

Lux Nordic Financial Opportunities Fund

DESPAIR VERSUS HOPE

While there were few places to hide in 2018 as most asset classes gave negative returns, 2019 proved to be the opposite. In 2018 liquidity tighten for the first time in 15 years as Central Banks decreased their balance sheets with USD 17bn. This was reversed in 2019 with major Central Banks again starting to expand their balance sheets. While the relationship between changes in central bank balances and financial market performance is not clear-cut, the liquidity that flooded markets during the years of stimulating central bank policy has undoubtedly induced excessive risk-taking by investors, and thus contributed to the returns in financial markets. This was again the case for 2019.

PERFORMANCE

Our fund delivered +9.7% for the full year 2019 corresponding to +78.2% since inception (November 2010).

THOUGHTS FOR 2020

Can the already record breaking investment cycle continue into 2020? Global economic growth is again likely to slow down with inflation still staying low. However, we believe that a global recession will be avoided in 2020 supported by accommodative central banks and more fiscal stimuli from Governments. This suggest a bond market environment that should continue to be characterized by low government bond yields and unusually tight spreads on corporate bonds. We do not expect further significant declines in yields, but rather broad sideways movement at low levels. In these circumstances spread assets are likely to perform due to better carry.

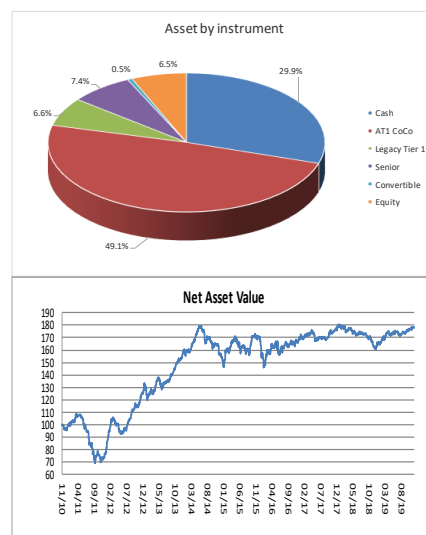
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Fund data and facts

Share class	BI (accumulating)
ISIN	LU0560186115
Bloomberg ticker	NDISEBI LX
Depository Bank	BIL Luxembourg
Domicile	Luxembourg
Lock-up	No
Subscriptions/redemptions	Daily/Bi-monthly
Base currency	EUR
Minimum investment (EUR)	125,000
Annual management fee	1.00%
Performance fee	20%, hurdle rate 5%
AUM (EURm)	34.1
Number of holdings	28
Portfolio Manager	Lux Nordic
Launch date	30.11.2010

Performance data

Net asset value per share	178.20
Since inception	78.2%
YTD	9.7%
1 year	9.7%
3 year	7.3%
5 year	13.6%



Returns, net of fees - EUR

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2010												-3.1%	-3.1%
2011	2.3%	3.1%	1.4%	3.2%	-0.9%	-7.4%	-3.7%	-11.2%	-11.9%	6.1%	-10.5%	5.0%	-23.8%
2012	18.1%	14.6%	4.1%	-4.1%	-6.9%	2.4%	3.4%	6.3%	6.3%	3.2%	3.7%	5.3%	69.8%
2013	2.6%	-3.5%	0.9%	5.2%	3.3%	-4.7%	2.7%	1.3%	3.4%	4.9%	3.9%	1.2%	22.8%
2014	1.4%	2.0%	2.0%	3.2%	4.9%	1.4%	-3.4%	-1.2%	-2.0%	-2.4%	1.2%	-4.8%	1.9%
2015	-5.6%	8.8%	0.2%	3.8%	-0.4%	-3.4%	1.3%	-2.6%	-0.7%	7.9%	0.6%	-0.5%	8.8%
2016	-7.6%	-3.3%	4.6%	2.7%	1.6%	-5.0%	2.5%	2.2%	-1.9%	2.6%	-1.3%	0.8%	-2.7%
2017	3.0%	-0.2%	1.3%	0.3%	-1.0%	-2.1%	0.8%	0.4%	-0.4%	3.3%	-0.2%	1.1%	6.5%
2018	1.5%	-0.4%	-2.2%	1.5%	-2.6%	-0.6%	1.4%	-0.4%	-0.3%	-1.8%	-2.3%	-2.1%	-8.2%
2019	1.9%	2.1%	0.2%	3.2%	-1.1%	0.7%	0.2%	-0.9%	0.8%	0.7%	1.0%	0.5%	9.7%

