Edison investment research

30 March 2012

Acencia Debt Strategies

12 Months Ending	Total Share Return* (%)	Total NAV Return* (%)	Total Target Return * (%)
31/01/09	(57.7)	(28.3)	10.2
31/01/10	57.9	21.0	6.0
31/01/11	10.0	7.7	5.7
31/01/12	0.9	3.3	5.9

Note: * 12-month rolling discrete performance.

Investment summary: When those about us lose their heads?

ACD is a closed-ended investment vehicle that offers exposure to a focused range of predominantly debt-oriented strategies, particularly distressed debt strategies, via a portfolio of carefully selected hedge funds. ACD gives exposure to some underlying managers with very strong track records, and whose funds are either closed to new investment or otherwise difficult to access. It does so at a c 20% discount to NAV despite the prospect of a winding up vote in 2014. We expect continuing investment opportunities for successful debt managers, particularly in the area of distressed corporate restructuring over the next two to three years.

Investment strategy: Distressed debt focus

ACD invests in a portfolio of predominantly debt-oriented hedge funds. It has traditionally focused on stressed and distressed corporate situations on a global basis, although most of ACD's underlying managers pursue multiple debt investment strategies, giving flexibility to adjust to market opportunities as they arise.

Performance has been strong

Performance has been positive in every year since launch with the exception of 2008 when financial markets collapsed after the Lehman failure. Over one and three years, NAV total return performance has beaten all similar credit funds of funds and most similar single-manager credit funds (Exhibits 11 and 12).

Sector outlook: Delayed opportunity?

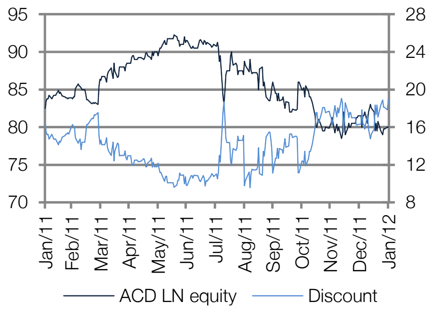
US economic growth prospects have improved and the corporate sector is generally in good health. But at the weaker end of the credit markets pricing has weakened, providing an attractive entry point for ACD's managers, who have been patiently waiting for the right time to invest more aggressively in distressed situations. They see signs of distress emerging in those weaker US corporates that have not successfully refinanced. Europe's slow growth and the need for banks to de-lever should also provide a stream of attractive investment opportunities over the next two to three years. Returns to shareholders should also be enhanced by a closing of the discount to NAV as the 2014 wind-up vote approaches, requiring a unanimous vote by shareholders for the company to continue.

Price	82.25p
Market Cap	£97.7m
AUM	£116.6m
NAV*	99.82p
Discount to NAV	17.6%
Yield	4.3%

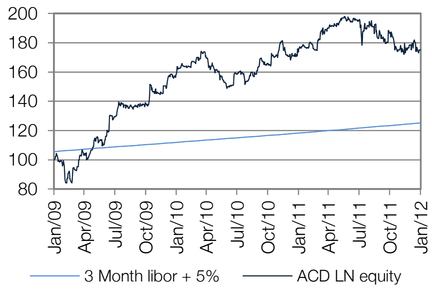
** As at 29 February 2012.*

*** Based on 3.51p full year 2011 dividend.*

Share price/discount graph



3-year cumulative performance graph



Share details

Code	ACD
Listing	LSE
AIC Sector	Hedge Funds
Shares in issue	118.8m

Price

52 week	High	Low
Price	92.3p	78.5p
NAV	102.5p	96.8p

Business

Acencia Debt Strategies (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.

