Fixed Income Liquidity: Should I stay or should I go?

Due to recent events at GAM, Woodford and now H20, investors are right to consider if liquidity in their fixed income portfolios meets their requirements.

"One particular concern is a mismatch of liquidity offered by some funds and the liquidity that is available in those funds' underlying assets."

In this paper, we seek to answer two questions:

- **How liquid is the convertible market relative to other fixed income markets?**
- **How liquid is the Polar Capital Global Convertible Fund?**

How liquid is the convertible market relative to other fixed income markets?

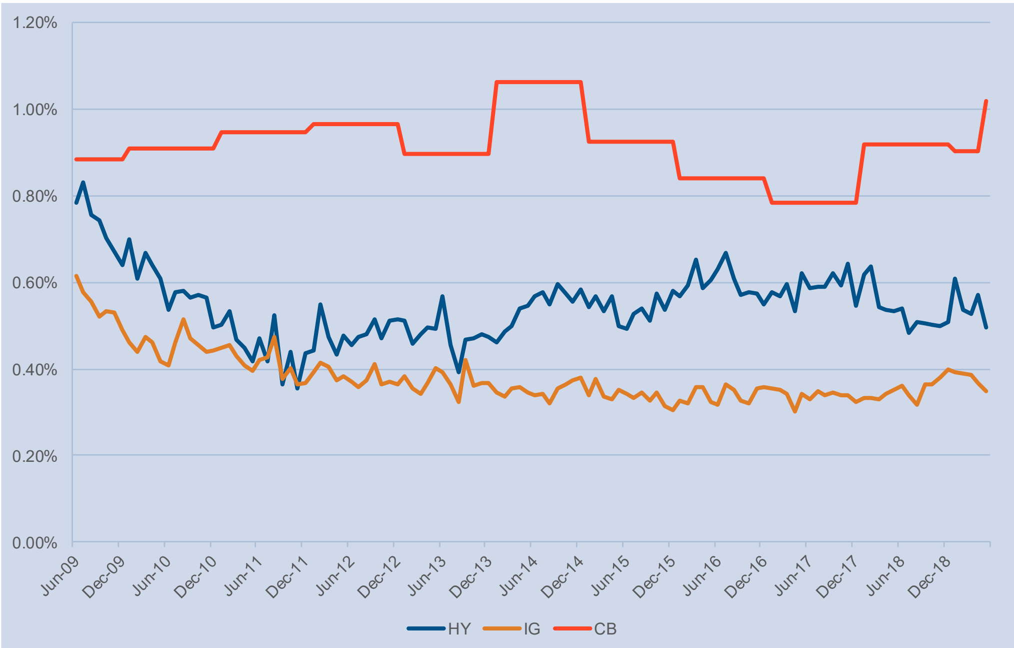
Like many others, we have often spoken about our liquidity concerns with regards to aspects of the fixed income markets. One particular concern is a mismatch of liquidity offered by some funds and the liquidity that is available in those funds' underlying assets.

To put this question into some perspective we have examined liquidity within three fixed income markets: **global high yield bonds, global investment grade bonds and global convertibles.**

Fixed Income Liquidity

The chart below shows the daily market turnover for global high yield bonds, global investment grade bonds and global convertibles, relative to the size of each market, for each trading day.

"What is immediately apparent is that the convertible market has not suffered the same degree of liquidity contraction seen in other fixed income markets"



Source: FINRA-TRACE; Yield Book FTSE; Barclays; Bloomberg; Polar Capital, May 2019.

What is immediately apparent is that the convertible market has not suffered the same degree of liquidity contraction seen in other fixed income markets over the past 10 years.

Polar Capital 16 Palace Street, London SW1E 5JD
T: +44 (0)20 7227 2700 | **E:** investor.relations@polarcapital.co.uk | **W:** www.polarcapital.co.uk
For further information, please contact your Polar Capital representative

Fixed Income Liquidity: Should I stay or should I go?

While there might be multiple reasons for the broader liquidity contraction seen, the three we consider to be the most pertinent are:

"There might be multiple reasons for the liquidity contraction seen, the three we consider to be the most pertinent are…"

- **The high yield market has more than doubled in size over this period, from $538bn to $1.2trn (source: Barclays).**
- **There has been a marked decrease in net inventories held by dealers and market makers in corporate bonds. Goldman estimates net inventories of corporate bonds has contracted by 68% from their 2006 peak. We believe there are a number of reasons for this; some regulatory (increase in capital that banks need to hold alongside inventory positions) and some due to bank restructuring, leading to a reduction in market-making personnel across many banks.**
- **The rapid growth of fixed income ETFs at the expense of decreased liquidity in the underlying corporate bonds. This has been particularly the case in investment grade credits (source: Goldman Sachs).**

However, in comparison to high yield and investment grade, the convertible market size at some $300bn today is similar to the size it was 10 years ago (source: BAML).