AFTER THE RAIN COMES SUN

After a difficult 2018, expectations for 2019 performance were low. The financial markets in 2018 reflected the changing monetary conditions, escalating trade tensions and fear of a recession. It was one year of negativity, and at the end of 2018, the negative signs wherever the eye could see seemed to suggest a terrible year for investments. But it wasn't, not at all.

2019 was a good year for investment performance across most asset classes and markets. Global growth is slowing, which in turn has encouraged continued widespread monetary easing. This has had a positive effect on certain assets as government bonds and corporate bonds trade with negative yields. In aggregate, over USD 17tn of bonds issued by governments and corporates have traded at negative yields during 2019. TINA (there is no alternative) has definitely been present, as this encourages investors to move up the risk curve.



The ongoing trade war between the US and China came to a truce at the end of 2019. Finally putting pen to paper on a US-China trade agreement will help both sides to stop adding to the economic damage they have sustained from their imposition of tariffs. The most important accomplishment of the negotiators is to put aside the risk of additional tariffs at least until after the US election. The two countries agree on the need to stop escalating

their trade war, but apparently not much else. In the deal, the US agreed to a very limited reduction of the tariffs already imposed, which in effect entrenches high tariffs on many Chinese goods. After the deal takes effect, the average US tariff on Chinese imports will be 19.3% compared to 3.0% before the trade war. The agreement also allows the US to reimpose tariffs if China fails to meet its commitments and further talks do not produce results.

In 2018 liquidity tightened for the first time in 15 years as Central Banks decreased their balance sheets with USD 17bn. This was reversed in 2019 with major Central Banks again starting to expand their balance sheets. While the relationship between changes in central bank balances and financial market performance is not clear-cut, the liquidity that flooded markets during the years of stimulating central bank policy has undoubtedly induced excessive risk-taking by investors, and thus contributed to the returns in financial markets.

Positive returns in most asset classes

While there were few places to hide in 2018 as most asset classes gave negative returns, 2019 proved to be the opposite. In 2018, cash was the asset class that gave the best performance. This was first time in many years. The table below shows the performance for different asset classes for the year 2019 and from the year 2018.

	31.12.2018	31.12.2019	P/L 2018	P/L YTD
DAX	10,558.96	13,249.01	-18.3%	25.5%
S&P	2,506.85	3,230.85	-6.2%	28.9%
OMX	1,408.74	1,771.85	-10.7%	25.8%
Oslo Børs	799.46	931.45	-1.8%	16.5%
MSCI World	1,883.90	2,358.47	-8.1%	25.2%
Banks 600 Europe	132.40	143.28	-28.0%	8.2%
MSCI Asia	146.71	170.66	-15.6%	16.3%
Shanghai A shares	2,609.67	3,195.98	-24.7%	22.5%
Gold	1,282.49	1,517.27	-1.6%	18.3%
Brent oil	53.80	66.00	-19.5%	22.7%
US Government Bonds	128.14	136.94	0.9%	6.9%
EU Government Bonds	255.32	272.61	1.0%	6.8%
AT1 index	98.01	108.39	-11.2%	10.6%
European investment grade	224.46	236.69	-0.9%	5.4%
European high yield	135.18	152.44	-6.0%	12.8%
EURUSD	1.1467	1.1117	-4.5%	-3.1%
EURNOK	9.9034	10.1880	0.6%	2.9%
EURSEK	10.1525	10.7440	3.2%	5.8%
GBPEUR	1.1122	1.1574	-1.2%	4.1%
GBPNOK	11.0500	11.7900	-0.2%	6.7%
GBPSEK	11.2920	12.4360	2.2%	10.1%
GBPUSD	1.2754	1.2868	-5.6%	0.9%
USDNOK	8.6409	9.1628	5.3%	6.0%
USDSEK	8.8533	9.6640	-3.8%	9.2%
CHFNOK	8.7958	9.2577	4.4%	5.3%

