Flash Notes – Under Review

June 2019

H2O Adagio

PARTNERS

Following the FT article dated 18th of June 2019, *"H2O Asset Management: illiquid love"*, the further Q&A release from H2O Asset Management published today, and following a conference call we had with the fund representatives, we maintain the fund in our selection list and advise to keep exposure to the H2O Adagio fund.

Non-rated Corporate Bond exposure

Today the exposure splits across 9 issues and amount to 4.3% of the fund net asset. These positions have been initiated for a long time (2015) following the arrival of a corporate credit specialist in the team. These private placements are related to Lars Windhorst by the fact they have been originated by Tennor Holding owned by Mr. Windhorst. Furthermore, you will find in the Q&A release by H2O more details in the nature of the relationship between H2O and Lars Windhorst, as well as the rational of their investments.

The illiquid nature of those investments has always been a public information and it has already been addressed in a newspaper article several months ago, largely unnoticed at that time. Although less detailed, the partnership between H2O and Lars Windhorst was also mentioned. It comes however as no surprise that the same information caused a major impact in the current circumstances, after the GAM / Woodford debacle.

As it stands today the parallel between the two situations is in our view unjustified. The key difference being that H2O hasn't been in breach of its compliance rules.

Valuation policy

Out of the 9 illiquid bonds, 5 are Level 3 Securities, meaning that they are either not officially listed or listed but discounted due to the limited numbers of pricing sources. They amount to 3.1% of the Adagio portfolio. Out of these five bonds, 3 are listed but discounted by 5 to 15% (2.6% of the NAV), and 2 are not listed and valued by the H2O valuation committee (0.5% of the NAV).

Fund's liquidity

At the time we selected the fund, we voluntary picked the most conservative portfolio (Adagio) from H2O, mainly due to its risk profile more aligned to those of traditional fixed income strategies. The exposure to max. 5% of the NAV to illiquid assets has also been a motivation. We remain convinced that this limited exposure to illiquid bonds is compatible with a daily liquidity fund, while H2O's positions are mostly financed through futures and currency forwards, which can easily be settled (56% of the portfolio is in cash and money market).

The lack of communication by H2O management, underestimating the impact the article would have, has been a clear mistake. Flows in the fund will be key in the next few days, even though the feedback we have so far is rather comforting. Nevertheless, the evolution will have to be monitored on a daily basis.

Conclusion

Based on factual information we have had so far, there is, in our view, no new elements to justify changing our "selected" rating on the H2O Adagio fund. Illiquid investments have been managed in line with the fund's investment guidelines and have been publicly disclosed. Although allowed, the relatively minor positive impact illiquid assets had on past performance should give H2O food for thought given the negative publicity it might attract.

Outflows in the fund will be the key element to monitor in the next few days. We expect the communication with investors to be fully transparent in this respect.