Analysts

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

Exhibit 1: Investment company at a glance

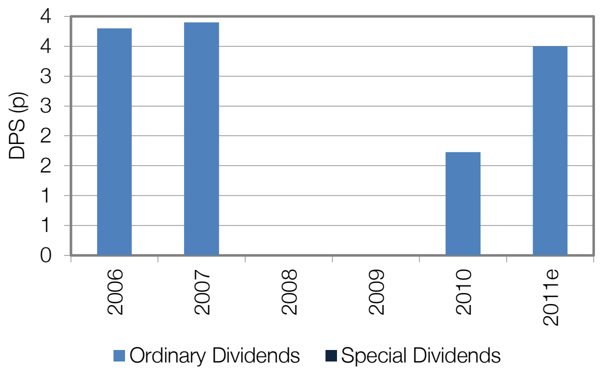
Investment objective and fund background

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 2012	Total expense ratio	1.0%	Group	Saltus Fund Management
Preliminary	March 2012	Look through leverage gross	9%	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	Vote Sept. 2014	Loan facilities	See pg 9	Website	www.acencia.co.uk

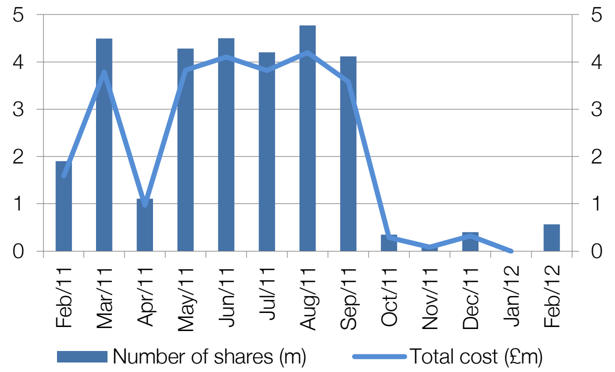
Dividend policy and history

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.

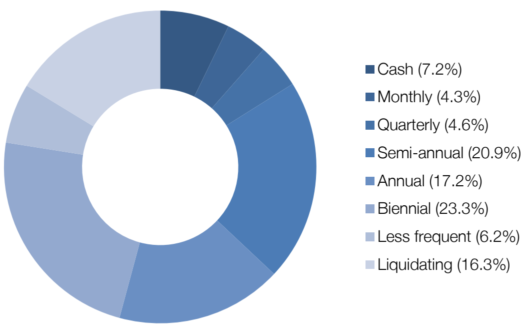


Share buyback policy and history

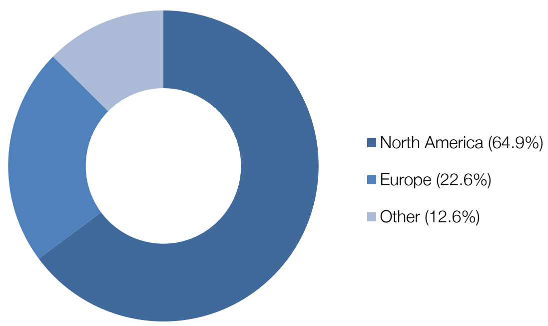
ACD has authority to repurchase 14.99% of the share capital, renewed at the September 2011 EGM. Since completing the Enhanced Share Buy-Back Programme ahead of the EGM, it has continued to repurchase shares, but at a slower rate.



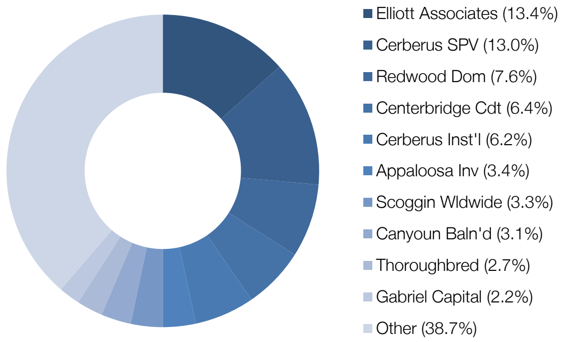
Portfolio liquidity as at 31 January 2012



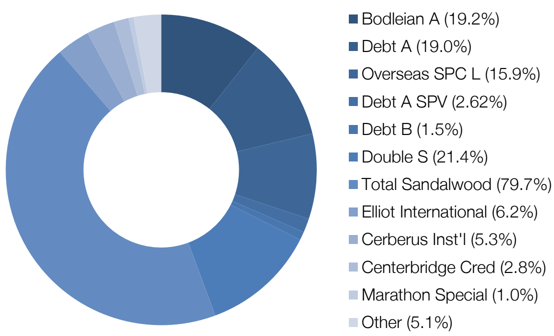
Geographic distribution of portfolio as at 31 January 2012



Portfolio composition – look through basis as at 31 January 2012



Portfolio composition – direct holdings basis (as at 30 June 2011)



Source: Acencia Debt Strategies, Edison Investment Research

Investment summary: When those about us lose their heads?

