Investment Company Review

Edison investment research

2 August 2011

Acencia Debt Strategies

12 Months Ending	Total Share Return* (%)	Total NAV Return* (%)	Total Target Return * (%)
30/06/08	(5.1)	(1.5)	11.1
30/06/09	(50.2)	(23.9)	8.3
30/06/10	32.7	17.8	5.7
30/06/11	31.5	8.3	5.8

Note: * 12-month rolling discrete performance.

Investment summary: Opportunities continue

ACD is a closed-ended investment vehicle that offers diversified exposure to a broad range of predominantly debt-oriented strategies, including distressed debt, via a fund of carefully selected hedge funds. We expect continuing investment opportunities for successful debt managers, particularly in the area of distressed corporate restructuring over the next two to three years. ACD gives exposure to some underlying managers with very strong track records, otherwise difficult to access, at a discount to NAV.

Investment strategy: Debt funds with low gearing

ACD invests in a carefully selected portfolio of predominantly debt-oriented hedge funds. It has a traditional strong focus on stressed and distressed corporate situations, but the broad strategic coverage of the underlying managers takes in structured credit, relative value and long/short credit trading, sometimes including equity (post-reorganisation, capital arbitrage, or event driven). ACD avoids structural gearing and looks to invest in funds that also have minimal gearing. Low gearing, careful manager selection, and diversification by underlying fund, strategy, and assets are the methods by which ACD seeks to limit volatility of the overall portfolio and achieve its target risk-reward balance. Over the two years to 30 June, the NAV has increased 27.5% and the share price by 56.1%, as the discount has continued to narrow, comparing very favourably with peers (see page 9).

Sector outlook: Second "default opportunity"?

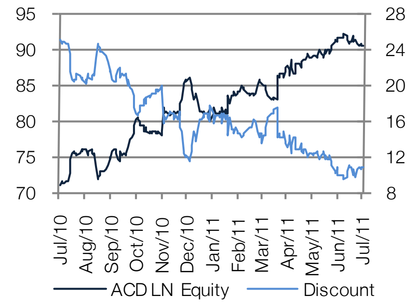
Distressed corporate debt managers tend to show the strongest returns following a debt default peak, benefitting from the opportunities created by corporate distress. Sector performance since defaults peaked in 2009 shows this generally to have been the case. Although defaults declined sharply in 2010 due to low interest rates and financial market support, we think this will likely be short lived and anticipate a "second peak" in corporate defaults driven by heavy refinancing needs for leveraged loans and high yield debt in the next two to three years. Arguably, this next round of defaults will be less focused on the financial sector and more on highly leveraged corporate situations, providing continued opportunities for distressed debt investing. However, most of ACD's underlying managers pursue multiple debt investment strategies, which gives them the flexibility to adjust to market opportunities as they arise.

Price	90.9p
Market Cap	£121.6m
AUM	£133.1m
NAV*	101.5p
Discount to NAV*	10.4%
Yield	1.9%

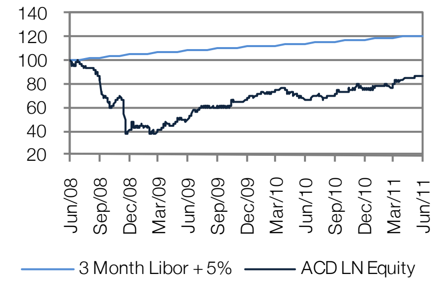
** Adjusted for debt at market value, excluding income. At 30 June 2011.*

*** Based on 1.72p final dividend 2010.*

Share price/discount graph



3-year cumulative performance graph



Share details

Code	ACD
Listing	FULL
AIC Sector	Hedge Funds
Shares in issue	130.6m

Price

52 week	High	Low
Price	82.75p	68.75p
NAV	96.54p	88.28p

Business

ACD is a Guernsey domiciled, authorised closed-ended investment company. Its objective is to produce an attractive total return while limiting volatility, defined as an annual return in excess of three-month LIBOR plus 5% over a rolling three-year period, and annual standard deviation of under 5%. It invests in an actively managed portfolio of predominantly debt-oriented hedge funds.

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Acencia Debt Strategies Limited is a research client of Edison Investment Research Limited

Exhibit 1: Investment company at a glance

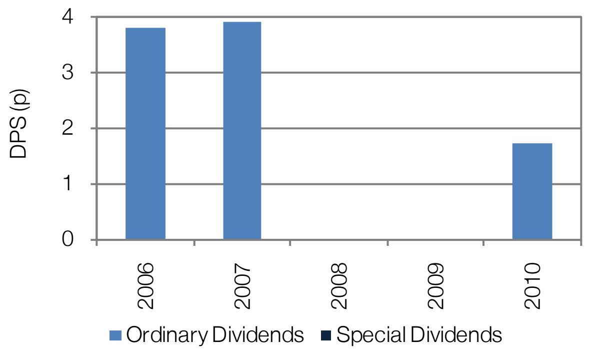
Investment objective and fund background

ACD invests in an actively-managed portfolio of mainly debt-oriented hedge funds and targets annual returns in excess of three-month LIBOR plus 5% over a rolling three-year period, and annual standard deviation of under 5%. The annual management fee is 1% and the manager is entitled to a performance fee of 10% subject to a 3% hurdle rate and high water mark (currently 106.25p).

