

Axiom European Financial Debt Fund

Initiation of coverage

Capital opportunities

Investment companies

Axiom European Financial Debt Fund (AXI) is a closed-end fund that invests in European financials regulatory capital. If a bank's operations and equity position are robust enough to withstand shock asset losses, these instruments can be a way to earn a premium return. Axiom also seeks opportunities from regulatory changes that lead banks to redeem some of their legacy instruments that no longer have the same capital rating under stricter rules. This is a niche space where it is important to be familiar with not only the banks, but also regulation, local legislation and even politics. The portfolio has a 6.1% running yield; 7.3% to perpetuity. The stock is trading on a 6.5% dividend, 8% below NAV.

13 April 2021

Price 92.50p
Market cap £85.0m
NAV* £92.0m

NAV per share* 100.2p
 *As at 09 April 2021
 Discount to NAV 7.7%
 Annualised current yield 6.5%
 Ordinary shares in issue 91.9m
 Free float 85.1%
 Code AXI

Primary exchange LSE Specialist Fund Segment
 AIC sector Sector Specialist: Debt

Gearing

Net cash as % NAV 31 January 2021 9%

Fund objective

Axiom European Financial Debt Fund is a Guernsey-domiciled, London-listed, closed-end fund investing in regulatory capital securities in Europe. It seeks opportunities presented by Basel III and Solvency II transitions. It has a diversified approach across a broad range of subordinated debt issued by financial services companies. It uses five sub-strategies to obtain attractive current income and capital gains. AXI has a target return of 10% pa over seven years.

Bull points

- Investment niche requiring expertise allows for relatively good returns.
- Bank regulatory capital instruments carry premium yields and should remain resilient as government and central banks support is tapered.
- Further capital optimisation means further investment opportunities for Axiom.

Bear points

- Bank equity and debt securities have been out of favour since the financial crises.
- Rising interest rates could affect debt prices.
- Macro shocks can impact risk perception

Analyst

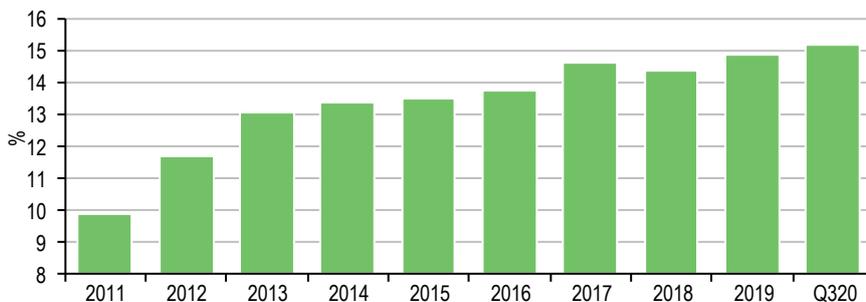
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Axiom European Financial Debt Fund is a research client of Edison Investment Research Limited

EU banks' common equity tier 1 ratios (CET1) at record highs



Source: European Central Bank, European Banking Authority

Why invest in bank regulatory capital now?

Bank capital ratios are at record highs. Loan loss reserves represent a cushion against portfolio losses that have been very manageable. The market is still pricing some uncertainty of the impact of government and central bank support measures being eventually cut back. The yields on bank regulatory capital are typically higher than similarly rated debt. Furthermore, banks and insurance companies still need to complete the redemption of their legacy instruments and have been given the hurry up by the ECB and the BOE's PRA. So the opportunity remains for investors such as AXI that seek to benefit from this bank capital optimisation from understanding which instruments, when and what prices are redeemed by these companies.

The analyst's view

The pandemic has been a real-life stress test for European banks and so far it has passed quite well. Central banks and governments have reacted pragmatically with largely successful support measures. We expect support to be tapered off carefully to avoid a cliff-edge scenario as some fear. Potentially higher than expected (and generally elevated) loan impairments are mainly an equity story. Banks now tend to have strong equity bases and de-risked business models due to stricter regulatory requirements. For the sizeable majority of banks, the regulatory capital instruments that AXI invests in will not be called upon to absorb asset losses.

Valuation: Dividend 6.5%, NAV discount 8%

The shares are trading at an 8% discount to NAV, with a trailing dividend yield of 6.5%. The dividend has been stable since 2016.

NOT INTENDED FOR PERSONS IN THE EEA

Why invest in bank regulatory capital?

Premium yielding debt

Banks and insurance companies are allowed to issue debt instruments that have sufficient equity-like features for them to be considered also regulatory capital. Regulatory debt is a form of loss absorbing capital that only suffers losses or modification once equity is wiped out or drops below certain thresholds. To qualify, instruments typically will be subordinated to secured debt, unsecured, offer variable non-cumulative coupons and be perpetual or very long duration.

These debt instruments are then graded according to their quality as capital and this guides their usage as regulatory capital. How much capital and what quality mix of capital is set by regulators and are among the high-level guiding principles being set by the Basel Committee on Banking Supervision (BCBS) in the set of rules known as Basel Accords. **We summarise the changes in regulatory capital in the appendix on page 13.**

To compensate for features such as higher subordination and coupon risk, these debt instruments are also higher yielding than regular subordinated debt. Therefore, if a bank's operations and equity position are robust enough to withstand shock asset losses, regulatory capital debt investments can be to a way to earn a premium return. The financial crisis of 2007–08 (the Global Financial Crisis, GFC) prompted regulatory changes that resulted in many banks de-risking their balance sheets and business models, while also bolstering the amount of equity (the effective buffer to the regulatory capital debt) on their balance sheets.

Regulatory opportunities

Investing in bank regulatory capital requires an understanding of not only the banks themselves, but also the complex rules and incentives banks have to redeem regulatory capital that has lost quality as a result of newer regulation. The newer rules are stricter and therefore some instruments no longer qualify in the same capital rating, either being excluded altogether as capital or being classified in a lower category. From the bank point of view, there has been a downgrade in regulatory value of some of these instruments that are typically more expensive than regular, subordinated debt or some other types of financing.

Banks are likely to buy back debt that offers poor regulatory value for cost as part of managing their funding and liabilities. Furthermore, there is pressure from some regulators to clean up the funding and get rid of older instruments that are now of reduced usefulness as regulatory capital. Both the European Central Bank (ECB) and the Prudential Regulation Authority (PRA) of the Bank of England (BOE) have issued statements in last 12 months encouraging the banks to do so.