Source Bloomberg

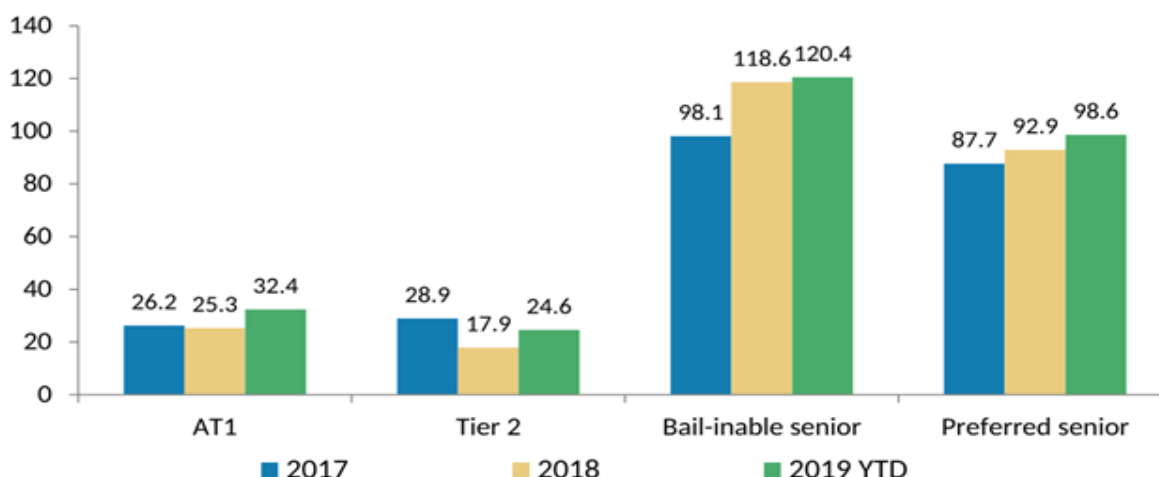
Financial equities still underperforming

2018 was miserable for many sector, but Financials was one of the worst performing sectors. Equities in European banks fell -28.0% measured by the Stoxx 600 Bank index. This is the worst fall since the European crisis in 2011 and the financial crisis in 2008. Since end of 2006 the index has fallen with -74.1%. While most sectors and indices recovered in 2019, the Stoxx 600 Bank index recovered only 8.2%. With most of the performance achieved in the second half of the year. The sector is still dragged by lower growth and the perception of lower rates for longer, and was in 2019 as well one of the worst performing sectors.

AT1 CoCo bonds did far better with the ICE BofAML CoCo Index up +10.6% for the year. Strong performance for AT1 CoCo's, but other bonds within the financial sector did also well. Especially longer dated bonds outperformed due to spread tightening and lower interest rates. We also noticed that most issuers decided to call AT1 CoCo's at first call (Santander was the exception), as they chose to refinance bonds up to six months in advance. We believe it is easier to get regulatory approval for a call when the bond is already refinanced and both bonds contributing to capital requirements. If a bank has sufficient capital, an unconditional call will normally be allowed by regulators.

Bail-in senior bonds reached an issuance of EUR 120.4bn in 2019, which is a new record. AT1 and Tier 2 supply has surprised to the upside, with 28% and 40% higher issuance than 2018. As mentioned above, issuers took advantage of favourable market conditions and refinanced upcoming calls early.

While we expect the largest issuance in 2020 to still come from bail-in debt, we also expect issuance of decent amounts of AT1 (EUR 25bn) and Tier 2 (EUR 20bn).