Forthcoming		Capital structure		Fund details	
EGM	Sept 2011	Total expense ratio	1.0%	Group	Saltus Fund Management
Preliminary	March 2012	Look through leverage gross	-7%	Manager	Saltus Partners LLP
Year end	31 December	Annual mgmt fee	1%	Address	18 Dering Street London W1S 1AQ
Dividend	Semi-annual	Performance fee	Above		
Launch date	November 2005	Investment company life	Indefinite	Phone	+44 (0)20 7290 9400
Wind-up	See pg 10	Loan facilities	See pg 9	Website	www.acencia.co.uk

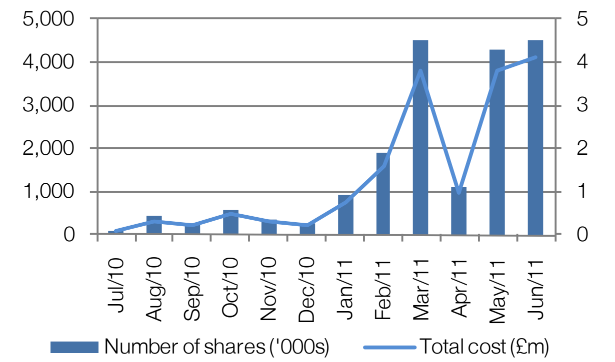
Dividend policy and history

Dividends resumed with a 1.73p final paid in respect of H210, reflecting the board's view of performance and prospects. ACD seeks to pay annual dividends totalling 3.5% of the company's NAV by way of six-monthly interim and final dividend payments.

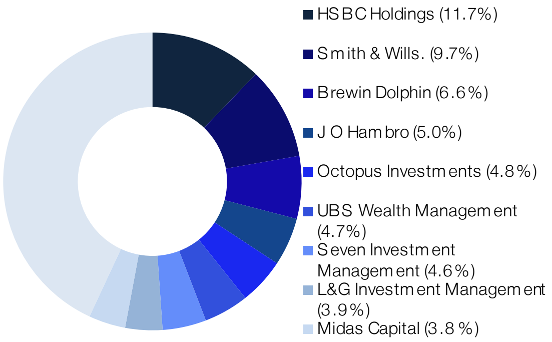


Share buyback policy and history

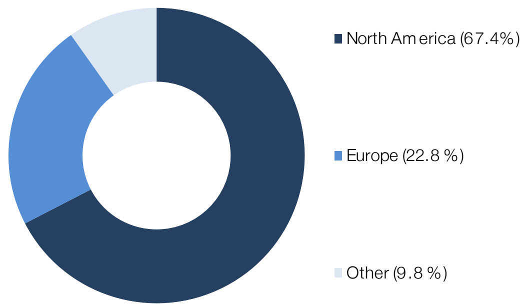
ACD intends to use the 14.99% buy-back authority in full before the September EGM, subject to a discount of more than 10% and adequate cash resources. YTD it has repurchased 20.4m shares (13.5% of total at 31/12/2010).



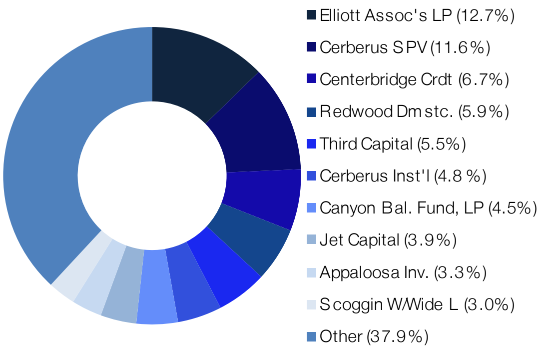
Shareholder base (as at 15 July 2011)



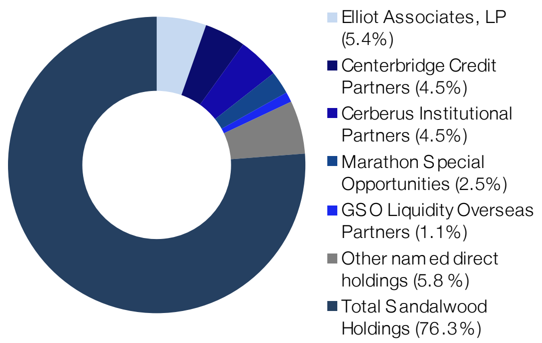
Geographic distribution of portfolio (as at 30 September 2010)



Portfolio composition – look through basis (as at 31 May 2011)



Portfolio composition – direct holdings basis (as at 31 May 2011)



Source: Acencia Debt Strategies /Edison Investment Research

Investment summary: Debt opportunities to continue

ACD is a closed-ended investment vehicle that offers diversified exposure to a broad range of predominantly debt-oriented strategies, including distressed debt, via a fund of carefully selected hedge funds. We expect market and economic conditions to present continuing investment opportunities for debt managers, particularly in the area of distressed corporate restructuring over the next two to three years. The investment objective is to generate attractive returns with low volatility, defined as a target annual return in excess of three-month LIBOR plus 5% over a rolling three-year period, while maintaining an annual standard deviation of less than 5%.