Axiom (the manager of AXI) has a proprietary model that looks at these various bonds to determine where these opportunities exist, which ones are most likely to be redeemed and at what prices.

Axiom uses five investment strategies, which we detail in the asset allocation section on page 6. These combine to generate a good steady income through coupons and upside by investing in special situations as well as restructuring (in terms of business model and operations, rather than the debt itself) stories. The European regulatory capital debt market is a relatively sizeable one at an estimated €800bn (Bloomberg) many investment opportunities across the various risk levels and different issuers.

Market outlook: Good stress

In one aspect, the COVID-19 crisis has been positive. For all the usefulness of stress tests by European banks and regulators, there is nothing like the real thing to test the banking system. And it seems that banks have passed this test with good marks.

What has been seen during this crisis is not only that banks are structurally in better shape to withstand a crisis, but that central banks and governments have been pragmatic and quick to provide the required regulatory and economic support. This contrasted with the GFC where not only were bank balance sheets in much worse shape, but delays in support resulted in a considerably worse situation. In fact, in most countries there were austerity measures during the GFC, in stark contrast with the current policies.

ECB and BOE measures included cutting capital buffer requirements, allowing relief on tier 2 capital mix, making nonperforming loan (NPL) recognition rules more flexible (loans from otherwise viable companies that were under stress only because of COVID-19 did not have to be classified as category 3) and making sure ample liquidity was available for all banks. Central bank funding as a percentage of assets grew from 2% to 5% in the eurozone in 2020 (according to the ECB). The ECB eased conditions for banks' longer-term refinancing (referred to as LTRO III), providing support for bank lending, especially to small and medium-sized companies. Government support in most European countries included loan guarantees, job furlough schemes, loan moratoriums and fiscal expansionary measures designed to help borrowers, both retail and corporate.

More capital than ever

Eurozone banks had an average equity tier 1 capital ratio of 10.2% in December 2009 and this was 10.0% in 2013. In comparison, common equity Tier 1 (CET1, which consists of a better mix of capital than the previous tier 1) was over 15% in the European global systemically important banks (G-SIB) in Q320 (ECB data). In fact, the average CET1 in European banks rose in 2020, helped by a ban on dividends and capital relief measures.

Following the GFC, banks have in general de-risked their loan portfolios and in many cases their business models as well. There have been limitation or de-emphasis on some activities such as proprietary trading or investment banking. Balance sheet funding is better, with less reliance on wholesale funding, and more healthy loan to customer deposit ratios. Regulatory oversight has also tightened.

The ECB and BOE have ended the ban on bank dividends payments in December 2020 and this reflects regulator confidence in the health and resilience of the banking system. **It is significant that despite the previous ban on bank dividends by regulators, coupon payments to regulatory capital debt (and specifically to additional tier-1 (AT1) bonds, which are next in line to equity to absorb losses) were permitted to continue.** This is another example of confidence in the bank equity being well positioned to withstand the crisis.

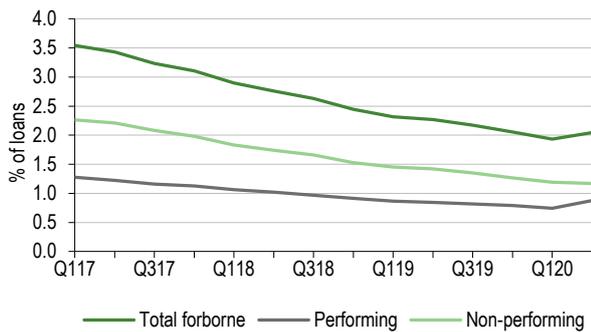
There were inevitably a couple of cases of banks with some significance stumbling, such as Greece's Piraeus Bank in 2020 and Spain's Banco Popular in 2017. In both cases, the ECB acted decisively to avoid any systemic problems. Piraeus was significant because it was the first time the ECB mandated that a bank not pay the coupon of the contingent convertible (known as CoCos) regulatory capital bonds and these bonds ended up being converted to equity, with the Hellenic Financial Stability Fund becoming the controlling shareholder in an effective nationalisation.

Cliff-edge scenario unlikely

The economic cycle outlook has improved as a permanent exit to lockdown seems to be approaching with vaccine rollouts, the optimism tempered by slower vaccine rollouts and new virus

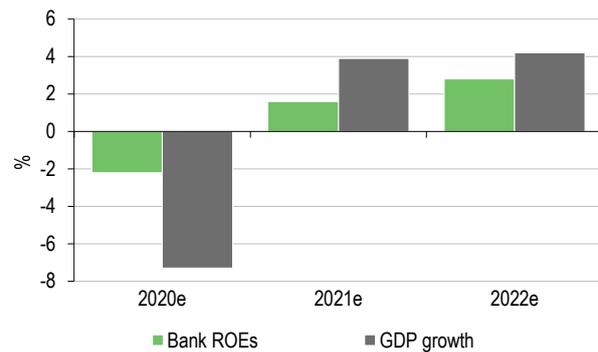
variants. However, the market is still pricing in significant concerns regarding future loan impairments. Government loan guarantees and moratoriums coupled with job support measures have led to NPL formation remaining at relatively low levels in most banks. The support has been sizeable. For example, at the end of Q320, 7.1% and 14.5% of eurozone corporate loans had been affected by government guarantees and moratoria, respectively, according to the ECB. The percentage of jobs benefiting from government support in the EU and UK ranged from 13% in Spain to as high as 29% in the Netherlands.

Exhibit 1: Eurozone banks – performing and non-performing forborne exposure



Source: ECB

Exhibit 2: Eurozone bank ROE and GDP forecasts



Source: Refinitiv, ECB

As these supports start to taper off and be removed, there is likely to be an increase in impairments and the ECB has highlighted optimistic provisioning by banks as a key risk in its Financial Stability Review. There are some market concerns that a cliff-edge scenario might be created, whereby impairments rocket up to levels that result in significant stress to banks' capital positions that spills over to the regulatory capital debt.

In our view, we do not see why governments and central banks should change their pragmatic support and allow such cliff-edge scenarios to emerge. We therefore believe that asset quality concerns are more relevant for equity investors (ie due to impact on earnings and possibly dividends) but not of a scale to realistically pose a significant problem for bank regulatory capital instruments.