Source Morgan Stanley

THOUGHTS FOR 2020

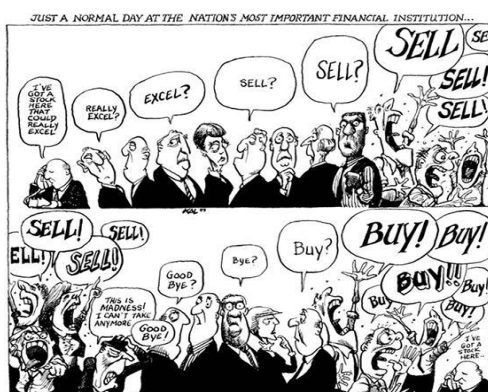
Can the already record breaking investment cycle continue into 2020? Global economic growth is again likely to slow down with inflation still staying low. However, we believe that a global recession will be avoided in 2020 supported by accommodative central banks and more fiscal stimuli from Governments. This suggest a bond market environment that should continue to be characterized by low government bond yields and unusually tight spreads on corporate bonds. We do not expect further significant declines in yields, but rather broad sideways movement at low levels. In these circumstances spread assets are likely to perform due to better carry.

Trade war is not over as the agreement between the US and China is merely a truce than a real agreement. The deal is design not to escalate the tariffs and give both parties time to focus on domestic issues. This year we believe Mr Trump will focus on the US election and refrain from political actions that can hurt the US economy. However, fundamentally, the political elite in both countries dislikes and distrusts each other. The Chinese regards that the unilateral trade actions by the US and the unpredictable back and forth of Mr Trump have shown that the US is an unreliable partner. Simple prudence demands that China relies less economically on the US and goes its own way internationally. The real trade war has evolved into a challenge for ownership and leadership of intellectual property and the industries of the future. This development has far greater potential ramifications than arguments over the fraction of a car that is manufactured in the US, or barriers to trade in agricultural products. We believe the dispute will continue for a longer periode.

Liquidity matters

Global economic growth and corporate profit growth deteriorated in 2019, while trade tensions and Brexit risks intensified compared to 2018. Still, 2019 turned out the best year in financial markets since 2009. In contrast to 2018, which was the worst year since 2008. Increased monetary easing is the main reason behind this, in our view. The US central bank moved from tightening liquidity and hiking interest rates four times in 2018 to cutting interest rates three times and injecting liquidity into the financial system via its renewed balance sheet expansion in 2019. We do not expect the Fed to do a new round of interest rate cuts this year. Thus, market sentiment will not be boosted in the same way this year as was the case in 2019. Liquidity matters as well, and the Fed looks set to continue to increase its balance sheet in 2020. This in combination with continued balance sheet expansion at the European Central Bank and the Bank of Japan, should provide continued support to market sentiment.

Psychology



Psychology has always had a major impact on market behaviour. Today's investors get real and fake news more frequently than in the past through normal and social media, which in turn contributes to both unexpected and larger market movements. Media today has become more powerful with social media and fake news in larger part contributing to market movements. This is sometimes frustrating, but in the longer perspective it creates opportunities as it often leads to mispricing of assets.

OUTLOOK FOR THE FINANCIAL SECTOR

The financial sector is sensitive to change in growth expectations and especially with the perception of a recession. For now, we do not believe that a recession is imminent. Most analysts share this view. However, the low rate environment will most likely continue for some time making it difficult for banks to increase earnings significantly. Economic releases have been stabilizing and if they are to improve, it will be a catalyst for the banking sector and especially European banks. Hence, we believe that we will continue to see the same difference in performance for equities and bonds within the financial sector. While we believe that bonds will be supported by regulatory changes, equities are more dependent on positive economic data.

Regulatory changes for AT1

The original (2009) proposal required AT1 to be a going-concern instrument. However, most AT1 issues have a trigger level of 5.125% or 7% of CET1, meaning that if a bank's CET1 ratio falls below these levels the AT1 bonds are either written down or equitized in order to recapitalize the bank. Back in 2009 these levels were adequate as we calculated BNP's CET1 ratio to 4.8%, while now it is 12%. Today these levels are totally inadequate as they most likely will not be reached before a bank enters resolution. Rendering AT1 is no more useful than Tier 2 or bail-in debt. In our view there is clearly a need to change the trigger levels. The legislative bodies have already stated that some of the framework will be reviewed this year (Basel 3 reforms), and although not explicitly referred to we believe this

should involve a review of AT1 trigger levels. If triggers are changed, we would expect a grandfathering period but effectively most AT1's will be called at first call and will in our view trade closer to Tier 2 instruments.

