GAM Star Credit Opportunities*

2018 Review and Outlook for 2019

Marketing material for professional/
institutional/accredited investors

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- **While prices of securities were under pressure in 2018, we believe they should recover as the market stabilises.**
- **Recent stress tests conducted on European and UK banks confirm the sector is resilient and banks are well capitalised.**
- **We continue to invest in the bonds of high quality companies, capturing predictable income.**
- **Income will remain a strong driver of performance going forward; we should also benefit from capital gains.**

2018: What worked for us:

Credit quality: all issuers performed according to expectations, with the average issuers' rating at BBB.

Income: all expected income was captured and is compounding.

Low sensitivity to rates: despite normalisation / volatility on rates, negative performance was driven by spread widening rather than rates.

Well-capitalised banks: recent stress tests conducted on European and UK banks confirmed the sector is resilient and banks are well capitalised.

2018: What did not work:

Performance: despite their strong fundamentals, the price of securities held in the funds was under pressure, irrespective of the high and predictable income that they have generated. We have always said that the only factor we cannot control over a short-term investment horizon is the price of securities held. However, as we invest in bonds of high quality companies, we know that the price of these bonds should recover once the market stabilises.

Benefits of diversification: portfolio diversification impacted negatively in 2018 as the subordinated debt of insurance companies underperformed the supposedly weaker credits of Additional Tier 1 (AT1) contingent convertible bonds (CoCos) of banks. Legacy securities of both banks and insurance companies also came under pressure, especially those which were owned to mitigate interest rate risk. Even corporate hybrids and senior unsecured debt from corporates performed in line with, or in some cases worse than, subordinated debt of financials.

* The commentary relates to GAM Star Fund plc – GAM Star Credit Opportunities (EUR); GAM Star Fund plc – GAM Star Credit Opportunities (GBP); GAM Star Fund plc – GAM Star Credit Opportunities (USD). Past performance is not an indicator of future performance and current or future trends. The performance is net of commissions, fees and other charges. The mentioned financial instruments are provided for illustrative purposes only and shall not be considered as a direct offering, investment recommendation or investment advice. Allocations and holdings are subject to change.

2019 Outlook

We believe current valuations are attractive on both an absolute and relative basis. The level of spread that the portfolio is capturing does not, in our view, reflect the strong fundamentals of the bonds held. As the market normalises, we do expect a sharp price recovery over the next six to 12 months, which should be complementary to the income generated.

While we hear many differing forecasts and confusing macro cross currents, for our part we will continue to focus on the simplicity of investing in a highly selective but diversified portfolio of strong individual credits, many of whom are national champions paying higher yields than in 2018, and on collecting coupon income.

With credit quality remaining strong and the effect in bonds – which is not there for equities – of pull to par, we believe prices should recover once the dust settles. Fundamentally, a secular theme of further balance sheet strengthening as well as deleveraging from the financial sector is supportive for subordinated debt holders. We believe income will be a strong driver of performance going forward; we should also benefit, at some stage, from capital gains.

2018 was frustrating from a price volatility standpoint. However, given the strong fundamentals of the underlying credits owned and the elevated coupon income flowing into the strategy, we believe the portfolio is well positioned for the next six to 12 months.

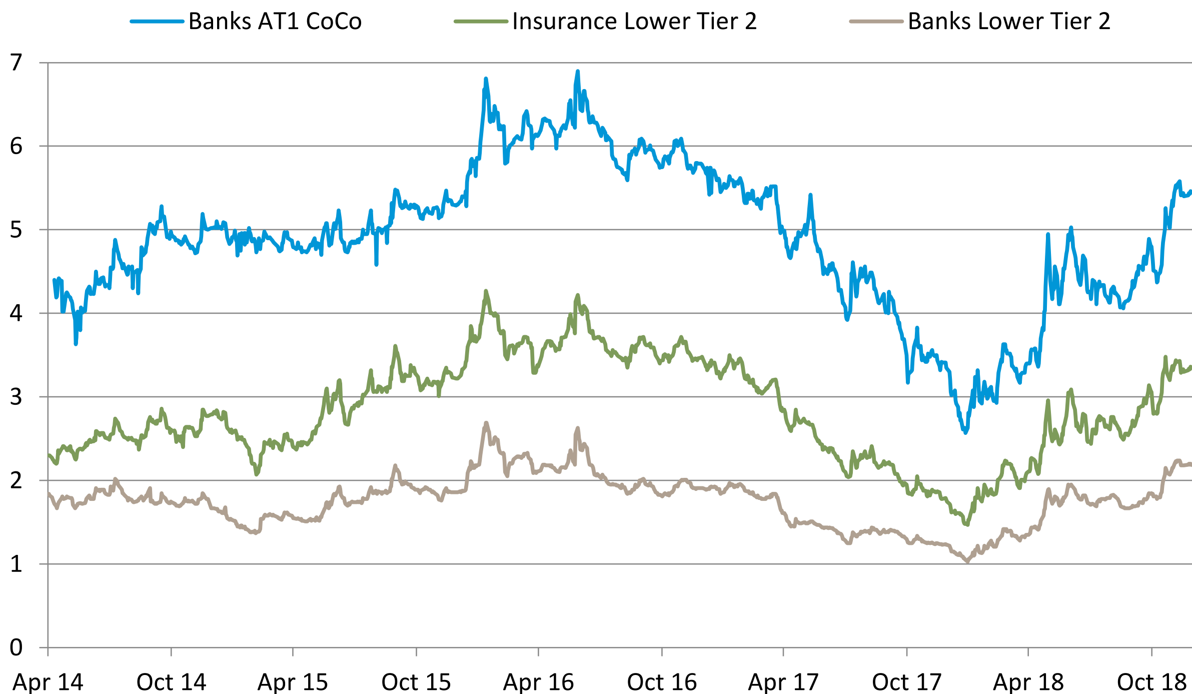
A more detailed look at some of the points mentioned follows below.