Earnings challenges not capital risks

Besides asset quality, there are other challenges facing European banks. These include the low interest rate environment that compresses margins and the need to cut costs and change business models to be more digitally focused. Although sovereign yields curves are now starting to price in some expectation of a rise in interest rates, it is fairly certain that rates will remain at depressed levels for some time. Compressed margins and the increased levels of capital will continue to weigh on bank profitability (return on equity (ROE)) in our view in coming years. This is something that banks are well aware of and again we think is really an issue for equity investors rather than regulatory capital debt investors.

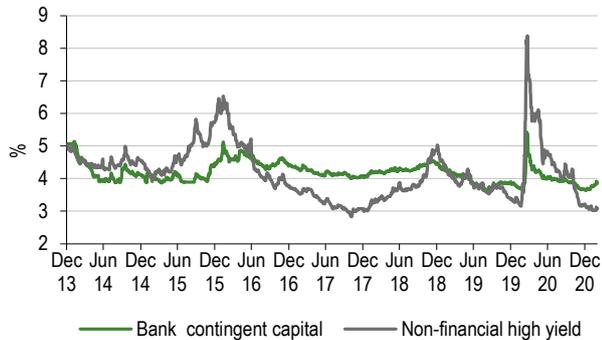
Regulatory capital prices

As with the bond market and many asset classes, regulatory capital bond prices have recovered from their 2020 low. If we look at the ICE BofA bank (investment grade only) contingent capital bonds as the proxy, the index yield was 3.9% at 4 March 2021, the same as at the end of 2019.

However, we note that high-yield non-financial bond prices have actually moved above the levels they were at before the crisis started. The ICE BofA non-financial high yield index was 3.1% on 4 March 2021 versus 3.4% at the end of 2019. We compare the yields in Exhibits 3 and 4.

We believe that the highly cyclical nature of banks combined with the aforementioned concerns regarding the pandemic exit have resulted in bank regulatory debt prices rebounding less than high yield bonds. As we exit the pandemic, and government and central bank support policies are cut bank, we will have greater clarity on the impact on banks and this could help regulatory capital bond prices.

Exhibit 3: Yields – European bank (investment grade) contingent capital vs non-financial high yield*



Source: Refinitiv. Note: *ICE BofA indices, yield to maturity, euros.

Exhibit 4: Yields – European bank (investment grade) contingent cap. spread vs non-financial high yield* (%)



Source: Refinitiv. Note: *ICE BofA indices, yield to maturity, euros.

The fund manager: Axiom Alternative Investments

Manager's view

Axiom Alternative Investments sees bank and insurance company balance sheets as being well capitalised and regulatory capital bonds valuations as relatively attractive, providing premium levels of income with relatively low risks having to be needed to absorb losses. Axiom points out that a BB+ rated bank AT1 bond will yield 3.0–3.5%, while a similarly rated non-financial company will only yield 1.5%, a very significant spread. It expects to see these bonds reprice upwards as we exit the pandemic, support programmes taper off and the impairment story plays out.

The manager notes in its latest monthly report (February) that bank results “continued to exceed analysts’ expectations” and that the “clean-up of Legacy bond continues” with Bank Austria (the Unicredit subsidiary) being the latest bank to call in legacy bonds.

Axiom expects banks to continue to redeem debt that is no longer efficient from a regulatory capital point of view. Regulatory capital is more expensive to issue than regular subordinated debt, so if the extra cost is not justified by the value as regulatory capital under the new stricter Basel 3 rules, then it can make sense to redeem or call these instruments. Axiom notes that both the ECB and the BOE's PRA in 2020 gave the banks a hurry-up call to clear out of their balance sheets these legacy instruments of now reduced regulatory usefulness. The key reason for this encouragement is that the regulators want to ensure that creditors are treated according to the current regulator ranking in the various tiers and not how they were originally issued and set in prospectus. The central banks want to avoid what the European Bank Association refers to as ‘infection risk’ and have regulator rankings clashing with the legal rankings because legacy instruments are still around. The regulators also clearly believe that banks have had plenty of time to redeem these legacy instruments. This problem is coming to a head because the grandfathering period of many of these legacy instruments is due to end on 31 December 2021.

Asset allocation

Current portfolio positioning

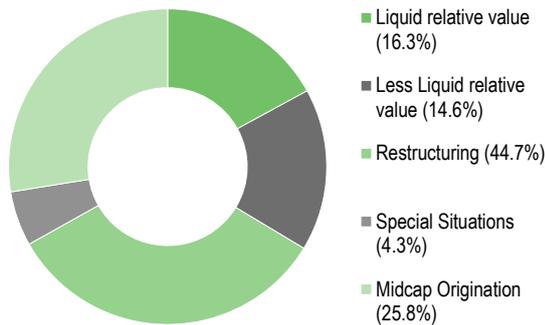
At the end of February 2021, about 58% of AXI's investments were in tier 1 bonds, including legacy (Basel 1–2) and Basel 3 compliant (AT1). These bonds are AXI's core and largest investment space. AXI also has 15% in tier 2 debt and 16% in straight senior debt. Finally, there is 3% in equity investments. All of the invested companies are financial services companies and banks.

On a geographical basis, the highest exposure was to the UK with 42%, the remainder being mostly European names. Euro exposure is 58%, but foreign exchange (FX) exposure is substantially hedged to the pound sterling through FX forward agreements.

The portfolio split between strategies is shown in Exhibit 5. Restructuring stories and mid-cap investments account for 45% and 26%. The various strategies are described on page 10.

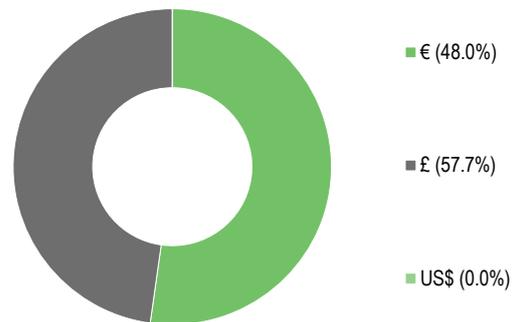
The ratings distribution is shown in Exhibit 7. Due to the loss absorbing and subordinated nature of regulatory capital debt, most of it is not rated as investment grade. This is true if the institution's senior debt is investment grade. For example, Deutsche Bank is rated A3 (Moody's) and BBB+ (S&P) for long-term senior debt. However, the AT1 bonds (similar to what AXI holds in its portfolio) are only rated B1 and BB-, respectively. As such, only 17% of AXI's portfolio is in investment-grade bonds.