ACD is a closed-ended investment vehicle that offers exposure to a focused range of predominantly debt-oriented strategies, particularly distressed debt strategies (discussed on page 10), via a fund of carefully selected hedge funds. ACD's manager expects market and economic conditions to present attractive investment opportunities for debt managers, particularly in the area of distressed corporate restructuring over the next two to three years. The prospect of a wind-up vote in 2014 should cause the discount to NAV (c 20%) to substantially close over this relatively short period. 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%. Volatility has been low, other than 2008-09 when large scale de-leveraging saw most asset classes falling in an unusually correlated fashion

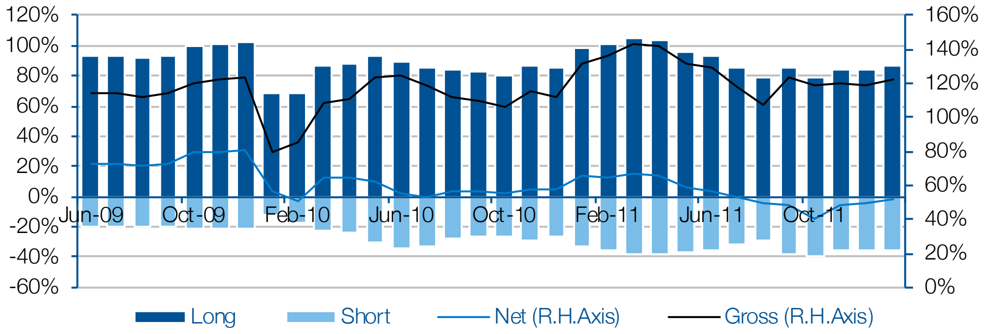
Investment strategy and outlook

Distressed debt investing is at the core of ACD even though the debt strategies pursued by the underlying managers provides flexibility to adjust to market opportunities as they arise. Put very simply, at the core of ACD's underlying fund strategies is the purchase of debt at attractive prices, which will yield returns when triggered by some anticipated future event, such as the bankruptcy of the issuer. The debt is generally secured and backed by identifiable assets and senior to (paid out before) equity interests, which is how the distressed debt investor looks to profit. This is what helps to limit volatility, although returns will obviously fluctuate over time. Distressed debt managers have often been able to generate the best returns when they can buy from forced sellers (forced by regulatory, sentiment or financial considerations) at prices that are below intrinsic value. This is often observed after a debt default peak. Much of the developed world saw such a peak in 2009, but subsequent events have not produced the "typical" cycle. Corporate distress has been soothed by persistent, historically low interest rates and debt reduction as companies focused on paying down debt rather than investing. But the debt burden has largely passed to sovereign borrowers (directly and by their implicit support for still leveraged banks, especially in Europe). However, not all weaker US borrowers have been able to restructure their debt and Europe faces low growth and bank deleveraging. The environment would appear to offer good opportunities for distressed and special situations investing, especially for those managers with the financial resources, skills and patience to wait for the best opportunities.

Cautious investment stance in 2011

Timing is crucial for successful distressed debt investing and ACD's managers adopted a cautious stance throughout much of 2011, expecting better opportunities to invest. The net long position (the net of long and short positions as a percentage of NAV) hit a low of 40% in October, but has recently started to rebuild. Around two-thirds of the long exposures relate to distressed debt, a fairly normal level

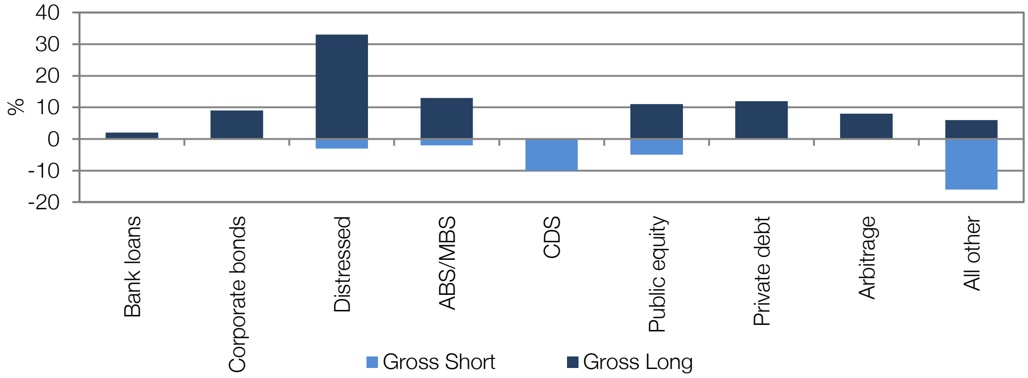
Exhibit 2: Long, short and net asset exposures (as % NAV)



