A Fresh Start

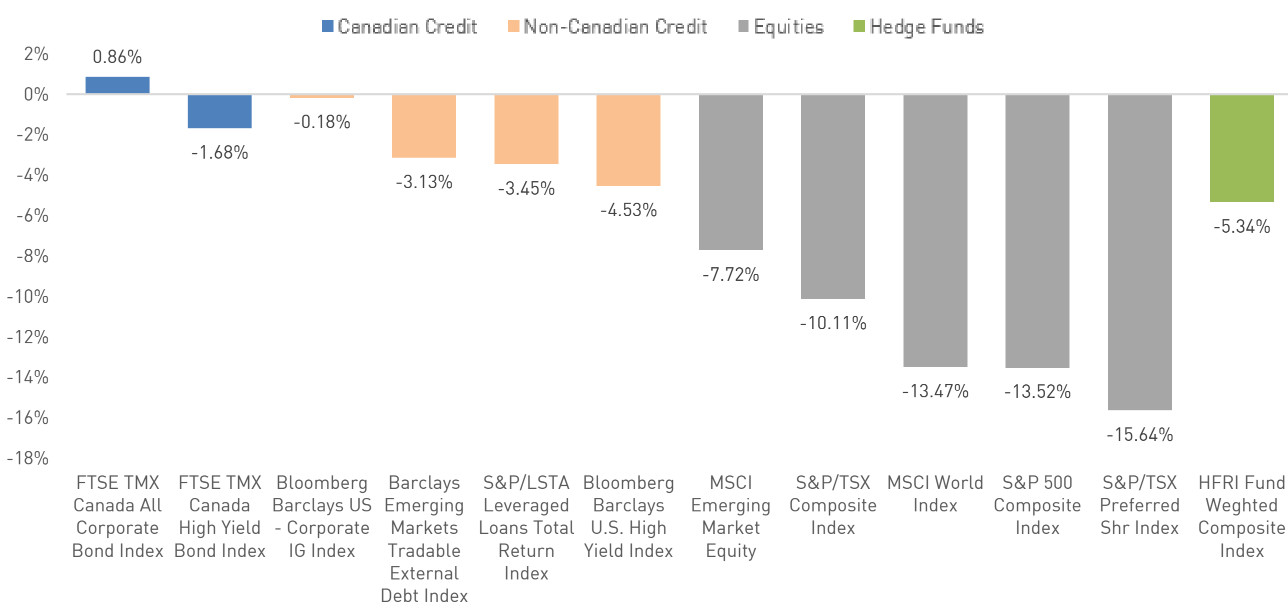
Q4 2018 Commentary

Executive Summary

- The final quarter of 2018 witnessed a sharp correction in the value of risk assets as investors questioned the narrative of strong U.S. growth.
- The magnitude of the correction was enhanced by the seasonal reduction in liquidity, and the role played by mutual funds and ETFs needing to meet redemptions.
- The backdrop will continue to be challenging. Nevertheless, with higher yields and wider credit spreads, the risk-reward proposition of credit has improved considerably.
- Fourth Quarter earnings will be an important driver of market sentiment in the coming period.
- We don't believe the economic cycle will end in 2019 but given its maturity we think credit can play an important role in investors' portfolios.

Market sentiment shifts as investors question the strength of the U.S. economy. At the end of September, most investors were hoping for a smooth ride into year-end after a volatile nine month period. In fact, the last three months of the year proved to be the most challenging yet. Concerns around the prospect of slower economic growth in the U.S. led to a dramatic shift in sentiment. The S&P 500 lost almost 20% "peak to trough", government bond yields moved lower and credit spreads – in particular for high yield borrowers – widened considerably. Asset values swiftly reset lower as investors started to incorporate a less optimistic set of forward-looking assumptions. Mutual fund flow data tell the story of what was on investors' minds as capital flowed out of risky assets into the "safe haven" of cash and money market products.