Exhibit 5: Portfolio breakdown by strategy (Feb 2021)



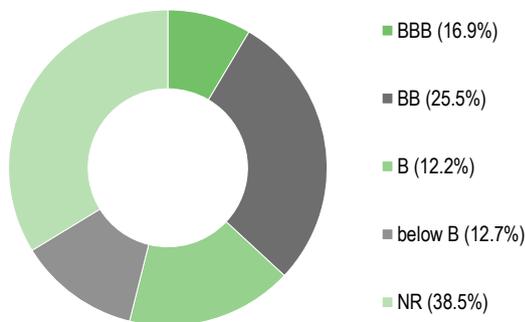
Source: Axiom

Exhibit 6: Portfolio currency breakdown (Feb 2021)



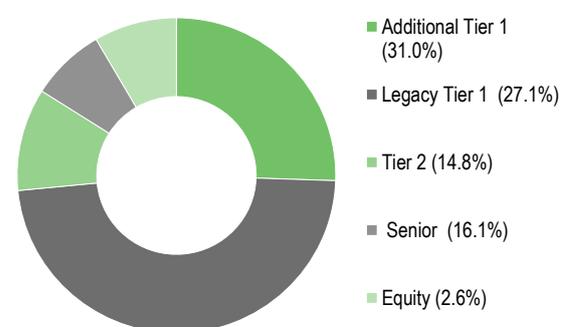
Source: Axiom

Exhibit 7: Portfolio ratings breakdown (Feb 2021)

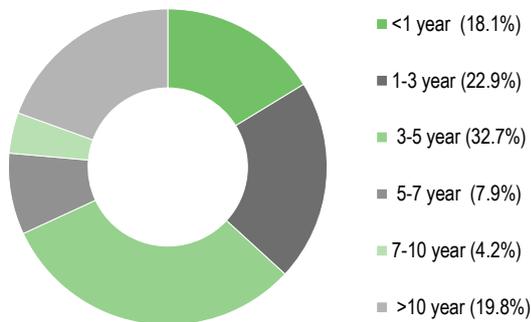


Source: Axiom

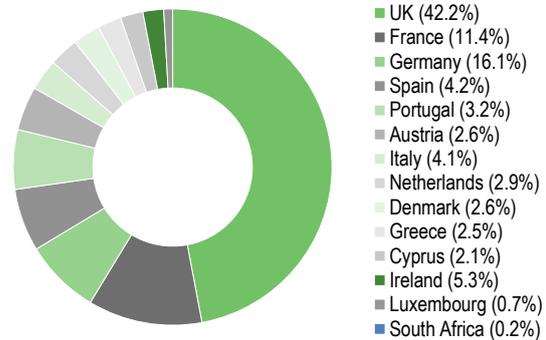
Exhibit 8: Portfolio subordination breakdown (Feb 2021)



Source: Axiom

Exhibit 9: Portfolio ratings breakdown (Feb 2021)


Source: Axiom

Exhibit 10: Portfolio subordination breakdown (Feb 2021)


Source: Axiom

Exhibit 11: Top 10 portfolio holdings (31 January 2021)

Security	Strategy	% NAV	Business description	Country
Promontoria MMB SASu 8.000% Perp	Midcap origination	4.0%	Retail finance	France
Shawbrook Group PLC 7.875% Perp	Midcap origination	3.9%	Retail and commercial bank	UK
International Personal Finance 9.750% 11/12/25	Restructuring	3.7%	Home credit and digital bank	UK
Grenke Finance PLC 1.500% 10/05/23	Restructuring	3.7%	Leasing and factoring services	UK
Ulster Bank Ireland DAC 11.750% Perp	Restructuring	3.6%	Retail and commercial bank	UK
Grenke Finance PLC 0.625% 01/09/25	Restructuring	3.4%	Leasing and factoring services	UK
Deutsche Bank AG 7.125% Perp	Restructuring	3.4%	Investment bank and financial services	Germany
Cofinga Funding Two LP 1.070% Perp	Special situation	3.2%	Retail finance	France
Coperative Bank Finance 9.500% 04/25/29	Restructuring	3.2%	Retail co-operative bank	UK
OneSavings Bank PLC 9.125% 05/25/22	Midcap origination	2.9%	Retail and commercial bank	UK

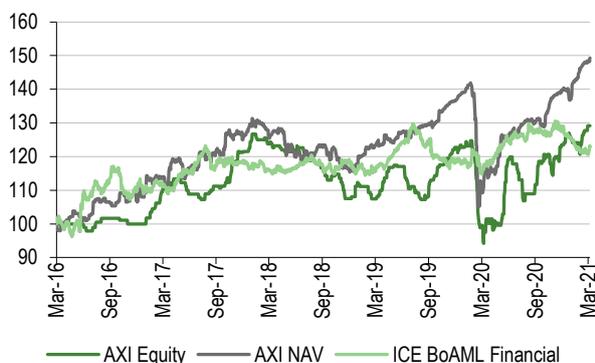
Source: Axiom

Performance

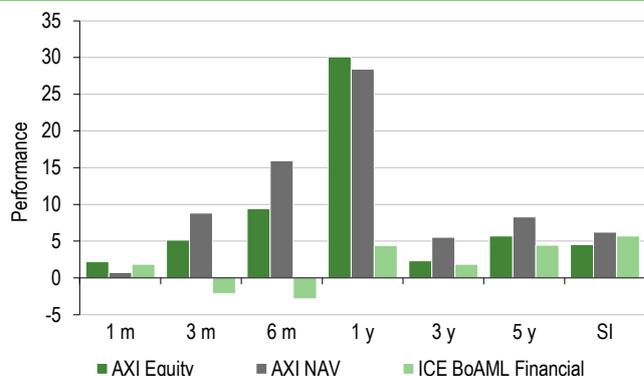
Although AXI is not benchmarked against any index, the managers use the ICE BofA European Financials Index as a reference point. AXI's shares and net asset value (NAV) had outperformed the over the last five years as shown in the exhibits. AXI's share price and NAV one-year performances are unusually high because there is a basis effect as the peak of the pandemic-driven market sell-off was exactly about a year ago.