"The convertible market has a number of inherent liquidity advantages, the principal one being liquidity transfer"

Also, the convertible market has a number of inherent liquidity advantages, the principal one being liquidity transfer. This occurs at the point of trading when the convertible's delta is matched and traded in the equity market as an offsetting trade, thereby allowing the convertible market maker to transfer the liquidity from the equity to the convertible market. Post the demise of the individual name credit default swap (CDS) market, there is no equivalent and offsetting trade available to the high yield market maker hence the high yield market is typically less liquid relative to its size than the convertible market.

Another distinct liquidity advantage convertibles have is that typically they have lower duration than both high yield and investment grade corporate bonds.

We believe all three factors help to explain why, while liquidity in the high yield and investment grade bond markets have declined some 40% over the past 10 years, convertible liquidity is broadly unchanged, or is even slightly higher, over that time period.

The net result is the convertible bond markets retain sufficient liquidity while those in traditional fixed income markets appear somewhat suspect. While the data above indicate that the entire convertible bond market turns over in approximately 4.7 months, it would take 9.6 months for high yield and a rather stark 13.6 months for investment grade.

Polar Capital 16 Palace Street, London SW1E 5JD
T: +44 (0)20 7227 2700 | **E:** investor.relations@polarcapital.co.uk | **W:** www.polarcapital.co.uk
For further information, please contact your Polar Capital representative

POLAR CAPITAL

Fixed Income Liquidity: Should I stay or should I go?

"We believe the Polar Capital Global Convertible Fund has demonstrated better liquidity than that of the convertible market as a whole"

How liquid is the Polar Capital Global Convertible Fund?

Since its inception in September 2013, liquidity has been a focus of the Fund as we defined its investable universe as "global and liquid convertibles with a balanced asymmetric profile". Additionally, there has been a large-cap skew since inception.

Both factors remain the case today and as a result of this focus and large-cap skew, we believe the Fund has demonstrated better liquidity than that of the convertible market as a whole.

We believe its liquidity is a function of:

- **The size of the convertible issue and the percentage of the issue we own.**
- **The number of trades required to liquidate a position.**
- **Market cap and liquidity of the convertible's underlying equity.**
- **Prevailing market conditions.**

In order to demonstrate the Fund's focus on liquidity we undertake periodic and frequent liquidity reviews of the portfolio. The results for the latest review, as at 28 June 2019, are:

"In order to demonstrate the Fund's focus on liquidity we undertake periodic and frequent liquidity reviews of the portfolio"

- **On average, the Fund's holdings represent only 2.7% of the respective issue sizes.**
- **The average number of trades to liquidate a position is 3.1.**
- **The market cap of underlying stocks of our convertible positions are:**

Large cap	**(>$5bn):**	**65.7%**
Medium cap	**($500m-$5bn):**	**34.3%**
Small cap	**(<$500m):**	**0.0%**

Thus, we believe the Polar Capital Global Convertible Fund meets its liquidity requirements well.

Our conclusion

While we are not complacent about market liquidity and share our investors' concerns, we feel the convertible market is one of the most liquid markets within the fixed income asset class, as demonstrated by the charts above.

Second, the liquidity of the Fund has been a clear focus for us since its inception in September 2013. Indeed, from the outset we established a process to determine if the Fund was meeting its liquidity requirements that allows us to show the positive results of our latest liquidity review. We believe these results demonstrate we continue to meet the Fund's liquidity requirements well.

Finally, in the context of our Fund's liquidity we are often asked what is its overall capacity? Our answer today is the same as at its launch six years ago: around $1bn, depending on prevailing market conditions. By being consistent with our answer throughout and thereby being prepared to limit the Fund's size when we need to, we trust our investors will take further comfort from our processes and our ongoing focus on liquidity within the Polar Capital Global Convertible Fund.