Call windows

A new innovation introduced by Nationwide who specified a call "on any day falling in the period commencing (and including) December 20, 2024 and ending on (and including) June 20, 2025, creating a six-month call window. Most banks still call these bonds at first call date even though it can be debated if the refinancing has been economical or not. Banks still need the regulators' approval before a call and with volatile markets it could be more difficult to get their approval. With a six-month call window, the issuer has greater flexibility around market timing to refinance, reducing the risk of an accidental non-call due to a few months of volatility ahead of call date. It also signals a clear preference to call on first call from the issuer. In our view, this is a bondholder-friendly structure, and one which has been copied by four other issuers so far.

Conclusion

We remain constructive on the financial sector especially for bonds as we believe regulatory changes will make spreads tighten towards Tier 2 levels. We are more cautious on equities as economic data still points to lower growth, which could give more headwinds for banks. With that said, especially European equities within the Financial sector are priced at distressed levels, leaving a limited downside as long as we avoid a recession.

PORTFOLIO

Even though we were relative positive for the market in the beginning of 2019, we still had a defensive approach going into the year. We had an asset allocation as of 31.12.2018 of 17.3% cash, 68.5% bonds and 14.2% equities. In the end of april, we increased our cash position to close to 30% and decreased our equity position to 7.4%. We maintained a relative short duration in the fund. The average cash and equity exposure were relative unchanged throughout the year, and even with a defensive portfolio we managed to have a positive gain of +9.7% for the full year 2019.

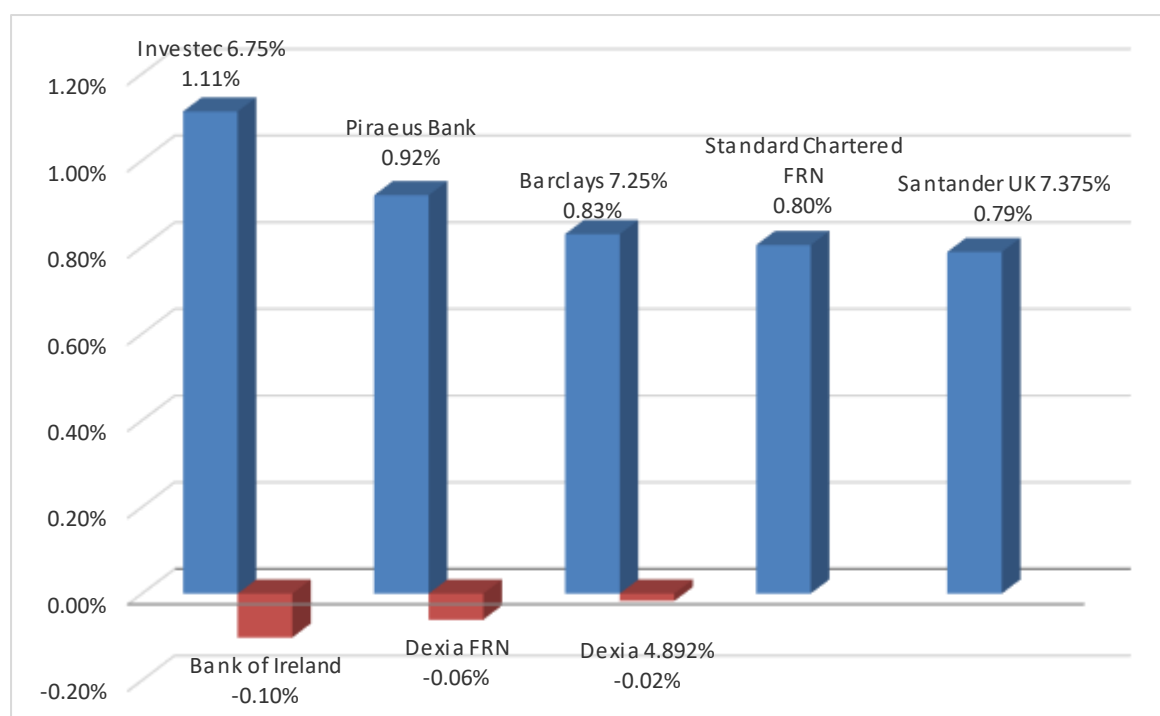
Breakdown of the performance shows that our equities beat the market quite significantly, while our bonds were slightly below market.