Exhibit 12: Investment company performance to 9 April 2021

Price, NAV and benchmark total return performance, five-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: SI=since inception. Inception date is 30 September 2015.

Exhibit 13: Share price and NAV total return performance relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years
Price relative to ICE BofAML European Financial	0.3	7.5	12.6	24.6	1.5	6.3
NAV relative to ICE BofAML European Financial	(1.1)	11.2	19.3	23.0	11.4	20.0
Price relative to ICE BofAML Europ. Subord. Financials	0.1	6.7	10.2	21.4	(2.4)	(3.2)
NAV relative to ICE BofAML Subord. Financials	(1.3)	10.4	16.8	19.9	7.1	9.3
Price relative to ICE BofAML European High Yield	0.0	5.7	6.0	12.5	(3.3)	(5.5)
NAV relative to ICE BofAML European High Yield	(1.4)	9.4	12.3	11.1	6.1	6.7

Source: Refinitiv, Edison Investment Research. Note: Data to end-January 2021. Indices and prices in £. Geometric calculation.

Exhibit 13 compares the performance of AXI versus two other bond indices: the ICE BofAML European financials subordinated debt and ICE BofAML general European high yield index. AXI's NAV has outperformed these two indices as well, but the share price has underperformed over the last five years.

Exhibit 14: NAV total return five-year performance relative to ICE BofAML European Financials



Source: Refinitiv

Peer group comparison

Exhibit 15 shows a comparison of AXI with a selected peer group of funds from the AIC Sector Specialist: Debt and AIC Sector Specialist: Financials sectors that have significant holdings in high-yield lending or similar investments. We note that there is not a pure European regulatory capital debt peer; AXI is unique. For investors seeking exposure to this asset class, AXI is clearly a more focused play than any of their peers.

The most comparable peers in the table are CQS (47% of fund is financials, but mostly UK). TwentyFour (35% banks), City Merchants (one-third financial) and EJFI (fully financial, but exposure is mostly through collateralised loan obligations). Henderson Diversified is about 20% financials, albeit it has significant US exposure.

We compare the performance over one year. We have also added longer time periods for the peers, to give greater context to the short-term performance data.

Exhibit 15: Selected investment peer group as at 22 March 2021* in sterling terms

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Premium/ (discount)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Axiom European Financial Debt Fund	85.0	11.0	17.9	58.3	-8	1.4	Yes	91.4	6.5
City Merchants High Yield Ord	193.3	7.2	17.9	48.9	-1.9	1.0	Yes	101.2	5.8
CQS New City High Yield Ord	229.3	-3.8	6.0	33.8	3.3	1.2	Yes	114.9	8.5
Henderson Diversified Income Ord	164.5	6.0	20.1	42.7	-5.1	0.9	Yes	112.9	5.1
Invesco Enhanced Income Ord	127.7	9.2	22.8	62.1	-2.9	1.1	Yes	116.8	6.8
EJF Investments Ord	75.8	-5.9	15.8		-24.8	2.3	Yes	108.1	8.6
TwentyFour Select Monthly Income Ord	174.9	11.7	22.2	65.5	-4.5	1.1	Yes	96.6	6.5
Simple Average	150.1	5.1	17.5	51.9	-7.0	1.3		106.0	6.8
Rank	6.0	2.0	5.0	3.0	6.0	2.0		7	5

Source: Morningstar, Edison Investment Research. Note: *Performance to end-February 2021. TR = total return in sterling terms. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

Dividends

AXI pays dividends quarterly in April, July, October and January. AXI has maintained its dividend during the pandemic and has been paying 1.50p per quarter since 2017. There have been years that the dividend has been covered (eg 2019) by cash income and years when it has not (eg 2018).

Exhibit 16: Dividends per share history

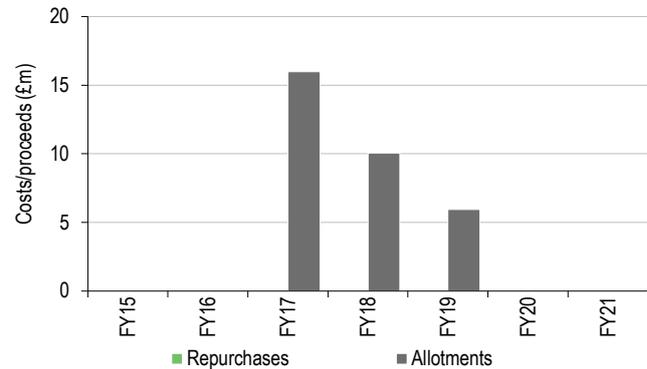

Source: Axiom

Discount: 8% below NAV

AXI's discount to NAV widened to more than 5% in the second half of summer of 2019. As a result of the pandemic crisis this discount has further widened and the shares are now trading at a 8% discount to NAV after being more than a 15% discount during the height of the first wave of the pandemic in 2020. The regulatory debt instruments are all accounted as market value (level 1) assets.

Exhibit 17: Five-year discount (%) diluted NAV cum income


Source: Refinitiv

Exhibit 18: Buybacks and issuance


Source: Morningstar

Fund profile: Bank debt specialist

AXI launched in September 2015 and is a Guernsey domiciled, London-listed, closed-end fund investing in regulatory capital securities in Europe. It seeks opportunities presented by Basel III and Solvency II transitions. It has a diversified approach across a broad range of subordinated debt issued by financial services companies. It uses five sub-strategies to obtain good current income and capital gains. AXI has a target return of 10% pa over seven years.

While the key investments targets are the regulatory capital instruments issued by European financial institutions, the fund will also invest in other debt instruments, such as senior debt, issued by these companies. AXI also invests in derivatives instruments (such as CDOs, securities or derivatives) that are linked to regulatory capital instruments or other financial institution investment instruments. AXI invests in both liquid and less liquid instruments. For those less liquid (for example with mid-cap issuers), AXI will sometimes create a market if it can be done profitably.

Investment process

The investment manager is Axiom Alternative Investments (Axiom) and the investment adviser is the Axiom Alternative Investments UK Branch. Although the investment management agreement is with the investment manager, the investment adviser also provides services and support.