Source: Acencia Debt Strategies

During 2011 ACD's managers were able to find some attractive pockets of opportunity 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. Other areas of opportunity identified by ACD's managers were in asset-backed securities (particularly 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), corporate transactions (spin-offs and M&A), and long/short credit.

Exhibit 3: Gross asset exposure by investment type (as at 31 January 2012)



Source: Acencia Debt Strategies

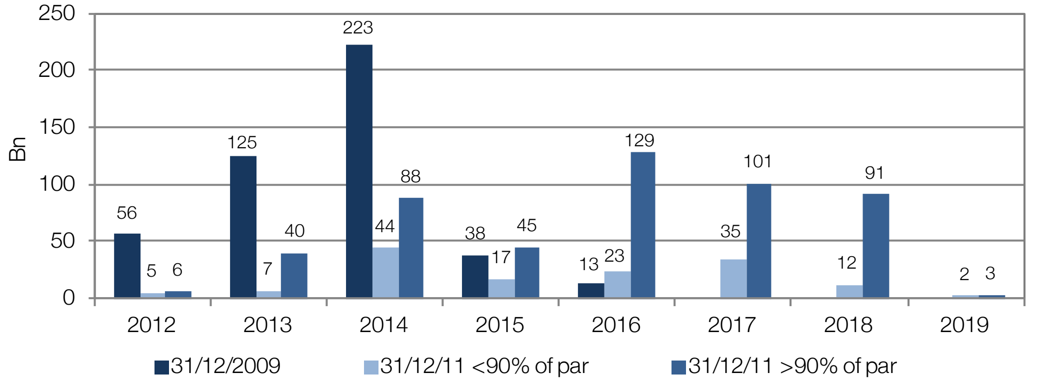
The liquidity structure of ACD's fund holdings is shown in Exhibit 1 (on page 2). The longer-term nature of distressed debt investing compared with, say, trading strategies implies that such funds can provide less frequent access to liquidity. Closed-ended investment companies, like ACD, are more suited to the liquidity profile of distressed debt investing than open-ended structures in our opinion. That said, more than 50% of the portfolio of funds is available to provide liquidity to ACD within 12 months. The weighting of liquidating assets is down over the past year and has not been a drag on portfolio performance.

But likely to become more active in 2012

The macroeconomic outlook remains highly uncertain. Europe appears to be facing recession as it pursues the austerity measures seemingly required to deal with the sovereign debt issue. The US seems to be on a slow recovery path with recent data offering more room for optimism. ACD's managers have been taking advantage of recently higher yields to acquire sub-investment grade bonds and loans, with a particularly focus on senior secured investments, while monitoring the economic and market environment for more aggressive deals.

In general terms, US corporates are in pretty good financial shape. We have been surprised in recent months at how successfully the average US company has been able to strengthen its balance sheet (cash levels are the highest since the 1960s) and successfully refinance what little more than a year ago appeared as a wall of maturing debt.