Below table shows the performance breakdown for 2019.

<i>Assets</i>	<i>Fund performance</i>	<i>Market performance</i>
Equities	16.6%	8.2%
Bonds	10.4%	10.6%

Some of 2018 worst performers, turned out to be some of our best performers for 2019. Especially Piraeus Bank who benefited from a strong recovery for the Greek economy and stronger than expected results. There were only three positions contributing negative to the performance in 2019.

Below you will find a table showing the five most positive contributors to the performance and the three negative contributors to performance.



Portfolio changes in 2019

Below you will find a list over the major changes to the portfolio in 2019:

- We decreased our equity position in April and in August by selling a percentage of all positions.
- We sold our entire position in Deutsche Bank AT1 CoCo bonds as they rallied to much on the back of a potential merger with Commerzbank.
- Banque Internationale a Luxembourg issued a new 5 year EUR fixed AT1 CoCo at 5.25% which is swap + 544.4 bp. The bank is also the custodian bank of the fund. We believe the credit spread is attractive with potential for tightening.
- We sold our entire position in Groupama Tier 1 bond as yield and spread fell to under our target level.
- We bought into Belfius 3.625% AT1 CoCo in EUR as the price dropped to 90. The bond has a low reset spread, but due to regulatory changes we believe the bond will be called at first call in 2025.
- We sold part of our position in DDM 8%.
- Santander was the only major bank not calling an AT1 CoCo, and we bought into the bond after this was announced. We found the credit spread interesting with swap + 5.41% and running yield of 5.481%.
- We sold our entire position in Deutsche Pfandbriefbank 5.75% AT CoCo as yield and spread fell to under our target level.
- We sold our entire holding in Societe Generale 6% AT1 CoCo with call in January 2020 as yield and spread fell to under our target level.
- We bought the new issue from AIB which did a new AT1 CoCo at 5.25% in EUR. After a good performance we sold the position before Christmas.

Asset allocation, yields and interest rate risk

At 31.12.2019 the fund had 29.9% in cash, 63.7% in bonds and 6.4% in equities. The yield to call (estimated call) is 4.6% and yield to perpetuity is 5.4%. At present the fund's modified duration is 1.8 years.

A geographical breakdown of the positions can be found in the Appendix.

Portfolio outlook

We will continue to invest carefully going forward, but we are cautiously optimistic for 2020 and in the time of writing we might experience a market correction due to the corona virus originated from China. We believe this could be a buying opportunity, as historically, similar outbreaks usually goes over after some time. We appreciate that yields are lower than previous years, but due to potential regulatory changes we are positive to spread tightening for AT1's with trigger level of 5.125% and 7%. We believe the trigger levels will be harmonized and increased as they are not sufficient at present levels. We continue to favour AT1's as we believe they will continue to perform as spreads tighten. We are still a bit cautious of equities as low interest rate environment and low growth prospects gives headwind for the financial sector. However, if we see an improvement in economic data then this sector will start to perform. We are watching this closely.

Top holdings

The table below shows our fund's top 6 holdings which comprises 34.4% of total assets.

Danske Andelskasser is located in Jutland in Denmark and is focusing on private clients, as well as medium sized corporate clients. The bank had problems after the financial crisis due to their large agriculture exposure. However, the bank has been reorganized and now runs a profitable business with declining non-performing loans. We have bought an AT1 bond which we find favourable compared to peers. This bond has already been refinanced by an equity issue and will be called at first call in February 2021.

Sparebank 1 Nord-Norge is a Norwegian savings bank providing commercial banking services to industry and private households in northern Norway. We believe Norwegian savings banks offer good opportunities as they are safe and normally calls subordinated and AT1 bonds at first call. We consider this as a safe investment which give around 5% yield to call.

Investec is an international specialist bank and asset manager. The bank provides corporate and investment banking, private banking, securities trading and asset management. In August 2017 they issued a new AT1 which was issued with a spread premium to peers. The bond is still attractive as it trades at a high spread compared to peers.