The investment team is led by David Benamou (chief investment officer and managing partner of Axiom) and Jérôme Legras (head of research, managing partner) with Gildas Surry (AXI's portfolio manager, partner) and, more recently, Antonio Roman as portfolio managers. Prior to joining Axiom, David Benamou and Jérôme Legras were managing directors and co-heads of the Capital Structured Finance department at Société Générale Investment Banking. Both of them designed and implemented many subordinated debt issuances for European banks. Mr Legras also was previously head of quantitative research at Société Générale. Gildas Surry worked at Lazard Freres, Merrill Lynch and Citibank with a focus as an analyst on subordinated debt. Antonio Roman joined Axiom in 2018 having previously worked at JP Morgan AM developing portfolio optimisation tools under insurance regulatory rules and at Goldman Sachs AM as a quantitative analyst focused on client solutions relating to institutional clients with unique economic, regulatory and accounting constraints.

Axiom is focused on the financial services segment and currently manages \$2.2bn in assets across nine funds, the first of which was launched in 2009. These funds include one investing only in equity and a long-short debt fund. The team currently has 24 professionals.

AXI follows a three-step process: 1) **identifying the target investment instruments**; 2) **portfolio construction**; and 3) **portfolio monitoring**.

Using in-depth analysis, Axiom looks at **structure, regulation and risks** when identifying new investments. Structure includes key terms, different types of call and issuer policies. Regulation includes regulatory category of issue, modelling of amortisation profiles and market mispricing. Risks include credit analysis, asset quality review (AQR) reverse engineering and stress testing analysis.

Portfolio construction is done by the investment manager from the instruments recommended by the investment adviser. Portfolio monitoring looks at both the evolution of regulatory circumstances as well as the usual company, sector and market trends.

The investment decisions are taken by the investment team and it is not required to, nor does it generally take them to the board, unless there are conflicts of interest or for the application of investment guidelines. David Benamou has veto rights at the investment committee level.

Five investment sub-strategies

AXI uses five investment sub-strategies to obtain the mix of capital gains and current income that it seeks.

These are:

- **liquid relative value (estimated return 7–8%)**: this strategy generates some carry income, as well as providing liquidity to deploy for investment opportunities. The heart of this strategy is not only understanding which securities provide good income for risk, but which ones are likely to be redeemed/called in by borrowers because they are expensive for their value as regulatory capital due to changing legislation. Besides regulation all sorts of factors must be taken into account, such as the complexity of the coupon payments and call options, local legal constraints, staff bonuses, dividends and the bank's likely available distributable profits. An attractive investment can be made if a security is redeemed sooner than the market expects at price of par or above. Or a high coupon bond that is being priced as if it is going to be redeemed (ie close to par) can provide an elevated level of income by remaining unredeemed. The complexity of the legacy hybrid debt market in areas such as coupon payments and call options can lead to market mispricing and therefore investment opportunities. Besides price discrepancies, AXI also looks for relative value trades where the spreads are not justified by fundamentals.
- **less liquid relative value (6–16%)**: this strategy looks at instruments that are less liquid but generating greater carry income, to help support dividend payments. Investments will be typically bought at a discount and held until maturity.
- **restructuring stories (7–25%)**: this strategy is not interested in the debt itself being restructured, but situations where financial companies have faced stressful events that have had an impact on regulatory capital prices (ie the market is pricing that the regulatory capital may have to absorb some losses, eg a skipped coupon payment, a conversion to equity). The aim is to capture remedial and restructuring actions by management and regulators that result in improvements in the financial company's risk profile and outlook and therefore regulatory capital prices. The changes could involve changed business models, cost cutting, capital structure reorganisation, etc. Here the returns targeted by AXI are greater and are expected to be mostly in the form of capital gains.

- **special situations (8–35%):** this strategy is based on events that trigger an improvement in the regulatory capital pricing and that have not yet been priced correctly by the market. Examples include merger and acquisitions, a bank that has been nationalised but is expected to be re-privatised, situations where there is conversion of some hybrid debt (such as contingent capital) into equity. Capital gains also have a greater emphasis in this strategy.
- **midcap origination (9–11%):** this strategy involves smaller issuers paying a premium for the same levels of risk and allowing greater carry income. AXI will typically look at either high credit quality mid-capitalisation banks or a subsidiary of a larger institution with limited access to capital markets and targeting a relatively small bond issuance (between €20m and €100m). AXI aims not to hold more than 10% of any issue, unless the risk-reward is unusually good to justify holding more.

There is no minimum portfolio weight for each of these strategies but there are caps. These caps are 20% for restructuring and for special situations, 25% for liquid relative value and 30% for less liquid relative value and midcap origination. The current weights are shown in Exhibit 5, page 6, and we note that the restructuring sub-strategy at 34% is above the stated cap.

Axiom's approach to ESG

AXI integrates environmental, social, and corporate governance (ESG) criteria in its investment in three ways: (1) an in-house database and tools dedicated to ESG, (2) engagement with management and investor relations for information, and (3) information published in annual reports and other regulatory filings (including sustainability reports and Task Force on Climate-related Financial Disclosures). The details of the ESG policy is posted on the website axiom-ai.com/web/en/regulatory-information. Axiom partners with external consulting firms to assess its portfolio. AXI signed up to the Principles of Responsible Investments (PRI) in 2016. PRI is a UN-supported investor network committed to implement its six investment principles, related to integrating ESG into investments decisions and policies.

Gearing

As set out in its articles of incorporation, AXI is permitted to borrow in any manner. However, the board has limited this to 20% of its direct investments. AXI had £2.6m in bank overdrafts and £8.4m in cash for a net cash position of £5.8m (against a NAV of £81.4m). However, AXI uses derivatives (usually sales and repo contracts) for gearing. The financial statement showed that at the end of H120, AXI had £16.3m of such liabilities with £9.5 in collateral assets used as margin. AXI disclosed a gearing position of 9% of NAV at the end of January 2021 with a cash allocation of 4%.

Fees & charges

AXI has an annual management fee of 1% of NAV that is paid quarterly and in arrears. This fee drops to 0.8% if NAV exceeds £250m on a marginal basis and for the whole amount if NAV exceeds £500m.

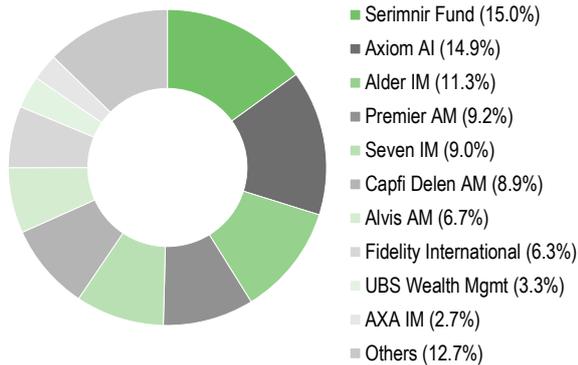
There is a 1.5% total cap on total expenses. So, if in the final quarter of an accounting period the total expenses (including management fee) exceed 1.5% of NAV, then this is offset by the management fee itself being adjusted downwards.