Performance

ACD has performed strongly over one and two years to 30 June 2011, recovering from the financial crisis that marred 2008. Over two years, the NAV has increased by 27.5% and the share price total return is 56.1% as the discount to NAV has narrowed to around 10%. Performance has also been strong compared with similar credit funds during this period (see page 9). In our opinion, ACD provides investors the opportunity to access some strong underlying managers with excellent historic performance records. Even though the discount to NAV has narrowed to around 10%, we do not think that the quality of the underlying portfolio of managers is being fully recognised, compared with quoted single-manager funds, many of which trade at premiums.

Investment opportunity

Distressed debt investing is at the core of ACD. While the multiple debt strategies pursued by the underlying managers provide flexibility to adjust to market opportunities as they arise, the best returns have traditionally been earned on distressed debt investing, and particularly following a peak of corporate default rates, during the period when companies and their balance sheets typically require reorganisation. We believe the improvement in corporate default rates in 2010/11 is likely to prove temporary and will give way to an unusual second spike in defaults under the weight of $1trn of leveraged loan and high-yield debt refinancing due over the next three to four years, originally arranged when debt capital was more freely available and on looser terms than it is today, and when the future business prospects of the borrowing companies often seemed brighter.

Continuation vote

In March 2009 shareholders voted in favour of a winding-up resolution to be put to an EGM in September 2011. In our view, the prospects for investors look much clearer today than they did then. ACD's performance has been strong, share buy-backs have been actively pursued, dividend payments have resumed, and ample opportunities for distressed debt investing seem likely in the next two to three years. We do not expect the board to recommend winding up the company nor for shareholders to support such a move. Rather, we expect ACD to be given a fixed life (see page 12).

Sensitivities

ACD's underlying investments expose it to a number of risks including movements in interest rates, in currency rates, and credit risk. By carefully selecting a diversified range of underlying fund managers and avoiding structural debt gearing, ACD seeks to limit the volatility of returns while delivering its investment return targets. As we show in Exhibit 10 (on page 11) it has generally been successful in limiting the volatility of returns to no more than 5%, although the credit crisis introduced unexpected level of risk and volatility.

Company description: Debt-oriented fund of funds

Acencia Debt Strategies (ACD) is a Guernsey-domiciled, authorised closed-ended investment company managed by the Saltus Fund Management group and advised by Sandalwood Securities. It invests predominantly in a broad range of debt-oriented strategies on a global basis, of which stressed and distressed situations are a significant element. Investments are made through a selected portfolio of hedge funds. The investment objective is to generate attractive returns with low volatility, defined as a target annual return in excess of three-month LIBOR plus 5% over a rolling three-year period, while maintaining an annual standard deviation of less than 5%.

Diversified debt-oriented strategies via hedge fund portfolio

ACD invests in a portfolio of hedge funds that give exposure to an actively managed and diversified range of predominantly debt-oriented investment strategies and a diverse range of underlying asset classes including bank loans, corporate bonds, distressed debt, asset backed securities (ABS), mortgage-backed securities (MBS) credit default swaps (CDS), private debt and public equity. Stressed and distressed corporate situations have traditionally been a significant element in the portfolio. Very broadly, these may be defined as investments in the securities of companies that have either filed for bankruptcy protection or are at significant risk of doing so. We believe that in such situations, securities are often mis-priced for a number of reasons including forced selling by existing holders (eg banks for whom the capital required to hold such positions may be excessively high, increasingly so under Basel III), illiquid trading, market sentiment, and the high level of expertise required to effectively manage these investments. Typically, distressed debt managers target returns that are higher than average, commensurate with the higher risk, and the most profitable investment opportunities have in the past been associated with the periods following a peak in corporate default rates. The diversity of underlying hedge fund managers (typically around 20 core managers) and strategies reduces the volatility of the ACD portfolio. ACD also avoids structural debt gearing and prefers to invest in funds that are similarly un-geared.

The portfolio is managed by the Saltus Fund Management group, a London-based and FSA-regulated investment manager specialising in multi-asset manager, multi asset-class investment. The investment adviser used by Saltus is SEC-registered Sandalwood Securities with more than $1bn of funds under management. We believe that Sandalwood has been a very significant factor in ACD's performance, providing key advice on portfolio composition, particularly regarding the selection of hedge funds. Its strong industry relationships have also helped ACD access chosen funds that may not otherwise have been available to it. Top-performing hedge fund managers are in a position to choose when they will accept new funds for investment and can often afford to be selective about from whom they accept funds. The power of industry relationships should not be under-estimated.

History

ACD was launched in November 2005 when it raised a net £42.6m and listed in Dublin on the Irish Stock Exchange. In June 2006, a further £62.6m was raised through the issue of C shares. In February 2007, with the shares trading at a premium to NAV due to strong secondary interest by investors, a further £86.7m was raised through a second C share issue. ACD joined the official list of the London Stock Exchange, becoming a constituent of the FTSE All-Share Index in December 2010. The company traded successfully, mostly at a premium to NAV, until the financial crisis. But in March 2009, as stated by the Articles of Association, shareholders were offered a vote on the continuation of the company as a result of it trading at a discount of more than 5% persistently during 2008, when the financial crisis was nearing a peak. At that time shareholders voted for winding up (or other reconstruction proposals from the board) to be put to a vote at an EGM in September 2011. Since then, performance has been strong and the company has completed a £30m tender offer, repurchased shares aggressively, and returned to dividend payments. We think it unlikely that the board will recommend winding up the company in view of investment and share price performance since 2008, and its views of prospective strong investment opportunities.