Banque Internationale a Luxembourg (BIL) is a local Luxembourg bank focusing on retail business and Private Banking. The bank is also custodian for our fund. BIL is a solid bank with A2 rating. They issued their first AT1 CoCo in 2019 with a spread of swap +544.4 bp, which we find high compared to peers. The issue is EUR 300m.

Standard Chartered is an international banking group operating principally in Asia, Africa and the Middle East. They have a legacy Tier 1 bond which they did not call in 2017. Next possible call is 2027, and it now trades as a floating rate note. We bought the bond at high 80's which is a reasonable yield to call.

Issuer	% of portfolio	Asset class
Danske Andelskasser	8.3%	Bonds
Sparebank 1 Nord-Norge	7.5%	Bonds
Investec	7.0%	Bonds
BIL	6.0%	Bonds
Standard Chartered	5.6%	Bonds
Sum	34.4%	

RISK CONTROL

The main risks are obviously related to factors that determine the value of the securities we buy, which we try to deal with by fundamental analysis of the issuers and the securities.

Leverage: Leverage has been zero for 2019.

Restrictions: The fund's investment restrictions are described in the prospectus.

APPENDIX: A description of the most common banking instruments we buy.

Basel III also known as CRD IV (Capital Requirements Directive 4) was implemented in most European banks from 1 January 2014, with full implementation of most of the new rules due by 1 January 2019.

The main capital ratio will, as before, be calculated by dividing **capital** by **risk-weighted assets**. In addition, a so-called **leverage ratio** (**capital** divided by **total assets** [i.e. no risk-weighting]).

While banks under the old rules should have a capital ratio of at least 8%, the required ratios will vary between banks and over time. The required total ratio is the total of different elements, Common Equity Tier 1 ratio, Capital Conservation Buffer, SIFI (Systematically Important Financial Institutions) requirement, Counter Cyclical Buffer, Sectorial Capital Requirement, and Systemic Risk Buffer. For instance, small banks will not be subject to the SIFI Requirement, while the maximum required Counter Cyclical Buffer should be used when the economy is booming.