Polar Capital Global Convertible Team **1 July 2019**

Important Information: This document is provided for the sole use of the intended recipient and it shall not and does not constitute an offer or solicitation of an offer to make an investment into any fund managed by Polar Capital. It may not be reproduced in any form without the express permission of Polar Capital and is not intended for private investors. This document is only made available to professional clients and eligible counterparties. The law restricts distribution of this document in certain jurisdictions; therefore, persons into whose possession this document comes should inform themselves about and observe any such restrictions. It is the responsibility of any person or persons in possession of this document to inform themselves of, and to observe, all applicable laws and regulations of any relevant jurisdiction. The information contained in this document is not a financial promotion. It is not designed to contain information material to an investor's decision to invest in Polar Capital Funds Plc – Global Convertible Fund. SUCH INFORMATION, INCLUDING RELEVANT RISK FACTORS, IS CONTAINED IN THE FUND'S OFFER DOCUMENT WHICH MUST BE READ BY ANY PROSPECTIVE INVESTOR. This document is only aimed at professional clients and eligible counterparties as defined by the European Directive n° 2004/39/EC dated 21 April 2004 (MIFID) as the same has been applied into French law by articles D. 533-11 and D.533-13 of the French Code monétaire et financier. This document is not destined for non professional clients who do not have the experience, knowledge or competence needed to take their own investment decisions and correctly evaluate the risks involved. Shares in the Fund should only be purchased by professional investors. Any other person who receives this presentation should not rely upon it. The law restricts distribution of this document in certain jurisdictions, therefore, persons into whose possession this document comes should inform themselves about and observe any such restrictions. It is the responsibility of any person or persons in possession of this document to inform themselves of, and to observe, all applicable laws and regulations of any relevant jurisdiction. This document does not provide all information material to an investor's decision to invest in the Fund. Before any subscription, it is recommended that you read carefully the most recent prospectus and review the latest financial reports published by the Fund. The Key Investor Information Document, full prospectus, articles and latest annual report are freely available upon request from BNP Paribas Securities Services, the centralising agent of the Fund in France: BNP Paribas Securities Services, 66, rue de la Victoire, 75009 Paris, France. Contact: Zaher Aridi, Tel: +33(0)1 42 98 50 57.

Please note that the prospectus of Polar Capital Funds plc and the supplement in relation to the Fund are only available in English.

The European Directive on collective investment schemes n° 2009/65/EC dated 13 July 2009 (UCITS) established a set of common rules in order to permit the cross border marketing of collective investment schemes complying with the directive. This common foundation did not prohibit different methods of implementation. This is why a European collective investment scheme may be marketed in France even though the activity of such scheme would not respect rules identical to those which are required for the approval of this type of product in France. The Fund received an authorisation for marketing in France from the Autorité des Marchés Financiers on 14 January 2014.

Statements/Opinions/Views: All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital. This material does not constitute legal or accounting advice; readers should contact their legal and accounting professionals for such information. All sources are Polar Capital unless otherwise stated.

Third-party Data: Some information contained herein has been obtained from third party sources and has not been independently verified by Polar Capital. Neither Polar Capital nor any other party involved in or related to compiling, computing or creating the data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any data contained herein.

Holdings: Portfolio data is "as at" the date indicated and should not be relied upon as a complete or current listing of the holdings (or top holdings) of the Fund. The holdings may represent only a small percentage of the aggregate portfolio holdings, are subject to change without notice, and may not represent current or future portfolio composition. Information on particular holdings may be withheld if it is in the Fund's best interest to do so. It should not be assumed that recommendations made in future will be profitable or will equal performance of the securities in this document. A list of all recommendations made within the immediately preceding 12 months is available upon request. This document is not a recommendation to purchase or sell any particular security. It is designed to provide updated information to professional investors to enable them to monitor the Fund.

Benchmarks: The following benchmark indices are used: Thomson Reuters Global Focus Convertible Index and/or Thomson Reuters Global Focus Hedged Convertible Bond Index (EUR). These benchmarks are generally considered to be representative of the Global Convertible universe. These benchmarks are broad-based indices which is used for comparative/illustrative purposes only and have been selected as they are well known and easily recognizable by investors. Please refer to http://thomsonreuters.com/convertible-indices/ for further information on these indices. Comparisons to benchmarks have limitations as benchmarks' volatility and other material characteristics that may differ from the Fund. Security holdings, industry weightings and asset allocation made for the Fund may differ significantly from the benchmark. Accordingly, investment results and volatility of the Fund may differ from those of the benchmark. The indices noted in this document are unmanaged, unavailable for direct investment, and are not subject to management fees, transaction costs or other types of expenses that the Fund may incur. The performance of the indices reflects reinvestment of dividends and, where applicable, capital gain distributions. Therefore, investors should carefully consider these limitations and differences when evaluating the comparative benchmark data performance. Information regarding indices is included merely to show general trends in the periods indicated and is not intended to imply that the Fund was similar to the indices in composition or risk.