Investment policy

ACD targets an actively managed portfolio of predominantly debt-oriented hedge funds. To gain the desired exposure to the chosen underlying hedge fund managers, ACD will invest directly into that hedge fund or indirectly via other funds of funds. The number of core underlying hedge fund managers in which ACD is ultimately invested is typically around 20. To gain access to chosen fund managers ACD invests through funds that are managed or advised by Sandalwood (around 75% of investments) but it it does not pay management or performance fees on those underlying vehicles, avoiding the double-layering of fees that characterise typical funds of funds. In our initiation note on ACD, dated 17 November 2010, we explain the investment process in great detail. In brief, the portfolio is constructed within certain parameters, including:

- No more than 15% of NAV may be invested in any one underlying hedge fund.
- No more than 20% of NAV in aggregate may be invested in funds managed by a single hedge fund manager.
- No structural or long-term borrowing, and short-term borrowing for liquidity purposes limited to 35% of NAV.

The debt-oriented investment strategies that ACD pursues generally seek to profit by way of interest earnings and capital appreciation of the debt securities that have been identified as under-valued or mis-priced (or by falling values in the case of short positions taken). This represents the majority of the ACD portfolio. The balance of the portfolio includes investment strategies for mezzanine debt and subordinated loans, real estate mortgages, mortgage and other asset-backed securities, trade claims, emerging market debt and convertible debt, and even equity, either of companies emerging from restructuring or as part of equity oriented and merger arbitrage strategies.

Currency exposure

The underlying investments held by ACD are predominantly US dollar-denominated, reflecting the size of the US market and the fact that the market in distressed debt is more developed in the US than in the somewhat more fragmented European markets. In contrast, ACD's share capital is sterling denominated, and so the company has a policy of seeking to hedge as effectively as possible the exchange rate risk that arises from this mis-match.

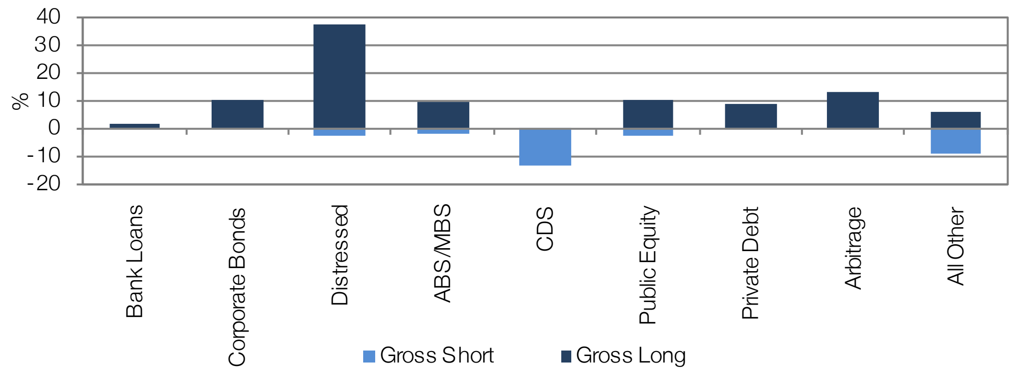
Underlying investment strategies

ACD needs its underlying hedge funds to perform well, but it is the diverse nature of those funds, their strategies, and their underlying assets that are crucial to limiting the volatility of returns within the overall ACD portfolio. Within the majority of the portfolio, the debt-oriented strategies, the majority of the assets that the managers invest, in fall into three broad areas:

- Event-driven investments. In this case the fund manager looks for opportunities that will be created by significant events such as a bankruptcy, or a business reorganising or recapitalising. Distressed debt investment is an example.
- Asset-backed investments. This is where the fund manager invests in debt instruments that are secured against the assets of the issuer, and may often be worth significantly more than the debt itself. Examples would be fund managers investing in collateralised loans and securities, senior bank debt, and distressed securities.
- Relative-value investments. This is where the fund manager buys one investment but sells another in the hope of benefitting from diverging values in the two. Examples would be fund managers undertaking capital structure arbitrage or convertible bond arbitrage.

As a result of these different strategies, and including the minority strategies described on page 4, the underlying ACD portfolio is made up of a range of long and short positions, in a number of different types of security, through a spread of different fund managers. 62% of gross long assets are exposed to distressed debt investing, which includes the distressed (ie distressed corporate debt), ABS/MBS, public equity, and private debt categories below. 62% of the portfolio is also spread among the top 10 underlying managers, as shown in Exhibit 1 (page 2). This underlying fund manager diversification along with tightly controlled debt gearing helps ACD to manage portfolio volatility despite having an overall bias to the long side (a net 63% of gross assets, shown in Exhibit 2) which exposes performance to periods of market volatility.