Exhibit 4: Anticipated US senior loan maturities as at end 2009 and today



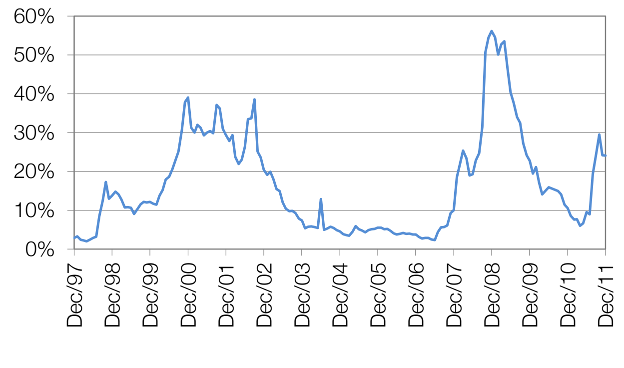
Source: S&P LCD

Backwards looking 12 month default levels for US speculative grade loans and bonds have fallen to low levels and recent US economic statistics have presented a slightly brighter outlook for the economy, supporting the value of the existing portfolio. The weighted average 12 month trailing default rate for SG loans and bonds is 1.82% at 31 December 2011 according to Moody's. Despite the recent improvements in the US economy, Moody's central forecast is for an increase to 2.76% by the end of 2012. The most likely driver is the increase in loan maturities in 2013 compared with the current year. We believe that the main US corporate opportunities will come from those borrowers that have been unable to refinance because of their weaker than average financial strength, particularly for loans taken late in the cycle and maturing in 2014. Exhibit4 shows how 2012-2014 maturities have been pushed out since the end of 2009 but also shows the remaining loans split between those trading at distressed levels (below 90% of par value) and those trading healthily. $56bn of US senior loans that are trading at less than 90% of par remain to be refinanced by the end of 2014. ACD's managers believes that a smooth refinancing of this debt without distress and the need for considerable corporate restructuring is unlikely. And this should provide continuing and increasingly attractive investment opportunities. Moody's pessimistic forecast for the 12 month trailing default rate on SG loans and bonds is a near fivefold increase to 8.6%.

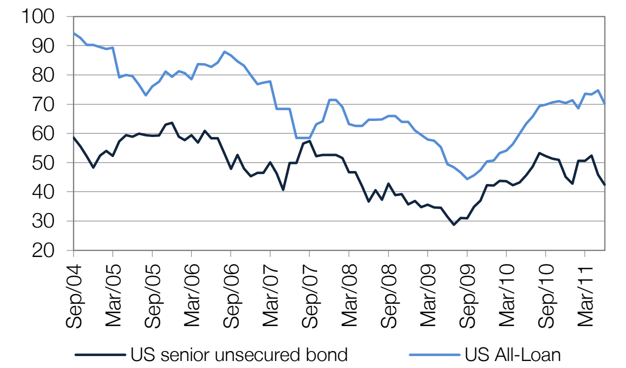
Moody's data for the distressed debt index (the percentage of bonds trading at a yield in excess of 1,000bp or 10%) shows a clear deterioration from March 2011, which seems to confirm that the situation is not uniformly positive for US corporates. Quite soon after the move in the distressed debt index, the prices of defaulted senior unsecured bonds more or less halved. Having adopted a cautious stance, ACD's managers have recently been using this re-pricing opportunity at the distressed end of the credit market to begin increasing positions.

Exhibit 5: Distressed debt ratio and price of defaulted senior unsecured bonds

Distressed Ratio (% of bonds trading at >1,000 bps)



