Letter to Shareholders – Value Bonds

Q4 2015

Dear Investor,

In February 2016, the Year of the Sheep in the Chinese calendar will come to an end. 2015, and especially Q4, has felt like the Year of the Black Sheep. China's transition from a manufacturing economy – growing at double-digit rates – to a consumer-driven economy – growing at a lower rate – has been blamed for much of the malaise seen in global credit markets. Q4, in particular, has been all about commodities continuing to hit new multi-year lows, whether it was oil, copper or coal.

Though we have continued to see weakness in oil-related markets, such as the Norwegian bond market, the pain across international energy companies got significantly worse as we approached the year end with its various technical implications. Whether it is repositioning ahead of the New Year or adjusting marks of illiquid positions, the market experienced a significant correction, especially in high yield. The fact that some high profile asset managers suspended their credit funds from daily redemptions led to widespread fear and search for liquidity in an already illiquid market. There can be no doubt that regulators in the US and Europe have a difficult problem on their hands, as they are the ones who drove all the liquidity out of the bond markets by removing the banks' ability to take on bonds at times when liquidity is needed. The simultaneous growth of passive daily liquidity products, such as ETFs, has only lead to amplification in volatility in our space.

Some of the highlights from the fourth quarter of 2015: Our Investment Grade strategy had a very strong quarter resulting in all funds being in positive (gross) performance for the year. The strong performance has been recognized by our average Morningstar rating of 4.5 stars in our Investment Grade funds. During the quarter, we also launched our new 2019 50% investment grade and 50% high yield fund as continuation of our family of maturity funds. Our 2018 vintages performed well throughout the turmoil. However, our shorter funds continued to suffer from their Norwegian oil & gas exposure. Equally, our Emerging Market funds underperformed on the back of energy and mining exposures. These strategies, in particular, now have some attractively priced special situations which will drive performance in 2016.

High Yield

The High Yield fund ended the year with total negative performance of more than -14%, which, compared to a benchmark return of -2%, is considered very disappointing.

The two main drivers of performance in 2015 were, needless-to-say, the oil price and China – some would argue two sides of the same coin. As the Chinese economy came to a stop, so did the demand for commodities. December was an extremely weak month for global high yield markets and resulted in the first negative annual return since the financial crisis in 2008.

As oil prices dropped, all activities and assets related thereto, took the same route. Only a few names in the portfolio were unaffected by the drop, the rest were dragged down along with the market. Not even efficiency-driven industry leaders with strong contract coverage and new assets were resilient against the low oil price and its impact on profit margins. It is especially the smaller players within seismic and oil service companies that have suffered during 2015, and several have capitulated or are struggling to stay afloat.

The energy exposure contributed with a total loss of more than 10% during the year. Hence the remaining part of the portfolio performed more-or-less in line with benchmark. Among the energy companies, we had a handful of positive performers – some as a result of successful restructuring and some as part of M&A activities. We experienced renewed risk appetite during mid-2015, but, as oil kept its downward momentum, even the most extreme risk-takers walked away.

Financials was the best-performing sector of 2015, as the markets perceived the continued de-risking of the banking sector as very positive, especially in the current environment. The portfolio gained 1.5% from the 25% exposure to this sector.

The negative trend from 2015 continued into the New Year with big fluctuations in all financial markets. All the leading stock markets took some serious beatings in January on continued bad news out of China and uncertainty about growth in the US and Europe.

Commodity prices also got an extra notch down in January, and the Brent oil price was way down, touching USD 28/ barrel, the lowest level since 2001. Rumours about a possible meeting between OPEC and non-OPEC countries, including Russia, caused oil to recover slightly.

The fund delivered a negative monthly return of roughly 1 pct. relative to benchmark during January.

The huge swings in oil prices shocked the markets once again, resulting in a -1.5% impact from the energy companies in the portfolio. Only our exposure to Petrobras could withstand the pressure and contributed with slightly positive performance. The uncertainty of the direction of global economy also led to losses in financials in general.

Best performance came from healthcare, where one of our US companies recovered from negative headlines presented in October last year.

The overall positioning of the fund – on the one hand in special situations and on the other in more defensive credits – has resulted in us holding up well in a spread-widening environment but then underperforming on credit-tightening events.