Regulatory Status: Polar Capital LLP is a limited liability partnership number OC314700. It is authorised and regulated by the UK Financial Conduct Authority ("FCA") and is registered as an investment adviser with the US Securities & Exchange Commission ("SEC"). A list of members is open to inspection at the registered office, 16 Palace Street, London, SW1E 5JD. FCA authorised and regulated Investment Managers are expected to write to investors in funds they manage with details of any side letters they have entered into. The FCA considers a side letter to be an arrangement known to the investment manager which can reasonably be expected to provide one investor with more materially favourable rights, than those afforded to other investors. These rights may, for example, include enhanced redemption rights, capacity commitments or the provision of portfolio transparency information which are not generally available. The Fund and the Investment Manager are not aware of, or party to, any such arrangement whereby an investor has any preferential redemption rights. However, in exceptional circumstances, such as where an investor seeds a new fund or expresses a wish to invest in the Fund over time, certain investors have been or may be provided with portfolio transparency information and/or capacity commitments which are not generally available. Investors who have any questions concerning side letters or related arrangements should contact the Polar Capital Desk at the Administrator on (+353) 1 434 5007. The Fund is prepared to instruct the custodian of the Fund, upon request, to make available to investors portfolio custody position balance reports monthly in arrears.

Fixed Income Liquidity: Should I stay or should I go?

Information Subject to Change: The information contained herein is subject to change, without notice, at the discretion of Polar Capital and Polar Capital does not undertake to revise or update this information in any way.

Forecasts: References to future returns are not promises or estimates of actual returns Polar Capital may achieve. Forecasts contained herein are for illustrative purposes only and does not constitute advice or a recommendation. Forecasts are based upon subjective estimates and assumptions about circumstances and events that have not and may not take place.

Performance/Investment Process/Risk: Performance is shown net of fees and expenses and includes the reinvestment of dividends and capital gain distributions. Factors affecting fund performance may include changes in market conditions (including currency risk) and interest rates and in response to other economic, political, or financial developments. The Fund's investment policy allows for it to enter into derivatives contracts. Leverage may be generated through the use of such financial instruments and investors must be aware that the use of derivatives may expose the Fund to greater risks, including, but not limited to, unanticipated market developments and risks of illiquidity, and is not suitable for all investors. Those in possession of this document must read the Fund's Prospectus for further information on the use of derivatives. Past performance is not a guide to or indicative of future results. Future returns are not guaranteed and a loss of principal may occur. Investments are not insured by the FDIC (or any other state or federal agency), or guaranteed by any bank, and may lose value. No investment process or strategy is free of risk and there is no guarantee that the investment process or strategy described herein will be profitable.

Allocations: The strategy allocation percentages set forth in this document are estimates and actual percentages may vary from time-to-time. The types of investments presented herein will not always have the same comparable risks and returns. Please see the private placement memorandum for a description of the investment allocations as well as the risks associated therewith. Please note that the Fund may elect to invest assets in different investment sectors from those depicted herein, which may entail additional and/or different risks. Performance of the Fund is dependent on the Investment Manager's ability to identify and access appropriate investments, and balance assets to maximize return to the Fund while minimizing its risk. The actual investments in the Fund may or may not be the same or in the same proportion as those shown herein.

Country Specific disclaimers: In the **United States** the Fund shall only be available to or for the account of U.S. persons (as defined in Regulation S under the United States Securities Act of 1933, as amended (the "Securities Act")) who are "qualified purchasers" (as defined in the United States Investment Company Act of 1940, as amended (the "Company Act")) and "accredited investors" (as defined in Rule 501(a) under the Securities Act). The Fund is not, and will not be, registered under the Securities Act or the securities laws of any of the states of the United States and interests therein may not be offered, sold or delivered directly or indirectly into the United States, or to or for the account or benefit of any US person, except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of such securities laws. The securities will be subject to restrictions on transferability and resale. The Fund will not be registered under the Company Act.

Country Specific disclaimers: This document has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this document and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of Shares may not be circulated or distributed, nor may Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor Pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA") or (ii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. The Prospectus and Information Memorandum are available to download at www.polarcapital.co.uk alternatively; you can obtain the latest copy from the Polar Capital Investor Relations team. The Fund is a collective investment scheme but is not authorised under Section 104 of the Securities and Futures Ordinance of Hong Kong by the Securities and Futures Commission of Hong Kong. Accordingly the distribution of this document, and the placement of interests in Hong Kong, is restricted. This document may only be distributed, circulated or issued to persons who are professional investors under the Securities and Futures Ordinance and any rules made under that Ordinance or as otherwise permitted by the Securities and Futures Ordinance

Country Specific disclaimers: Polar Capital LLP (Investment Manager) is exempt from the requirement to hold an Australian financial services licence in respect of the financial services it provides to wholesale investors in Australia and is regulated by the Financial Conduct Authority of the UK under UK laws which differ from Australian laws.