Price of defaulted US Senior unsecured bonds

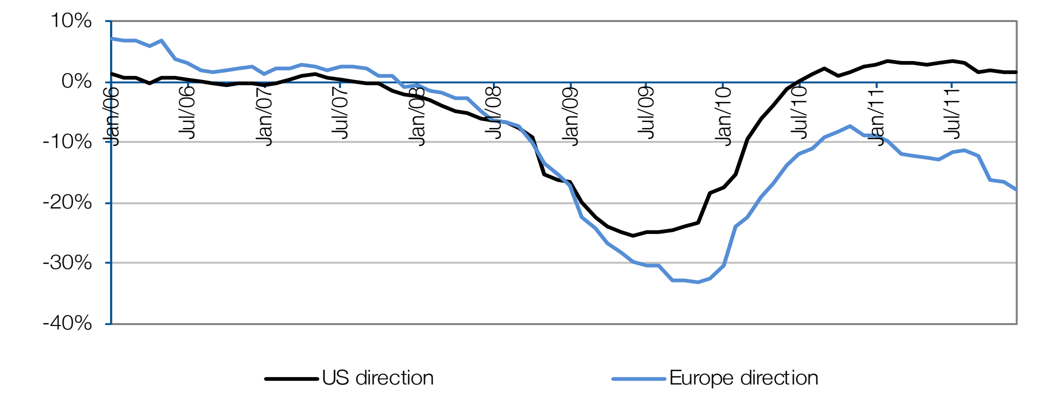


Source: Moody's, Acencia Debt Strategies

The economic situation in Europe looks far more challenging given the need for banks to de-lever their balance sheets and for governments to trim their budget deficits. So far banks have been reluctant to dispose of assets at "distressed" prices, creating something of a stand-off between potential buyers and sellers. But in a weakening economic environment the pressure to do so would increase, creating a positive environment for distressed debt investors to make investments on attractive terms. The European weighting within ACD's portfolio, at 22.6% (see Exhibit 1), is already high relative to history, and we would not be surprised if it increases further. Not surprisingly, given the European economic developments of recent months, Moody's data (Exhibit 6) shows an increasing number of downgrades relative to upgrades.

Exhibit 6: European credit ratings drifting lower

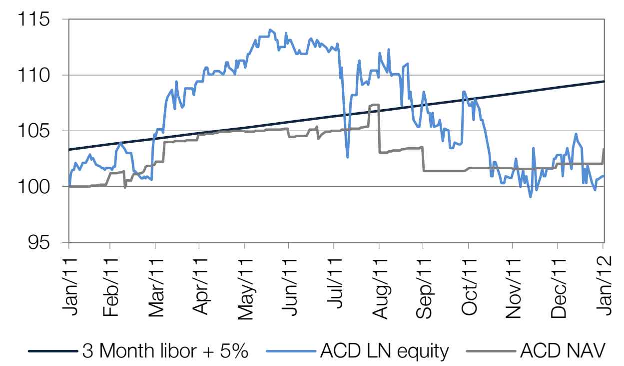
Note: upgrades-downgrades, as a % of all rating changes



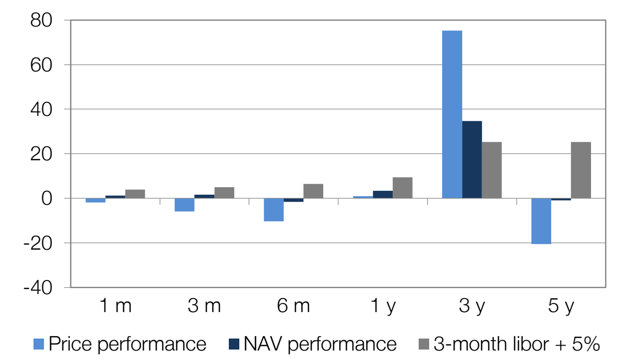
Source: Moody's, Acencia Debt Strategies Performance

Exhibit 7: Single manager credit fund performance (NAV total return)

Price, NAV & benchmark total return performance 1 year



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream/Edison Investment Research

ACD has performed strongly over the past three years, recovering from the financial crisis that marred 2008. As Exhibit 7 illustrates, following two years of strong growth, the past 12 months (to 31 December 2011) has been a relatively quiet period in terms of ACD's NAV development. But this was achieved in a very difficult market for credit funds in general, and in relative terms ACD performed strongly against other credit funds (Exhibits 11 and 12). Returns have been positive in all years except 2008. In 2011, ACD repurchased 20.5% of the opening share capital, accretive to NAV per share by 2.9%.

Exhibit 8: 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%)	0.5%	(1.7%)	(1.6%)	0.3%	0.0%	0.4%	1.7%
2012	1.3%	1.2%											2.5%

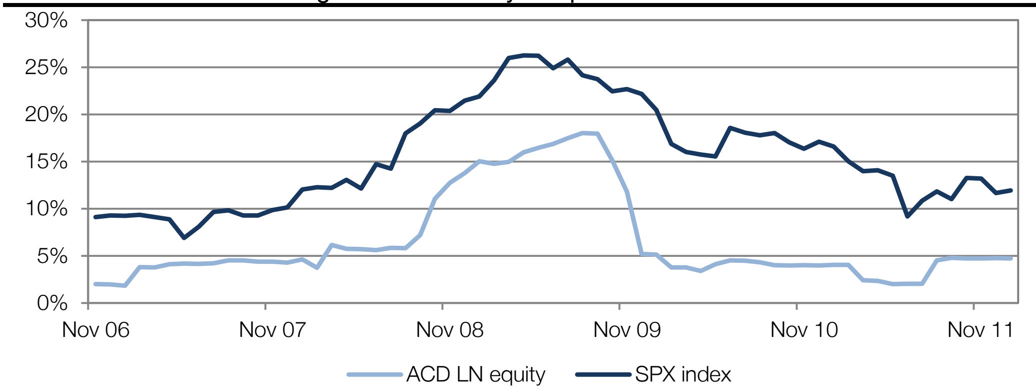
Source: Acencia Debt Strategies

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. ACD 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 considerably lower today, with less fundamental risk of weakness.