Exhibit 2: Gross asset exposure by investment type (as at 31 March 2011)



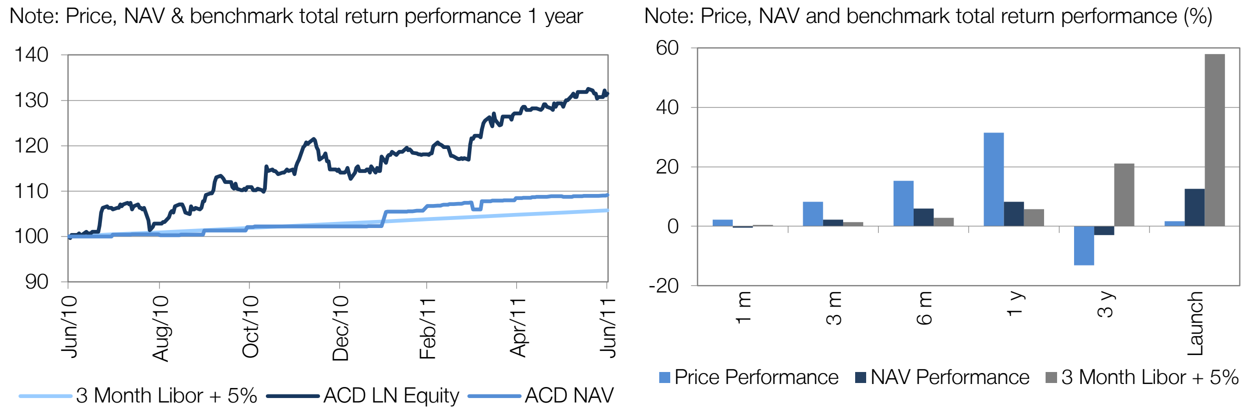
Source: Acencia Debt Strategies

Recent performance

As Exhibit 3 illustrates, over the 12 months to 30 June 2011, ACD's NAV has increased by 8.3% and the total return share price by 31.5%, as the discount has narrowed to around 10%. Over two years to 30 June 2011, the NAV is up 27.5% and the total return share price by 56.1%. ACD targets an annual return in excess of three-month LIBOR plus 5% over a rolling three-year period, and seeks to limit annual standard deviation of less than 5%. The target return has clearly been exceeded over this period and as we discuss below, performance against peers is also strong. Taking a longer perspective, Exhibit 5 shows that 2008 was an extremely difficult year for ACD, in common with much of the sector, and NAV fell by 31.7% during the year. 2008 was the year of Lehman Brother's collapse and a period of acute fear for the entire financial system. Much of the 2008 loss suffered by ACD was unrealised and valuations recovered in the strong rally of 2009/10. But some of its problems were specific and related to its currency hedging policy. US dollar assets are hedged into sterling (ACD sells dollars). In the unusual turmoil of 2008, the value of the hedged assets fell as the dollar rose significantly. The hedges required cash settlement but assets were difficult to realise.

Borrowing temporarily increased and with it the gearing of NAV to weakening asset prices. The manager does not anticipate a repeat of these unusual conditions, and also points out that the fundamental value of sterling on a purchasing power value basis is more robust today. As we anticipate another peak in corporate defaults over the next two to three years, providing opportunities for distressed debt investing, we think it important to discuss in the investment strategy and outlook section on page 9 why we think conditions will be different to those that generated the 2008 performance.

Exhibit 3: Investment company performance



Source: Thomson Datastream/Edison Investment Research

We think the tightening in the discount to NAV reflects a number of factors including good investment performance, the prospects for continued investment opportunities (discussed on page 9), significant share buy-backs, a return to dividend payments, increased visibility on the “illiquid” elements of the portfolio (see page 7), and entry to the FTSE All-Share Index in December 2010, which contributes to visibility and liquidity.

Exhibit 4: Discount over five years (%)

Source: Thomson Datastream/Edison Investment Research

As Exhibit 4 illustrates, ACD’s shares had traded at a premium to NAV for much of the period from launch until August 2008. But as the credit crunch approached its most frightening stages (Lehman Brothers filed for bankruptcy on 15 September 2008) and investor fears of a complete collapse of the financial system grew, ACD shares moved to a significant discount, reaching an all-time high of 49.9% in December 2008. It was this movement that triggered the discount floor mechanism and shareholders being offered a continuation vote in March 2009, culminating in the winding-up resolution to be put to the September 2011 EGM (see page 12). The discount has tightened steadily since the peak, supported by improved investor sentiment as government and central banks introduced financial market stabilisation measures as well as ACD’s investment and operational performance and capital management measures, including share buy-backs and the £30m tender offer. It may be difficult for the discount to narrow a great deal further in the near term; it is now at the low end of that observed for a typical fund of funds (see page 9) though still at a significant discount to single-manager credit funds. However, as we discuss on page 10, we think there will be ample opportunities for successful distressed debt managers in particular to create value and grow NAVs over the next two to three years. We also consider that ACD has exposure to a number of underlying fund managers with very strong performance records.

Exhibit 5 shows the strong run of monthly performances over the past 30 months. In the 12 monthly periods to June 2011, ACD showed small negative returns in only two months.