We still expect to see some turmoil in high yield in the short-term, closely correlated to the volatility in the commodity prices. As we get closer to the end of 2016, prices should stabilize on a more long-term level and slowly begin the journey back to a sustainable equilibrium.

Investment Grade

Performance-wise the IG fund ended 2015 flat versus a benchmark loss of 0.5%.

The main performance contributors were financials and industrials, whereas utilities was the worst performing sector.

In terms of regions, the lion's share of performance attribution came from the European exposure. On an issuer level, the largest performance contributors came mainly from the portfolio's subordinated bonds.

In January, investment grade bonds were dominated by two large opposing trends: Sharply falling interest rates and rising credit spreads. The 5-year American, German and British interest rates fell by 0.43%, 0.27% and 0.45% respectively and 10-year yields fell almost as abruptly. Both the interest rate drop and the spread widening were driven partly by slower economic growth in China and a sharp decline in oil prices from the beginning of the year. Under the surface of the benchmark's undramatic January return of 0.4% lies an estimated loss of 1.8% due to spread widening and a gain of approximately 2.2% as a result of falling interest rates.

January's performance was more or less in line with benchmark. The fund was burdened by wider credit spreads contributing negatively by approximately 1.6% whilst it benefitted from the drop in interest rates contributing positively by approximately 1.8%. Relative to the benchmark, the fund proved somewhat more robust towards the spread widening, but benefitted less from the lower interest rates due to a lower level of duration in the portfolio versus the benchmark.

The main absolute performance drivers were information technology, industrials and consumer discretionary whereas energy made a negative performance contribution. Relative to benchmark, energy contributed positively, as the fund is under-weight this sector.

In terms of regions, the majority of both absolute and relative performance attribution came from the fund's North American exposure, whereas the European exposure burdened performance.

Emerging Markets

The fund delivered disappointing underperformance of almost 10% compared to benchmark, primarily from over-weights in high yield energy and materials.

China devalued its yuan currency mid-August, with Chinese regulators indicating the move was a bid to see the exchange rate better reflect market forces. But the market agreed that the real reason had to do with falling exports. A weaker, more market-oriented yuan would benefit China's economy. Another interpretation of the move to make the yuan more responsive to market forces was that it was a move to help the currency gain entry to the International Monetary Fund's Special Drawing Rights basket – a facility that could come in handy in case of further trouble. The lower growth trajectory of the Chinese economy induced lower demand for commodities, from base metals to oil. Commodity prices were under pressure, especially in the last six months of the year. This put pressure on corporations with exposure to commodities, especially in Africa and Latin America.

2015 was also a year of geopolitics. The ongoing conflict between Russia and the West was on hold and it seems that President Putin is trying somewhat to de-escalate the tension. This brought about a rally in Russian and Ukrainian corporate bonds, so much so that Europe was the outperforming region.

Political deadlock was the theme in Brazil and the country found itself in a corruption scandal that involved business people as well as politicians. Brazil was the underperformer in Latin America.

Base metals stabilized in December after a brutal November, but oil is still under pressure and continued its downward spiral in December. The liquidity in the market was especially poor in December going into year-end, as investment banks were cleaning inventory. Non-investment grade credit-names were the clear underperformers in December. Sector-wise, the oil and gas sector underperformed together with names in metals and mining. In effect, credits in Latin America and Africa suffered the most in December.

The fund has been overweight commodity-related names and based on this the fund has been underperforming the benchmark. Also, the fund has been overweight non-investment grade credits which have also underperformed the benchmark.

On a positive note, the fund has been overweight Russian credit names that have outperformed the benchmark.

Worst performer in the fund was an industrial transportation company with business activities across Latin America. The company has been in talks with debt holders for some time, but defaulted on its bond obligations in December.

Best performer in the fund was a Ukrainian meat and poultry company that rallied on the back of the positive geopolitical story and a successful negotiation of the Ukraine sovereign debt.

Lower oil and growth fear gave January a risk-off sentiment. In particular, lower-rated Emerging Market credit names underperformed higher-rated credit names. As the fund is overweight lower-rated credits, it underperformed in January.

