance another, previous bond), leading the company to pay a high cost debt against its limited cash generation, and ii) Philip Falcone, CEO and HC2´s largest shareholder, has prioritised so far the acquisition of new companies (insurance and television station businesses) or has focused on the growth of existing ones over deleveraging the company. However, we believe that this will not be for long as the sale of the subsea cable business and the potential monetization of other medical companies that are owned by HC2 under its medical subdivision, Pansend, change the company´s focus. Given the EV we estimate for the company in the base case scenario ($800-$1-100 million), the current amount of debt ($450 million) and the current price (first lien debt is quoted at a discount of 15%), we believe that the current LTVs of 37% are attractive due to the profitability offered by the bonds, the alternatives available to the management team to unlock value and the alignment of interests between management and shareholders, as well as Falcone's long track-record in value creation.

- ***Aimia***: Aimia is an old acquaintance, having been invested both in its bonds and its preferred shares over the last two years. Again, we have considerably increased our position in the preferred shares (all of the company´s bonds have now been retired), who trade at a significant discount to par value, and now in a company whose investment thesis has simplified greatly from the sale of Aeroplan to Air Canada last year. Without this investment, most of Aimia´s value derives from its Mexican loyalty business, where it has a stake of 49%, followed by a large stack of cash from the sale of Aeroplan, other small businesses (including its stake in Cardlytics) as well as NOLs accumulated over the years that can be monetized through the acquisition of cash generating assets. We estimate that all of these assets (excluding NOL´s for the sake of conservativeness and including other digital marketing businesses that are currently losing money) in a base case scenario can be valued anywhere between 900-1000 million CAD, against the 332 million that represent the preferreds (cash and other short-term investments, which have been adjusted for the recent buy-back program, represent 450 million CAD). Although there has been going a battle for control of the company between activist investors (including Christopher Mittleman) and a board of directors who do not have a single share of the company and that has witnessed an unprecedented destruction of value, we believe that the value of the preferred shares is sufficiently covered in any potential outcome – although we would be more comfortable if a reputable investor in capital allocation like Christopher Mittleman would take the reins of the company.

- ***GSE's:*** The Government Sponsored Enterprises, Fannie Mae and Freddie Mac, had a very busy first half, doubling in price from January to their highs of $22 to finally fall into lows of about $17, which we have covered in our monthly updates. With the aim of not repeating ourselves, it will only be pointed out that even though the prospects for an immediate recap and release next year have cooled down following Trump´s administration´s comments in July, we believe that more and more details will gradually emerge over the following months, increasing thus the value of our preferred shares again. We are also pending a possible ruling in the coming months in the Fifth Circuit Court of Appeals to review the legality of the net worth sweep, because although the likelihood of finding a viable solution via this route is low, the first hearing a few months ago was very promising.

- ***Polyus*:** Even though Polyus is also an old friend of ours, we had not been invested for a while, in fact, it was not until March where we began purchasing the convertible bonds that expire in 2021 and become one of our main positions. Polyus is a Russian gold producer and one of the worlds´ leading companies (behind ones such as Barrick, AngloGold and Kinross) with a production of roughly 2.4 million ounces a year. Polyus´ investment thesis is simple: at par, Polyus´ convertible bonds are the equivalent of buying free exposure to the price of gold, since the low coupon you get is offset by hedging costs. The question is therefore whether the multiples at which the underlying stock trades at are attractive or not; and indeed, they are. At the price of £4.5 per share (the convertible strike), it would imply valuing Polyus at a multiple of $210 for 2P gold of reserves, well below the $298 at which Goldcorp trades, the $310 of Gold Fields, the $357 of Barrick or the $628 of Agnico. Moreover, Polyus has the lowest costs out of the *majors* (we estimate AISC of around $700-$750, higher than those reported by the company, yet substantially lower than its competitors), with its Olimpiada and Blagodatnoye mines being consistently plotted on the lowest part of their cost curve. Whilst we understand that the corporate governance of the company and the fact of being Russian deserves a discount in the multiple, we believe that the current discount is far too excessive, and with a modest reversion to the mean, the investment could become very lucrative (as it would involve a bond price of 140-160). Although we have no particular outlook for gold prices (even though we would like to point out that the costs of developing a mine have been increasing dramatically after several years of a severe cost deflation), the optionality of the investment to higher gold prices is so antifragile in the *Talebian* sense of the term (being the losses in a bear case limited to the par of the bond) that we think it offers a very interesting protection to the rest of our portfolio.