Low volatility

A key element of ACD's investment approach is to seek to limit volatility of NAV returns (to a standard deviation of less than 5%). As Exhibit 9 shows, this has been achieved during most of the past six years, with the exception of the 2008-9 financial crisis, which saw a high degree of correlation between the prices of most financial assets as hedge funds, banks and other non-bank institutions moved to de-leverage.

Exhibit 9: Acencia Debt Strategies – NAV volatility compared with S&P

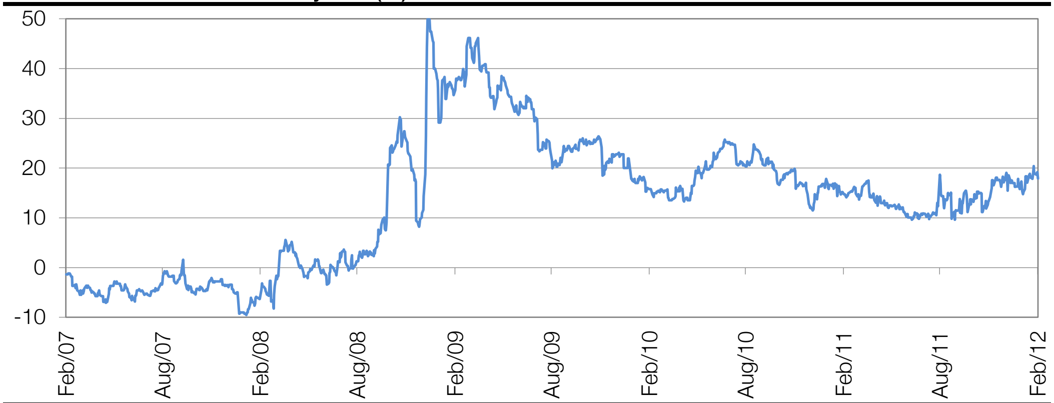


Source: Acencia Debt Strategies

As Exhibit 9 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. The discount has tightened substantially since the peak, supported by improved investor sentiment as well as ACD's investment and operational performance, capital management measures (including substantial share buy-backs), and the commitment to a winding up vote in 2014. The discount fell as low as 10% in Q311 but has since widened again, to around 20%. We believe that much of the investor interest in debt strategies has been focused on US senior loans, which have continued to perform well with higher spreads than available before the financial crisis and the current low level of defaults. However, we think there will be ample opportunities for successful distressed debt managers as well to create value and grow NAVs over the next two to three years. We also consider that ACD offers investors exposure to a number of underlying fund managers with very strong performance records, which it would be difficult to access otherwise.

Exhibit 10: Discount over five years (%)