Value Bonds 2016

The fund ended 2015 with a return of 0.65%, which compared to the overall high yield and investment grade market performances of -3% and -1% respectively, is very satisfactory. Despite poor performance from the energy exposure, the remaining part of the portfolio actually benefitted from the low oil price.

Of the total return, exposure to energy-related companies contributed with more than -1.25% so the remaining gained almost 2% during the course of the year.

The fund continues to have a relatively high exposure to energy, but primarily to the large state-owned companies such as Petrobras, Rosneft and Gazprom that are expected to perform better through the crisis than the smaller players and subcontractors. The big players have also followed the rest of the market downwards, but will regain the lost ground as soon as the supply and demand again find a natural balance.

January return was slightly negative, but still better than broader markets.

Value Bonds 2017

The fund had a negative year in terms of performance, but managed to remain in positive territory for the fourth quarter.

The main negative contribution came from energy-related issuers in the portfolio and a further deterioration in the pricing of a defaulted Brazilian soft commodity trading business. A mining company delivered the highest contribution where a restructuring resulted in additional capital commitments from the shareholders in exchange for bond-holders approving covenant waivers. Sector-wise, all sectors delivered negative contribution to performance given the widespread weakness in high yield.

In January, the fund had negative performance in line with overall weakness in high yield but also driven by the fund's exposure to commodities. The weakest contribution in month came from our non-rated holdings and materials in terms of sector. There we had the weakest performance coming from negative price action on a mining company, which widened despite a very positive operational update from the company during the month. At same time we have witnessed repricing in energy names across the fund. The strongest performance in portfolio came from exposures in consumer cyclicals and healthcare.

Value Bonds High Yield Short Duration 2018

Despite the general widening of spreads in the fourth quarter, the fund managed to deliver a positive return of 0.55%, ending the year at approximately the same level as where it started.

Sector-wise, energy-related companies were again the main driver of bad performance, and this was the only sector contributing with negative return during the 2015. The fund only has a 10% exposure to the sector, hence the impact from the oil crisis has been below market average.

Financials was the best performing sector, as the markets perceived the continued de-risking of the banking sector as very positive, especially in the current environment. The portfolio gained almost 1% from the 18% exposure to this sector.

The fund had a negative return in January, in line with weakness in high yield.

The energy sector was the worst-performing sector in the portfolio in January. The financial sector was the second worst-performing sector in the portfolio, losing the strong momentum from 2015. Information technology and materials were the two best-performing sectors in the portfolio.

Value Bonds 2018 50/50

The fund ended the year with disappointing performance slightly south of -1.5%. It is important to keep in mind that the fund lost at least 1% in the initial phase due to very low AUM.

In investment grade no single sector or company stood out performance-wise. So the segment was in general affected by the negative sentiment.

Among the high yield issuers, the worst contribution came from a US company providing self-service retail solutions within DVD and video game rentals and coin-counting. The company lowered its guidance for 2016 compared with the previous year, and the bond fell 10%.

The highest contribution came from a Norwegian drilling company where, during 2015, we succeeded in reorganizing and optimizing the business to an extent that eventually enabled the company to repay majority of the principal.

In January, this fund was also impacted by the general move in global spreads, resulting in a 0.7% loss.

The energy sector was also the worst-performing sector in the portfolio in January with the financial sector the second-worst. Information technology and healthcare were the two best-performing sectors in the portfolio.

The worst-performing position in the portfolio was a Kurdish oil producer. The company receives most of its revenue through oil export payments from the Kurdish government. The oil price decline has challenged the Kurdish public budget and has therefore made payments to the Kurdish oil producers more uncertain, this situation however improved post month-end, with more clarity on the political side. The best-performing positions in January were an airport service company that called its bond at the month end and a fallen angel North American IT company which is undergoing an M&A transaction.

All in all, 2015 and the beginning of 2016 have turned out to be very challenging for corporate bond investors. Both high yield and investment grade delivered the first negative annual returns in 7 years and we saw several fund managers close down their funds due to extreme losses and lack of liquidity. We believe that we will continue see rocky markets, with high volatility, during the course of the year, but we are optimistic that markets will slowly, but steadily, return to more normal levels and that there will be a lot of attractive opportunities to be exploited.

This edition concluded on 4 February 2016.

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