- ***Emerging markets:*** our exposure to emerging markets is the shyest it has been in a long time due to the excessive valuations they present. We have been expelled from Ukrainian assets after the returns on our MHP and Kernel bonds (both exceptional companies) fell below the threshold we consider acceptable (currently 7% in dollars), from Turkey, where we only have a reduced exposure to Petkim and almost from Indonesia, where we have closed our positions of coal companies as well as reduced our involvement in palm oil producers, Tunas and Sawit, for the same reasons. Although we have found companies with strong balance sheets in more unusual locations such as Georgia, Moldova and Ecuador, we currently believe that it is better to not be involved in emerging markets.

In the case of emerging economies, there is no doubt that we will witness interesting opportunities, due to the continuous changes in the liquidity of developed countries (which is in fact the biggest factor in determining emerging market valuations)[3], as well as for purely idiosyncratic issues of each economy; it will be then when we will not mind allocating a higher share of our portfolio to companies with extraordinary businesses and always selling in hard currency.

On the trade war and low interest rates

We would like to conclude this semi-annual letter with two macroeconomic concerns that are in the press every day and which we believe are widely misunderstood. Both concerns have the potential of greatly influencing the returns of our portfolio in the future, so we believe that it is fundamental that our investors understand our stance on these issues. We are referring to the current Sino-American trade war and the low interest rates.

The trade war between China and the United States has undoubtedly been the most discussed geopolitical event over the past few months. Due to the fragile economic growth experienced globally (especially in China where GDP statistics clearly contradict more reliable statistics such as the PMI or private vehicle sales, which are displaying a slowdown in economic activity), markets fear that a trade war could start a negative spiral, causing thus a setback on asset returns. The most listened narrative nowadays is that Trump has exacerbated the trade war, disregarding the Chinese efforts to bring back life to negotiations, promoting free trade, opening its economy and holding the Renminbi at reasonable levels. Only when the Americans become more reasonable will the negotiations be able to move forward, and given that the US elections are just around the corner, hopefully we will see progress soon.

Is this assessment accurate? Whilst we have always thought (even before being elected president) that the incompetence of the Twitter-in-chief and his team of advisors was going to have negative effects on the American economy and the global order, we think that the US´ approach to the trade war (in terms of forcing China into being more transparent in international trade affairs) is the right one. As Brad Setser excellently explains on his blog, the trade issues with China go beyond a few simple tariffs or the sale of some soy products. China´s import substitution in the manufacturing sector over the last decade is truly staggering, and what is even more surprising is that it has not receded in the last few years. Despite all of the grandiose words on tariffs and on *America First*, the volume of US manufacturing imports has grown in recent years, relative to GDP (i.e. the US is more "globalised" than before) whilst the same metric China hasn't stopped falling (as an anecdote, one may think of the rise of the semiconductor industry in China). China is also unique in terms of its economic development. Initially, most of the developed countries today had high barriers to entry into their domestic markets in order to protect their industries and create powerhouses, only then would they open to trading with the rest of the world, once they became competitive. The Chinese case of manufacturing imports becoming less important is completely unprecedented in economic history, showing that such commercial involution is a political objective for Beijing.

As Brad Setser explains in this article, (whose issues had already been tackled in Mark Wu´s famous paper of 2016), the real problems are deeper than a matter of tariffs or even a respect for each other's intellectual property. The problem is that, unlike the rest of the world, where each buyer freely decides which products to buy, the larger buyer of products in China (especially in the capital equipment sector) is the Chinese state itself. And such a buyer can also decide overnight to stop buying, without any need to resort to new tariffs or competitive currency devaluations. Some examples include: all purchases relating to railways must be approved by the Ministry of Railways, purchases relating to telecommunications networks go through the three-state owned enterprises, agriculture products are mainly decided by COFCO (China National Oilseeds, Grains, and Foodstuffs Company) and aircraft purchases must have the approval of the NDRC. To think that China would change so many of its economic and established entities in such a short time to ease the tension with the US in the trade war is truly astonishing.
The fact that we do *not* believe that the trade war will have a real resolution in the short-term (other than some absurd tweets that temporarily calm down the market) nor in the mid-term, it is not because of the historical dynamics just mentioned, but due to the fact that China, in 2015, (in a

[3] Pettis, M. (2001); *The Volatility Machine: Emerging Economies and the Threat of Financial Collapse*, Oxford University Press.

different international context) made it clear that it would not scale down such pretensions. In that year, China presented its ten-year plan, *Made in China 2025*, in which it showed government's commitment to promoting and developing high-tech industries, such as: electric vehicles, IT, advanced robotics, AI, agricultural technology, aerospace engineering, biomedicine, high speed trains and synthetic materials. After such an extraordinary list, it seems as if China is not offering any options to other countries to buy their products in the future, is it?