Valuation and subordinated debt spreads

Chart 1 shows spread moves in the subordinated debts of banks / insurers on the following three indices:

AT1s CoCos – Barclays Bloomberg European Banks CoCo Index (Global) OAS
Banks Lower Tier 2 – Barclays Bloomberg Capital Securities Banking LT2 Index (Global) OAS
For Insurance Lower Tier 2 – Barclays Bloomberg Capital Securities Insurance LT2 Index (Global) OAS

Chart 1: Banks & Insurance Subordinated Debt Spreads



Source: Barclays Bloomberg Indices based on weekly data from 30 May 2014 to 30 November 2018 (no prior data on AT1 index). The y-axis corresponds to the close price in EUR. Past performance is not an indicator of future performance and current or future trends. For illustrative purposes only.

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Spread widening has occurred even as, from the beginning of 2016 to Q2 2018, the average Common Equity Tier 1 (CET1) ratio increased by 140 bps to 14.3%, which made the financial institutions safer in our view and hence we anticipate further spread tightening.

Furthermore, we also feel the coupon risk on AT1 CoCos has significantly decreased as the European Central Bank (ECB) split its Pillar 2 requirements into a hard requirement (which counts for maximum distributable amount (MDA) purposes) and guidance – hence increasing the buffer to regulatory requirements.

Legacy Tier 1 and Tier 2 paper

The strategy invests in legacy bank capital securities, the rationale being that these securities will be phased out as banks' regulatory capital and we have seen a number of securities being redeemed in recent years, which can be done via calls, tenders or exchanges. We expect the bulk of capital securities to be withdrawn in some way through to the end of 2021 (the end of the grandfathering period).

As an example, Santander UK[1] called one of its legacy T1 instruments in October 2018, as the securities had become ineligible as capital. The call mechanism was generous for investors as Santander UK could only call the bonds at a specific price (corresponding to a spread of 150 bps over UK treasuries) and resulted in circa 20% upside for bondholders compared to the market price. This highlights banks' efforts to clean up their capital structures as securities lose their capital value and regulatory pressure to take out legacy bonds.

Overall, we expect banks to continue cleaning up their capital structure; we believe the process will accelerate as we move towards the end of 2021. We will continue focusing on those securities likely to be withdrawn amid positive outcome for investors.

Call or non-call of AT1 CoCos

The call or non-call of AT1 CoCos is largely an economic decision for a borrower. During 2018, spreads widened significantly, with the EUR CoCo index more than 200 bps wider. The financials subordinated debt market has been hit by both the negative price movements (from spread widening) and a subsequent repricing to perpetuity from increased extension risk (the risk of bonds not being called at the next call date by the issuer, meaning the bond price is likely to decrease as investors require a higher yield or spread to compensate for the potentially longer holding period).

As the bonds reprice from call to maturity, the impact of a move in spreads wider to perpetuity has had a greater impact on prices compared to moves in spread to call.

For example, on the euro denominated HSBC 5.25% AT1 CoCos (perpetual callable in 2022) the spread to call has widened significantly since December 2017; hence the move in spreads to call has been much larger compared to a smaller move in spread to perpetuity. The fact the spread to maturity is currently significantly smaller than the spread to call demonstrates that the bond is now priced to maturity.

In essence, we have seen a large number of AT1s already repriced to "price to perpetual"; we believe the impact of a non-call should be limited as the market is already pricing a number of bonds not to be called. Moreover, since some of the bonds are callable quarterly, we expect they will be called if spreads tighten even if those bonds are not called on the first call date. Finally, if spreads were to tighten, the bonds would likely start repricing towards "price to call", hence the risk is skewed to the upside in our view.

It is worth noting that despite the move in 2018, we assess the bonds held in our portfolio on a yield to worst basis (lower of yield to call (YTC) and yield to maturity (YTM)) rather than an assumption of whether the bonds will be called or not. We still find compelling valuations in the bonds we hold both on both a YTC and YTM basis.

[1]The company listed was selected by the portfolio managers to assist the reader in better understanding the themes presented. The company included is not necessarily held by any portfolio or represent any recommendations by the portfolio managers.

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