Exhibit 5: Monthly performance data (% monthly increase adjusted for dividends paid)

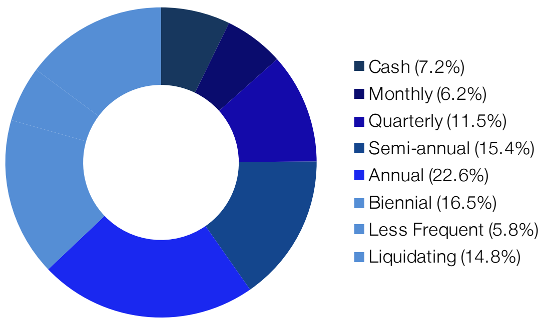
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2005												1.4%	1.4%
2006	1.6%	0.2%	1.0%	1.2%	0.3%	0.1%	0.2%	0.2%	0.5%	1.6%	1.2%	1.1%	9.6%
2007	1.2%	0.9%	0.0%	2.2%	1.2%	0.5%	(0.2%)	(1.1%)	0.7%	0.8%	(0.5%)	0.2%	6.0%
2008	(2.0%)	(0.2%)	(1.1%)	1.0%	1.0%	(0.2%)	(2.2%)	(0.6%)	(5.1%)	(9.8%)	(8.6%)	(8.8%)	(31.7%)
2009	2.8%	(1.9%)	0.1%	3.8%	2.7%	1.9%	2.4%	2.7%	2.5%	1.3%	1.3%	1.4%	22.9%
2010	1.2%	0.2%	3.8%	1.0%	(0.7%)	(0.3%)	0.4%	(0.1%)	1.0%	0.8%	0.0%	1.7%	9.3%
2011	1.4%	1.3%	1.0%	0.6%	0.2%	(0.4%)	-	-	-	-	-	-	4.2%

Source: Acencia Debt Strategies

Portfolio liquidity

The liquidity structure of ACD's fund holdings has been steadily improving. Hedge funds, by their nature, are relatively illiquid instruments. Distressed debt hedge funds are subject to an even greater degree of illiquidity, which reflects the nature of their underlying investments. With hedge funds in general, there is typically an initial lock-up period and, following this, redemption can only occur at regular intervals and after enough notice has been given. Closed-ended investment companies, like ACD, are more suited to the liquidity profile of distressed debt investing than open ended structures in our opinion. Exhibit 6 illustrates the liquidity profile of ACD's portfolio as 31 May 2011.

Exhibit 6: Liquidity profile (as at 31 May 2011)



Source: Acencia Debt Strategies

Liquidating assets are investments in funds where ACD has submitted a redemption request but where the manager is unable to raise enough liquidity from the underlying fund holdings to honour the request in full, in a timely manner. Investors have tended to be wary of the valuations of liquidating assets contained within stated NAVs, believing them to be potentially over-stated. The usual reasons cited are because:

- the assets are illiquid, so they cannot realistically be marked-to-market;

- the manager of the assets is generally in run-off, not expecting repeat business, so there is less incentive to perform; and
- such assets have been seen to trade at discounts of up to 30% in the secondary market.

These general market issues with liquidating positions do not cause us any concern with regards to ACD because in its case:

- the pool of liquidating assets has been steadily shrinking (from more than 20% last year to 14.8% as at 31 May 2011) and should continue to do so; and
- the actual recent performance of the liquidating assets has been strong, giving material comfort on their carrying values in the ACD portfolio and adding to performance.

ACD does not have any material exposure to so called 'side-pocket investments', which are investments made into a separate share class at the time of investment because of known illiquidity. However, it does have exposure to two longer-dated lock-up funds, contained within the 'less frequent' category in Exhibit 6. Both are closed-ended funds structured as limited partnerships, have largely drawn-down investment commitments, and have been performing well during the past year or so.

Peer group discount comparison

As we discuss above, ACD has shown strong NAV performance and even stronger share price performance over the past two years. In this section we show the price (total return) and NAV performance of ACD compared with a selected range of quoted funds of hedge funds (Exhibit 7), and also compared with a selected range of quoted single manager credit funds (Exhibit 8). Over both one and two years to 30 June 2011, ACD has outperformed the fund of funds group in terms of both NAV total return and price total return and its discount to NAV is second lowest in the group In Exhibit 7, showing the comparison with single manager funds, ACD again compares well over the period, especially so in price performance as the discount has narrowed. Third Point Offshore Investors is a stand-out performer in the sector (itself a component of the ACD portfolio).

Exhibit 7: Price and NAV performance of selected funds of funds (as at 30 June 2011)

Note: Discounts calculated at 21 July 2011.

	Price performance (%)				NAV performance (%)				(Discount)/Premium
	1 year	2 year	3 year	5 year	1 year	2 year	3 year	5 year	%
HFRI FOF Index	(0.7)	14.4	17.3	24.0	(0.7)	14.4	17.3	24	N/A
ACENCIA DEBT STRATEGIES LTD	31.5	56.1	(13.2)	(6.2)	8.3	27.5	(3.0)	6.3	(9.8)
DEXION ABSOLUTE	5.6	20.8	(8.2)	N/A	5.6	14.4	4.6	22.1	(11.2)
DEXION EQUITY ALT.	9.5	17.4	(9.3)	(0.2)	3.8	6.4	(2.0)	12.8	(12.7)
ALTERNATIVE INV.STGIS.	10.1	17.0	(13.7)	(16.3)	3.6	7.3	(6.3)	0.6	(13.1)
DEXION TRADING	5.8	16.5	(7.8)	13.3	5.1	9.8	4.5	28.7	(8.9)
SIGNET GLB.FXI.STGIS.£	13.1	37.3	(11.1)	N/A	7.8	25.0	5.3	N/A	(14.5)
THAMES RVR.MLT.HED.PTG.	11.0	15.8	(22.2)	4.2	6.7	8.3	(8.3)	22.5	(11.8)
GOLDMAN SACHS DYM.OPPS.	11.6	32.7	(15.9)	(3.5)	5.9	24.9	(1.9)	N/A	(14.2)