The performance fees are 15% of the total shareholder return in excess of 7% pa are paid annually and subject to a high-water mark. The performance fee is not subject to the 1.5% total expenses cap. 50% of the performance fee is in cash; the remainder will be in shares.

Capital structure

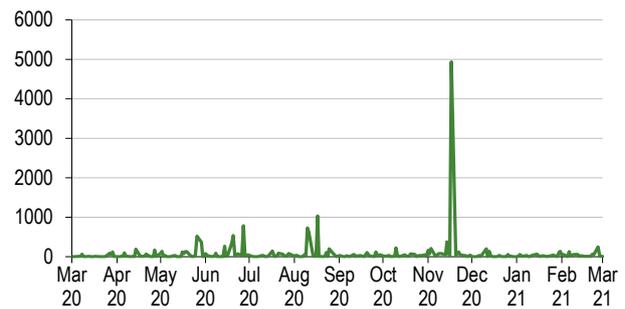
AXI currently has a single share class, with 91.852m ordinary shares in issue trading on the Specialist Fund Segment (SFS) of the London Stock Exchange. There are no rules restricting the ability of the directors to issue additional shares on a non-pre-emptive basis at any time. The directors may issue additional shares, pursuant to a placing programme or otherwise, if they determine this to be in the best interests of shareholders and Axiom as a whole. Since the IPO in 2015, there have been 30.9m shares allotted with proceeds of £32m as shown in Exhibit 18.

Exhibit 19: Major shareholders (9 April 2021)



Source: Refinitiv

Exhibit 20: Average daily volume (£000s)



Source: Refinitiv

The board

AXI's board is comprised of three non-executive directors, all of them independent of the investment manager.

William Scott, chairman: Bill is an independent non-executive director of a number of investment companies and funds. He was formerly senior vice president with FRM Investment Management, a leading manager of institutional fund of hedge funds in Guernsey and now part of Man Group. Prior to this, he was a director at Rea Brothers (which became part of the Close Brothers group in 1999 and where he was a director of Close Bank Guernsey Limited). He is a chartered accountant, holds the Securities Institute Diploma and is a chartered fellow of the Chartered Institute for Securities and Investment. He is also a chartered wealth manager.

Bill currently serves on two other Premium London-listed fund boards, Pershing Square Holdings, and Worsley Investors, and has served continuously on Premium London-listed boards for over 18 years. He is also a director of RTW Venture Fund, which is listed on the Specialist Fund Segment of the London Stock Exchange Main Market.

John Renouf is a qualified accountant and was employed by FRM Investment Management, which is now a wholly owned subsidiary of Man Group, as a director and then managing director. Prior to this, John was employed on a part-time basis by Collins Stewart to assist in its development of offshore funds and he also spent over 10 years with Royal Bank of Canada Offshore Fund Managers in Guernsey. In this role he had overall responsibility for the management and administration of Royal Bank of Canada's offshore funds in the Channel Islands together with funds managed and administered on a third-party basis. John currently holds a number of directorships of funds and fund management companies.

Max Hilton returned to Guernsey from New York in 2008 and formed the predecessor firm to Clarus Risk. He previously worked for JP Morgan Securities in New York within proprietary equities and was responsible for managing a global equities portfolio. Prior to this Max had worked at Ziff

Brothers Investments in New York and London as a senior associate within the quantitative strategy group. Max has a BSc (Hons) economics from the University of London and has held the CFA designation since 2001. Since 2009 he has served as chair of the CFA UK Performance and Risk Measurement Special Interest Group.

Exhibit 21: AXI's board of directors

Board member	Date of appointment	Remuneration in FY19	Shareholdings end-FY19
William Scott (Chairman)	7 October 2015	£35,000	0
John Renouf (Audit Committee Chair)	7 October 2015	£32,500	0
Max Hilton	7 October 2015	£27,500	0

Source: Axiom

Appendix: Changes in bank regulatory capital debt

Regulatory rules exist to ensure that banks and insurance companies have sufficient capital and balance sheet solvency to keep trading in times of financial stress and with shock losses in the value of assets. Among the various rules and ratios, capital adequacy ratios are among the most important. These capital adequacy ratios essentially are available capital as a percentage of risk weighted exposure (usually expressed as risk weighted assets, RWA).

There are other ratios governing capital (such as leverage ratios) as well as liquidity ratios such as the net stable funding ratio. Insurance companies also have their own set of rules, but in this appendix we will focus on the changes in bank regulatory capital instruments since this is Axiom's key investment space.

The regulatory standards and frameworks in most financial systems in the world and Europe are strongly influenced by the Basel Committee on International Banking Supervision (BCBS). The BCBS is linked to the Bank for International Settlements (BIS) and in the past often the ratios were referred to as the 'BIS' ratios. The BCBS committee members come from various central banks and banking regulators and they set the standards. They are non-binding, but local regulators, including the ECB and the BOE, usually follow the principles and high level rules.

The evolution of regulatory capital can be divided into two periods: before and after the GFC. There have been three Basel Accords, numbered 1, 2 and 3, and the third was a response to the problems and issues raised by the GFC. A key objective for the introduction of Basel 3 was to increase the quality and quantity of capital in banks.

Capital is important for banks

Banks depend on regulatory capital as a buffer for when there are unexpected decreases in the value of the assets. Banks are also typically highly geared companies when compared to non-financial companies. Assets (of which loans and securities are the most salient asset classes) are often 5–10x greater than equity; historically asset gearings were as high as 30x and even 40x.

The business model relies on the gearing to product profitability. Too much capital is a drag on profitability, while too little capital is an inadequate buffer for sharp decrease in asset values. Banks see financial debt instruments with equity-like features as attractive to issue because they can be used as regulatory capital (ie a buffer) but are less expensive to use than common equity.