In short, we believe that the trade war between China and America is in its early stages and that, unless China changes its approach, which seems highly unlikely, the result of this dynamic system will be an equilibrium where the world ends up in a bipolar system, which is something that we can already see happening within the field of communications and technology (Alibaba and Amazon, Tencent and Google, etc.). Donald Trump´s hostility, although clumsy, is not, in our view, misplaced; rather it is the European Union, offering Huawei to develop its 5G networks, over companies like Nokia and Siemens, who proves its lack of knowledge for what is at stake in the long term.

Finally, the problem regarding low interest rates (and whether they will continue in the foreseeable future) is significantly harder to explain than the issues regarding the trade war. We believe that, in any case, the amount of time that the participants of the market dedicate to forecasting, commenting and complaining about central bank policies is completely disproportionate to their other duties and, at any rate, of little practical significance (it is something that at BrightGate we devote less than 5% of our time to).

Firstly, it is not clear whether low interest rates stimulate higher inflation, as recent articles suggest the opposite and that an expansionary monetary policy could cause deflation, something which could be completely feasible.

Secondly, we have seen that monetary policy is, in general, a fertile ground to make fallacy-of-composition arguments. An example of this is: after asserting during social gatherings that "the FED is falling behind the curve and when the next recession comes, it will have no weapons to fight it with", market participants leave these discussions to access their Bloomberg terminal to make investment decisions in fixed income securities, decisions that, over the past three years, have flattened the slope of the yield curve, which has been finally inverted this year, indicating that the FED is currently pursuing a policy that is too restrictive for the current economic conditions. Is it the schizophrenia of the participants that what they believe at the individual level is diametrically opposed to what happens when all their individual actions are added together?

To help us better understand why what happens at an individual level does not have to happen at a macro level we have allowed ourselves to present to you this fun excerpt from the masterpiece of the scientist Douglas Hofstadter, *Gödel, Escher and Bach: An Eternal Golden Braid*.[4] In it, Hofstadter produces a dialogue explaining how ant colonies can be conceptualised from a reductionist point of view, as the simple sum of the ants (as Achilles does in the dialogue), or holist, as an independent entity from the behaviour of each individual ant (as the anteater does):

> *Tortoise: I am sure that we have much to learn from you, Dr. Anteater. Could you tell us more about ant colonies, from a reductionistic point of view?*
>
> *Anteater: Gladly. As Mr. Crab mentioned to you, my profession has led me quite a long way into the understanding of ant colonies.*
>
> *Achilles: I can imagine! The profession of anteater would seem to be synonymous with being an expert on ant colonies!*
>
> *Anteater: I beg your pardon. "Anteater" is not my profession; it is my species. By profession, I am a colony surgeon. I specialize in correcting nervous disorders of the colony by the technique of surgical removal.*
>
> *Achilles: Oh, I see. But what do you mean by "nervous disorders " of an ant colony?*
>
> *Anteater: Most of my clients suffer from some sort of speech impairment. You know, colonies which have to grope for words in everyday situations. It can be quite tragic. I attempt to remedy the*

[4] Hofstadter, D. (1979); Gödel, Escher, Bach: An Eternal Golden Braid, Chapter X.

situation by, uhh-removing the defective part of the colony. These operations are sometimes quite involved, and of course years of study are required before one can perform them. [...]

Achilles: I thought anteaters were devourers of ants, not patrons of antintellectualism!

Anteater: Well, of course the two are not mutually inconsistent. I am on the best of terms with ant colonies. It's just ANTS that I eat, not colonies-and that is good for both parties: me, and the colony.

Achilles: Well, I can vaguely see how it might be possible for a limited and regulated amount of ant consumption to improve the overall health of a colony-but what is far more perplexing is all this talk about having conversations with ant colonies. That's impossible. An ant colony is simply a bunch of individual ants running around at random looking for food and making a nest.

Anteater: You could put it that way if you want to insist on seeing the trees but missing the forest, Achilles. In fact, ant colonies, seen as wholes, are quite well-defined units, with their own qualities, at times including the mastery of language. [...]

Tortoise: It seems to me that the situation is not unlike the composition of a human brain out of neurons. Certainly no one would insist that individual brain cells have to be intelligent beings on their own, in order to explain the fact that a person can have an intelligent conversation.

Whereas being Achilles (the reductionist) can be advantageous in some situations, we believe that when considering the macroeconomics of interest rates, being the anteater or the turtle (who were holists) helps you have a much clearer view of what we can expect in the future of interest rates in developed countries. Given that the greatest determinant of long-term inflation is the increase of wages, and since wages in the developed world have not grown for a long time due to an increasingly unequal income distribution and more globalised and competitive markets, we see no immediate risk of rising inflation in the near future (despite the "ultra-expansionary monetary policy", as some argue), and therefore, we expect lower rates for a while longer.

In any case, our portfolio is built to both withstand additional tensions from the trade war with China as well as a long period of low interest rates.

We wish you a happy summer and hope to bring you good news in our end-of-year missive.

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