Source: Thomson Datastream/Edison Investment Research

Single manager funds are currently being valued more highly by investors relative to NAV. We think there are currently two main reasons for this. The first is the nature of the 2008/09 credit crisis, in which the correlation between different asset price performances and strategies was high. Under such circumstances, the benefits of diversification within a fund of funds were not universally clear. Moreover, especially in the current low rate environment which influences available investment returns, the extra layer of fees within a fund of funds becomes more significant. While ACD uses

Sandalwood funds as an investment tool, it avoids a double-layer of fees on those funds and gains exposure to a number of first-class fund managers with excellent track records. A number of the funds in which it invests (we estimate around 40% of the total) are closed to new investment and not available to new investors. We would expect the funds of many of these managers, if quoted, would trade at industry best valuations, which currently suggests a premium to NAV. Within ACD these fund managers can be accessed at a discount to NAV, a discount that ACD is determined to limit or eliminate.

Exhibit 8: Price and NAV performance of selected single manager credit funds (as at 30 June 2011)

Note: Discounts calculated at 21 July 2011.

	Price performance (%)				NAV performance (%)				(Discount)/Premium
	1 year	2 year	3 year	5 year	1 year	2 year	3 year	5 year	%
HFRI FOF Index	(0.7)	14.4	17.3	24.0	(0.7)	14.4	17.3	24.0	N/A
ACENCIA DEBT STRATEGIES LTD.	31.5	56.1	(13.2)	(6.2)	8.3	27.5	(3.0)	6.3	(9.8)
ASHMORE GLOBAL OPPS.(£)	11.3	31.5	(18.8)	N/A	11.1	19.9	(0.4)	N/A	(21.2)
BETTER CAPITAL	7.7	N/A	N/A	N/A	3.4	N/A	N/A	N/A	16.4
BH CREDIT CATALYSTS	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	4.9
CQS DIVERSIFIED FUND	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1.8
NB DSTRSD.DEBT INV.FD. (~£)	(4.6)	N/A	N/A	N/A	(1.5)	N/A	N/A	N/A	3.8
NB GLOBAL FLOATING RATE INCOME FUND L	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	3.1
SIGNET GLB.FXI.STGIS.£	13.1	37.3	(11.1)	N/A	7.8	25.0	5.3	N/A	(14.5)
THIRD PNT.OFFS.INVRS.£	38.9	82.0	15.0	N/A	31.3	92.5	18.9	N/A	(9.6)

Source: Thomson Datastream/Edison Investment Research

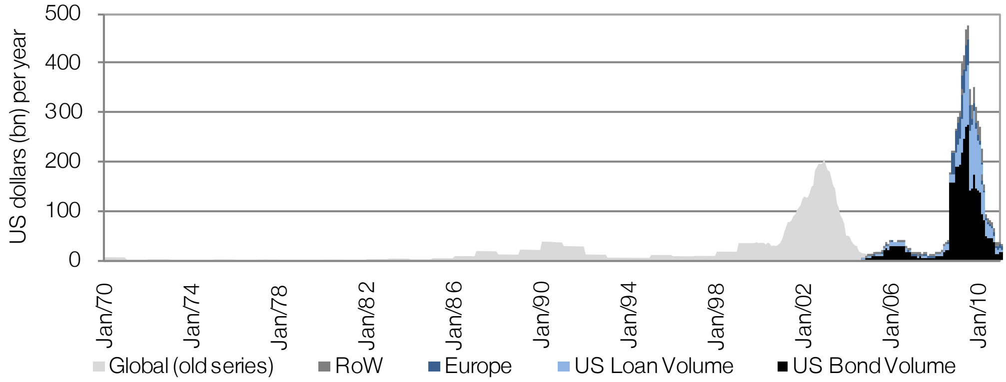
Investment strategy and outlook

For distressed debt investors, the best investment returns have generally been seen in the period following a peak in corporate defaults. Corporate defaults spiked up very sharply in 2009 to a new high but improved almost as quickly in 2010 (Exhibit 8). We share management's view that a second spike in corporate defaults is likely, as we argued in our recent sector note, *"Distressed debt investing: Have we hit rock bottom?"* (May 2011). The current credit cycle seems likely to be different to past cycles. We would argue that the full negative effects of the 2005-2008 buy-out boom are yet to be seen, deferred by loose monetary conditions including quantitative easing, but are likely to be felt over the next few years when substantial amounts of leveraged loans and high yield debt become due, especially if inflationary pressures begin to lift interest rates. We believe that there remain many companies with unsustainable capital structures that will ultimately require restructuring.

As we note above, the majority of ACD's underlying managers are multi-strategy debt managers who can dynamically reallocate resources to where they see the best investment opportunities. The sharp decline in corporate default rates during 2010, supported by tentative economic recovery, historically low interest rates, and other support measures such as quantitative easing, and the re-opening of capital markets are limiting opportunities for traditional distressed investing in the large corporate space. However, ACD's managers are still finding ample attractive situations in the mid-corporate space (typically, less than $2bn market capitalisation and less than $500m of debt) where these smaller issuers find it more difficult to access debt capital markets.