Being subordinated to virtually everything else (other than equity) is crucial as a buffer. The ability to skip or postpone coupons or triggered conversions to equity are also a common feature. Some degree of permanence is also preferred, to ensure that the capital is around when needed. Hence the use of perpetual bonds, or bonds with limited call options. The more equity-like features in the debt, then the more useful it is as capital but it is also more expensive to issue. Some of these bonds that combine both debt and equity features are often referred to as hybrid bonds.

Bank regulators (guided by the Basel Accords) determine which financial instruments qualify for which regulatory capital tier. They also determine (again guided by Basel) minimum levels of capital that must be held.

Before the 2007-08 GFC: Basel 1 and 2

Under Basel 1 and Basel 2 rules, banks had to have a total regulatory capital of 8% of RWAs. The regulatory capital was divided into several tiers as shown in Exhibit 22. Tier 1 bonds were the most equity like and equity itself was included in this tier. Tier 2 was split into upper and lower levels with different rules.

A minimum of 50% of the total regulatory capital had to be tier 1. Hybrid bonds could usually not be more than 15–35% (this varied by bank regulator) within tier 1. So, banks had to have a minimum tier 1 of 4% of RWA and straight equity (issued capital and retained earnings) in some jurisdictions could be as low as not much more than 2% of RWA.

Exhibit 22: Basel 1 and 2 regulatory capital tiers				
Bond features	Tier 1	Upper tier 2	Lower tier 2	Tier 3
Order of subordination (4 most subordinated)	4	3	2	1
With a maturity date?	No	No	Yes**	Yes
Callable?	After 5 years*	Yes	Yes	Yes
Coupon can be skipped at management discretion	Yes	Yes	No	No
Cumulative coupon?	Non-cumulative.	Cumulative	Cumulative	Cumulative

Source: BCBS, Edison Investment Research. Note: *Has to be replaced by instruments at same or better capital adequacy quality level. **Usually two-year minimum, tier 3 instruments were typically shorter duration than lower tier 2

Tier 1 bonds sometimes had an annual interest rate step-up feature after the first callable date. Since they became progressively more expensive that was an incentive to redeem them and these bonds are referred to as 'innovative'. These bonds could not be more than 15% of tier 1.

After the storm: Basel 3 changes

The GFC showed up the limitations of the existing regulatory framework and one of the key issues was that the regulatory capital was not sufficiently absorbing the losses in the value of bank assets (eg loans, securities, investments). In several cases, governments had to step in and bail out the banks at the cost to taxpayers – not a particularly popular outcome.

The definition of what constitutes equity has become stricter. Quite a few items are now discounted from banks' regulatory equity such as goodwill, minority interests, some deferred tax assets and investment in other banks. There have also been adjustments on RWA. All of this has helped strengthen banks' equity bases and improve the buffer for regulatory capital debt.

Basel 3 rules started to be implemented in 2012 in a phased approach until the end of 2018. The phased approach was necessary to give the banks time to adapt to the new rules. The criteria for recognising capital was tightened and the capital structure also simplified. This meant some instruments no longer had the same value for regulatory capital as before.

The key changes in bank regulatory debt were as follows:

- **T1 was replaced with CET1 and Additional T1 (AT1).** CET1 is essentially little more than straight equity and bonds accepted as AT1 had to have greater loss-absorbing capacity than the bonds previously qualifying as Hybrid T1 in Basel 1 and 2.
- **Upper and Lower tier 2 (T2) was merged into single T2,** with a profile similar to previous Lower T2.
- **T3 was eliminated.** T3 has been replaced by instruments senior to the previous T3 but with similar loss-absorbing capacity. These are included when calculating the minimum requirement for own funds and eligible liabilities (MREL) ratios.

AT1 stricter than hybrid tier 1

Because the rules are stricter for AT1 than the previous Hybrid T1, there are some instruments that no longer fit into the new capital regulations under T1. Key changes include:

- **Interest rate step-up** (incentives) are no longer allowed.
- Coupons are now fully discretionary and **disentangled from dividends**. Dividend pushers (mandatory hybrid bond coupon payment if dividends are paid) and stoppers (dividends are also skipped if hybrid bond coupon payment skipped) are prohibited.
- Banks are **unable to make full distribution** to instruments such as AT1 if capital **buffer** requirements are **not met**. Banks have to calculate a maximum distributable amount (MDA) to see how much they can pay CET1 and AT1 and for staff bonuses.
- Issued AT1 bonds have to be **permanently** available.
- AT1 is required to **convert** to CET1 (essentially equity) or be depreciated if CET1 falls below 5.125% of RWA or if regulators believe that the bank is likely to fail in the future. Securities with this equity conversion feature are referred to as **CoCos** (contingent convertibles).

Tier 2 changes

The key changes are:

- step-ups are not allowed;
- bonds have to have at least five years before call date (under Basel 2, this applied to T1, but tier not T2);
- bonds can no longer have rating calls (ie calls triggered by a change in 'equity credit' ratings); and
- the bonds' regulatory capital value (ie their capital weighting) declines as they approach their maturity date.

The Basel 3 capital buffers

The minimum capital requirement under Basel is 8%, as was the case with Basel 2 but with a different composition: 4.5% CET1, 1.5% AT1 and 2% T2. Basel 3 also introduced additional requirements (buffers) and these have to be met with CET1. Furthermore, these buffers trigger automatic safeguards when breached.

The first two buffers are the capital conservation buffer (2.5%) and countercyclical buffer (this varies with point of the economic cycle) and apply to all banks. In order to avoid a repeat of the too big to fail problems of the GFC, the bigger banks have to carry more CET1. These banks are classified as a global or a national systematic institution (GSII or NSII) and have an associated buffer. The former typically ranged from 1–3.5% of RWA and the latter can be up to 2%. In addition to this, individual countries can add further buffers up to 2%, although within the eurozone, buffers can sometimes have to be cleared with the ECB.

It worth also highlighting the Pillar 2B (also known as PRA) buffer in the UK. It is a cyclical buffer on top of the total capital requirement. The buffer varies and it interacts with the countercyclical buffer. The latter is more systematic, while Pillar 2B is more idiosyncratic (ie specific for that bank).

All of these measures added up means that banks are carrying more CET1 than ever, which provide protection for the AT1 and T2 capital instruments that make up most of AXI's portfolios. Furthermore, there is pressure from the market for banks to carry equity significantly above what the regulators are asking. Therefore, the average CET1 in the larger banks under the ECB is 15% and under the BOE it is 16%.

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