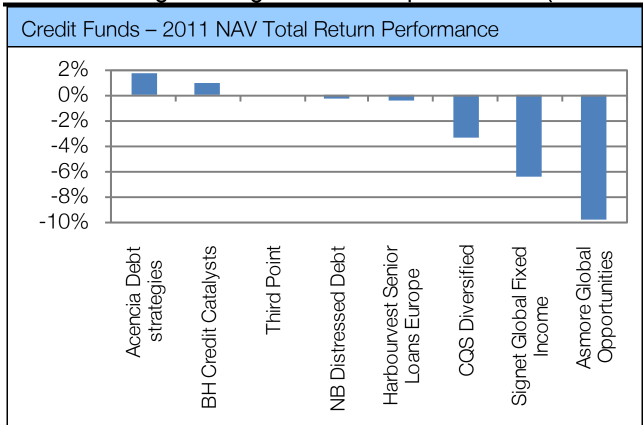


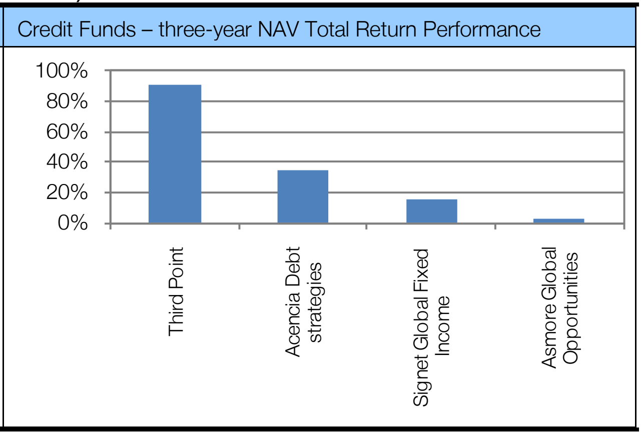
Source: Thomson Datastream/Edison Investment Research

Peer comparison

As we discuss above, ACD has shown a strong NAV total performance over the past three years. This compares favourably with peers, both single manager credit funds and funds of funds.

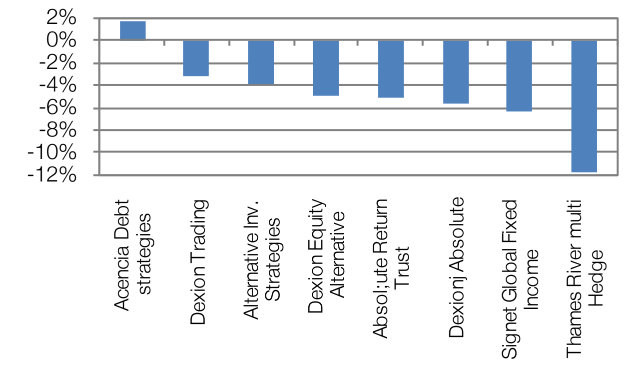
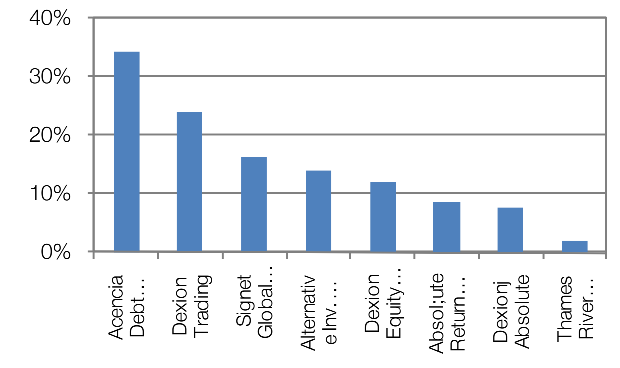
Exhibit 11: Single manager credit fund performance (NAV total return)





Source: Datastream

Exhibit 12: Funds of funds' performance (NAV total return)

Funds of funds – 2011 NAV Total Return Performance	Funds of funds – three-year NAV Total Return Performance
	

Source: Datastream. Note: Excludes small and liquidating funds.

Over five years, the weak performance of 2008 still negatively impacts ACD's comparison with peers.

Despite the performance over the past three years and despite the mandated 2014 continuation vote, ACD is at a high discount to NAV compared with both single manager funds credit funds and funds of funds. The latter tend to exhibit higher discounts to NAV.

Company description: Portfolio of debt-oriented 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 which 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.

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.

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 benefiting from diverging values in the two. Examples would be fund managers undertaking capital structure arbitrage or convertible bond arbitrage.

Winding-up resolution passed; buy-backs continuing

At the AGM in September 2011 shareholders voted overwhelmingly in favour of a resolution requiring the Company to hold a vote in September 2014 for it to be wound up with effect from 31 December 2014. Moreover, if the shares have persistently traded at a discount of more than 10% of NAV over the six months to 30 June 2013 then the board will seek to return up to 20% of the share capital.

Authorisation to repurchase up to 14.99% of the share capital was also renewed and buy-backs have continued since, although at a slower pace than during the Enhanced Share Buy-Back Programme that was completed ahead of the EGM.

Dividends

ACD returned to dividends in 2010 after a two-year break, paying a final dividend of 1.73p and stating its new dividend policy, taking account of the strong investment performance and promising investment outlook. Its policy is to seek to pay annual dividends totalling 3.5% of NAV by way of six monthly interim and final dividend payments. In the first half of 2011 it paid a dividend of 1.78p.

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.

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 9 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.

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