Another area that has recently attracted some of ACD's underlying managers is in the mortgage-backed securities market, where the managers believe that they can continue to generate attractive returns even when making highly conservative assumptions about future loan defaults and losses.

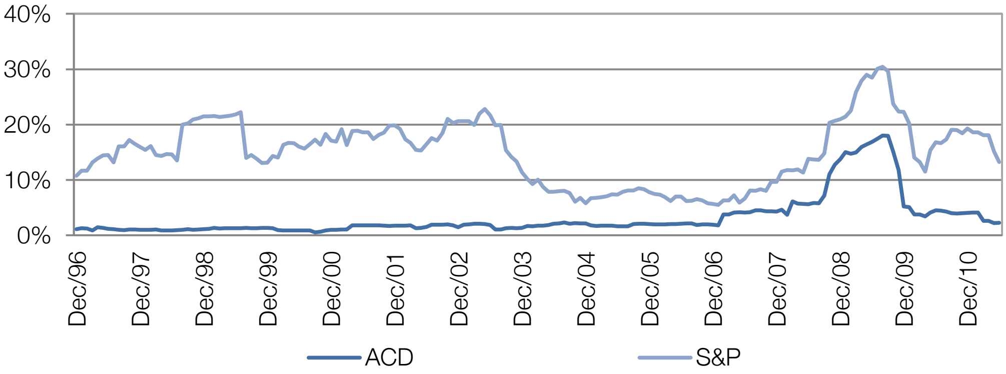
Exhibit 9: Default debt volumes – inflation adjusted



Source: Moody's

We believe that the main trigger for a second spike in corporate defaults will be the heavy requirement for refinancing leveraged loans and high yield bonds over the next three to four years, debt that was used to fuel the 2005-2008 corporate buy-out boom. Against a background of sluggish economic growth, continuing growth in sovereign debt requirements, and a still-fragile banking sector, we think a smooth refinancing of this debt without distress and considerable needs for corporate restructuring is very unlikely.

Exhibit 10: Acencia Debt Strategies, volatility compared with S&P



Source: Acencia Debt Strategies

To us, the bigger question for investors is whether they can gain exposure to these potential distressed debt opportunities without again having to experience the investment losses that were seen in 2008. While this question cannot be answered with any certainty, we do feel that there are important differences. The first wave of the financial crisis was very much focused on the financial sector, the banks and the "shadow banking system" in particular. The financial sector entered the crisis with enormous and unsustainable amounts of leverage and in the scramble to unwind this, the market for many financial assets disappeared altogether. The dramatic fall in interest rates and other monetary stimuli including quantitative easing arrested the situation, but the working through of past excesses is far from over, and is moving at varying speeds through different parts of the economy. Meanwhile, economic growth remains anaemic in many developed economies and the burden of economic support on government finances is a cause of increasing concerns. Saltus believes that the likely impacts of the heavy refinancing to come through will this time be felt more on 'Main Street' than 'Wall Street', as the financial system (Wall Street) is less leveraged than it was at the start of this process, with a lot of the leverage passing to governments. We can see evidence of this in the balance sheets of the banks (reduced equity to assets ratios), lower leverage in transactions such as buy-outs, or greater equity cushions in structured debt. We consider it much more likely that the process of adjustment is moving on towards another spike in corporate default activity but without the features of systemic crisis that marked the 2008 period.

ACD typically shows little correlation with the performance of the S&P and the unusual nature of the 2008 financial crisis period can be seen in Exhibit 10.

EGM and winding-up vote – or maybe fixed life alternative

ACD has no fixed life but at the EGM in September 2011, shareholders will be given the opportunity to vote on a winding-up resolution, requiring support from 75% of those voting to be passed. We do not expect the board to recommend that shareholders vote in favour of the resolution in view of the company's performance record since 2009 and the manager's view of the investment opportunities ahead. Rather, we expect it will propose limiting the life of the company to a fixed period of three years, after which the investment portfolio would be put into run-off and capital returned to shareholders. If after 18 months (the mid-way point) the shares are trading at a discount of more than 10% then the company may look to return a further 20% aggregate share capital. We also expect that shareholders will be offered the option of continuing to invest in a continuation vehicle, subject to demand. The winding-up resolution results from a shareholder vote in March 2009 which itself was triggered under the discount floor mechanism contained in the company's Articles of Association. This required the board to propose a continuation vote when the share price discount to NAV exceeded 5% at each monthly valuation date for the full 12 calendar months of 2008.

Return to dividends and continuing buy-backs

After a break of two years, ACD paid a final dividend of 1.73p in respect of 2010 and the board stated its new dividend policy, taking account of the strong investment performance and promising investment outlook; to seek to pay annual dividends totalling 3.5% of NAV by way of six monthly interim and final dividend payments. ACD has authorisation (renewed annually) to repurchase up to 14.99% of the shares. So far this year 20.4m shares (13.5% of the December 2010 total) have been repurchased, recently at around a 10% discount to NAV. The board intends to make full use of the facility in the run-up to the EGM in September, subject only to the shares being at a discount of at least 10% and there being sufficient liquid resources available to fund the purchases. We do not expect the latter to be a hurdle given the current cash position of the company. On the assumption that the winding-up vote is not carried, we would expect the buy-back programme to continue while the discount to NAV exceeds 5%.