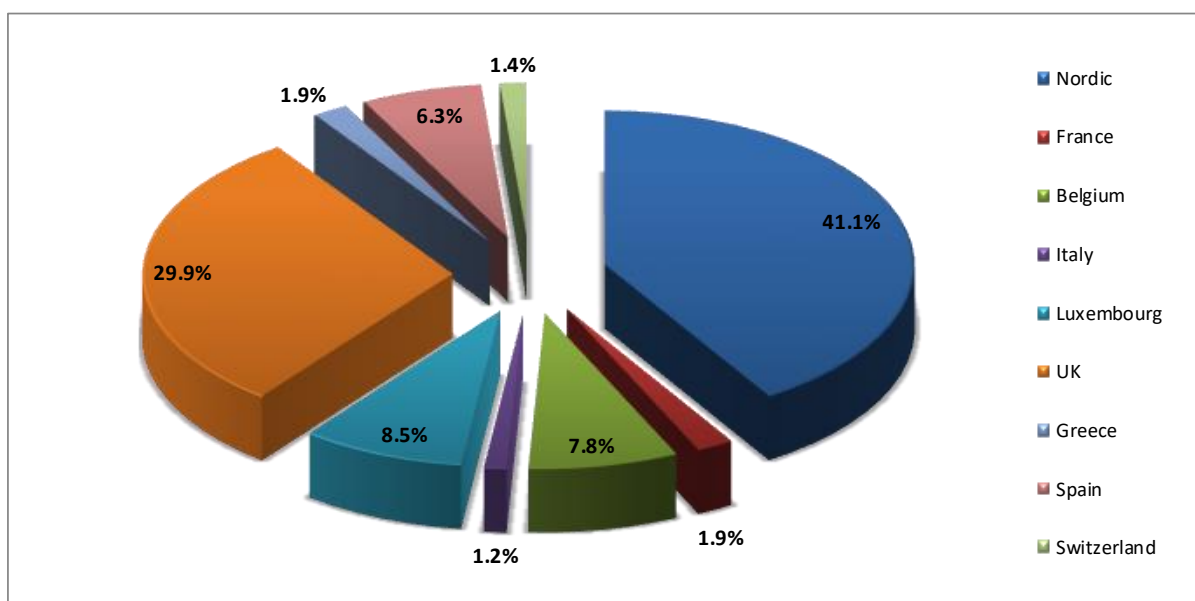
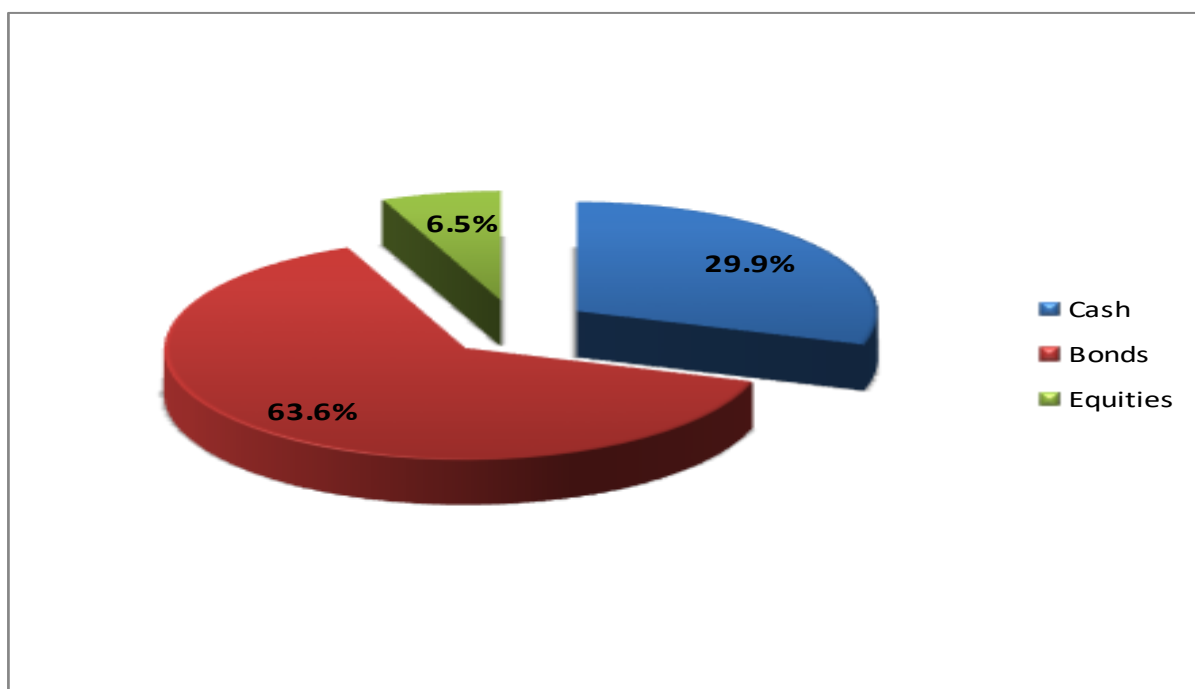
The main element in a bank's capital is shareholders' capital. If we would like to invest in that part of a bank's capital structure, we would typically buy the bank's listed **stocks**.

In addition, the banks can meet some of the required buffers described above by issuing **Additional Tier 1 Capital** and **Tier 2 Capital**.

We can also buy **Senior Bonds**, secured or unsecured and bail in bonds. They represent a funding source that is not part of the bank's capital base.

The new tier 1 and tier 2 instruments must be loss-absorbing in a going concern. How the loss-absorption mechanism works is regulated in the prospectuses and varies between issues and between banks. As an example, a new tier 1 instruments could be written down to zero (or converted to shares at a pre-determined price) if the bank's capital ratio falls below a certain level, while a new tier 2 instrument could be written down, because the regulator decides that the bank is no longer viable.

In addition to the new instruments, we buy **old-style** tier 1 and tier 2 instruments. These instruments will gradually cease to qualify as capital, based on the capital requirements' transitional rules. In general, when a bank runs into trouble, investors are better protected when owning old-style instrument than the new ones (which is why the old instruments will no longer qualify as part of the banks' capital).

APPENDIX: Exposure**Disclaimer**

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