

Quarterly Commentary – 30th September 2024

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As has become the norm, the third quarter of 2024 saw risk assets reprice higher, but not without the odd bout of volatility to contend with. In fact, risk assets performed so well that to the end of Q3 the S&P 500 has enjoyed its best start to a calendar year since the turn of the century.

Early August did see some volatility as the already thin liquidity at that time of year was strained further when US data soured just as the Bank of Japan hiked rates, leading to an unwind of the ever-popular Yen carry trade. However, this was something of a storm in a teacup; the VIX did see a significant rise but go even a little out on the term structure and volatility remained relatively subdued. The VIX's efficacy as a barometer for volatility continues to wane. Those who were short gamma did get burned. As ever, when clipping some volatility to pay for protection; buyer beware.

The episode did likely prompt the Federal Reserve to take Jackson Hole as its opportunity to announce a turn in the cycle and pivot away from their inflation mandate, the war having been won (sic), and to employment, which has been weakening in the US for a year or so, as is normal for this stage in the cycle. This turn in the narrative prompted risk assets to resume their rise and at the time of writing, with the first 50 basis point cut in the books, the benchmark index is at a new all-time high.

As a result, the bond market is where the more notable moves have been seen, and where pricing for a while remained far ahead of the Fed's own Summary of Economic Projections. The cuts being priced were suggestive of a full-blown crisis rather than the softest of landings that equities were foretelling. Again, both of the major asset classes cannot be right. It remains to be seen which is.

Commodity markets have until recently been out of vogue for some time within the minds of multi-asset investors. During the quarter, an escalation in tensions in the Middle East not seen for at least twenty years brought them front and centre. Israel's incredible retaliation against another of Iran's proxies in Hezbollah caused Iran to enter the conflict directly, firing missiles directly into Israel. The reaction in energy markets was volatile, but it is important for investors to understand that the world has moved on from the 70s with regards to its resources. Shale has entered, proving unbreakable in the 20-teens, and Saudi have dropped the ball once more over the past 18m ceding market share to OPEC+ members unwilling to stick to their quotas. Before now, taking back that market share would likely have led to oil prices of sub-\$50. As long as the Strait of Hormuz remains open, Saudi are likely to plug any gap in supply that an Israeli strike may cause.

Against that backdrop the Fund returned 1.0% over the quarter and 1.8% in the calendar year-to-date.

Income

The Fund is fully collateralised by short-dated, high-grade debt. As such, its liquidity profile extends to the liquidity profile of the Income portfolio. This part of the Fund returned 0.8% over the quarter. As long as the environment does not return to one in which interest rates are floored at zero, the Income portfolio should continue to provide a base level of return such that the Fund can produce positive returns even when defensively positioned and at its maximum spend on the Protection portfolio.

Beta

The Fund makes no allocation to the beta portfolio.

Diversifier

The Diversifier Portfolio has its main exposure to core, structural alternative risk premia strategies, proven through various cycles over decades.

Total Return	2024	Q3
UK 100	9.8%	1.8%
US 500	21.7%	5.8%
Europe 50	13.1%	2.4%
Japan 225	14.8%	-3.6%
Hong Kong 50	29.0%	21.5%
US 2000	11.2%	9.3%
Swiss 30	12.8%	1.6%
Global Equity	18.9%	6.4%
Global Bond	7.0%	3.6%
Commodities	1.7%	-0.6%
PGF	5.2%	1.2%
AGF	1.8%	1.0%
DGF	5.1%	1.6%
USI	20.9%	5.8%
ARF	5.3%	1.3%
CARF	-	1.9%

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Whereas the Fund's FX value strategies, which monetise the fact that over time developed market currencies converge to Purchasing Power Parity (PPP), have been the laggard diversifiers in a high-rate environment, the huge moves seen in bond markets were beneficial as those currencies previously dominated by carry trades, particularly the Yen, saw some return to fundamental drivers. If this truly is the turn in the cycle, then PPP strategies tend to perform very well as central banks around the world cut simultaneously and fundamentals begin to outsize rate differentials (IRP).

There was some detraction from the Fund's rates volatility strategies. The strategies have a funding leg which pay for an overall net long volatility exposure in US rates (hence why they sit in Diversifier and not protection). The strategies are long volatility further out on the curve and thus when the front end reacts as seismically as it did to the poor data and pivot news, the strategies will suffer some drawdown. However, the positive carry available to the strategy is now higher, and it remains well positioned to profit from the inevitable volatility that is likely to beset the long end as:

- Fed ends duration reinvestment / outright sells MBS
- Foreign buyers of USTs continue to reduce (Japan / China)
- The end of BTFF
- Higher coupon issuance in QRA, as is the Treasury's stated maturity schedule

Commodity curve was a positive contributor in spite of the dramatic escalation in geopolitical tensions seen during the period. While short-term mark-to-market is driven by changes in the shape of the futures curves, the premia itself and its returns through time are not driven by the spot price and/or the volatility of the spot price.

What drives the structurally positive curve carry returns over the long run is the fact that commodity curves tend to be concave. This concavity derives from the structure of the market itself whereby we have:

- A positive cost of storage
- Producers hedging selling futures further out on the curve

Traditionally, it is natural gas that dominates at this time of year as we head into winter in the northern hemisphere and, even in the week during which Iran entered the war itself rather than its traditional participation via proxy, natural gas had a bigger impact on the strategy than oil.

Fortem continues to expand its team, and during the period Jonny Matthews officially came on board. Jonny was head of equity derivatives trading at Citi before spending 12 years at Brevan Howard as a partner and Senior Portfolio Manager, applying his trading expertise in a macro framework. Jonny joins Fortem as Senior Portfolio Manager and member of the Investment Committee and is running a sleeve of monies within the Diversifier portfolios within the strict guidelines that Fortem's Diversifiers adhere to.

Protection

The Fund's protection portfolio was a detractor over the period as risk assets continue to re-rate higher. The Fund employs protection on the benchmark US index, which sits at record highs, and benchmark CDS, where credit spreads are now at their tightest since March 2005. Investor optimism over the economy is incredibly high and has entirely divorced itself from fundamentals, as it tends to towards the end of the cycle.

Outlook

As has been the case for some time, the Fund remains positioned at the most defensive end of the spectrum, even for a strategy that does not take on beta exposure. However, this year has seen positive returns from the Diversifier portfolio in spite of the defensive positioning and in spite of the US stock market enjoying its best start to a year since 1997. The addition of a macro sleeve, run in-house, within the Diversifier portfolio should further enable that part of the portfolio to produce positive returns while the Fund maintains its exposure to Protection strategies allowing its investors to maintain an alternative exposure that is positioned to benefit from market stress rather than simply weather it, which most also fail to do.

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