Figure 1: Markets had a tough time in Q4 as investors questioned the strength of the U.S. economy



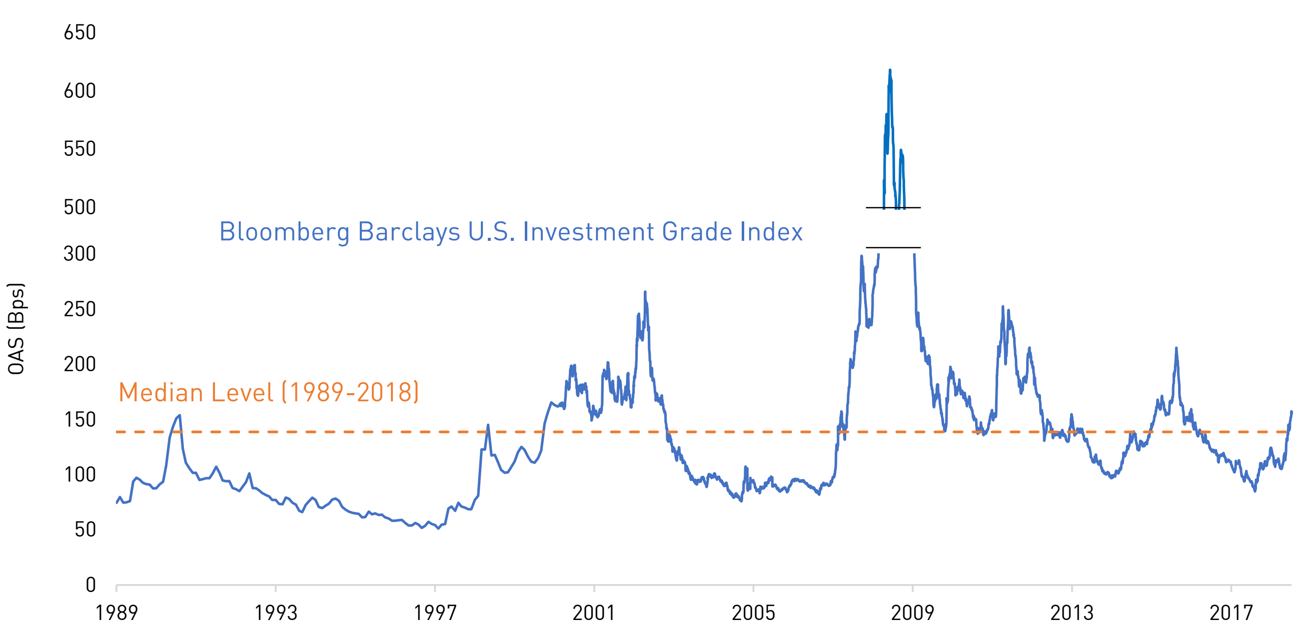
Source: FTSE PC-bond, Barclays, Bloomberg, HRFI

This adverse change in market sentiment occurred at a time of the year when liquidity is impaired for seasonal reasons. Psychologically speaking, many investors adopt a "less is more" approach towards year end, particularly after a difficult year. This year that translated into a desire to reduce positions, with the intention of starting afresh in 2019. Liquidity tends to be lower than usual towards the end of the year as market-makers are incentivized to end the year with as little inventory as possible. Taken together, these factors probably accounted for the sharpness of the move lower in credit assets. Another factor that exacerbated the price movements going into year-end is the growth in ETFs in recent years. These daily liquidity products tend to experience outflows when performance is weak, precipitating further selling pressure, leading to a negative feedback loop. This will not change and is part of the "new normal". Managed well, though, it is an opportunity for active managers to add value.

Generally speaking, when sentiment shifts this dramatically there tend to be opportunities. Looking forward, we are encouraged by the fact that the risk-reward proposition for credit has materially improved. Relative to a year ago, yields on fixed income portfolios have increased. Investment grade credit spreads are now greater than the median level of the last 30 years presenting a greater margin of safety versus a year ago (Figure 2). Correlations generally increase during market corrections as identifying value takes a back seat to reducing exposure. As such, when the dust settles there are always interesting investment opportunities to uncover. We see opportunity in adding high quality short-dated assets and in the long-short funds we have established short positions in highly leveraged companies in cyclical sectors.

The environment will continue to be challenging and calls for active portfolio management. Looking forward, the biggest risk factor for investors remains how successfully central banks are able to drain liquidity from the financial system after the great experiment in Quantitative Easing. We are still toward the beginning of this process. It is incredibly difficult to predict how central banks will react to the uncertain economic outlook, and the impact their actions will have on markets. With this in mind, we believe it is a market where to be successful, investment managers will need to be tactical. For the time being, we continue to position our portfolios conservatively, with a focus on high quality, liquid issuers. We believe the value proposition for active management of fixed income has never been stronger, and that volatility will continue in the coming quarters.

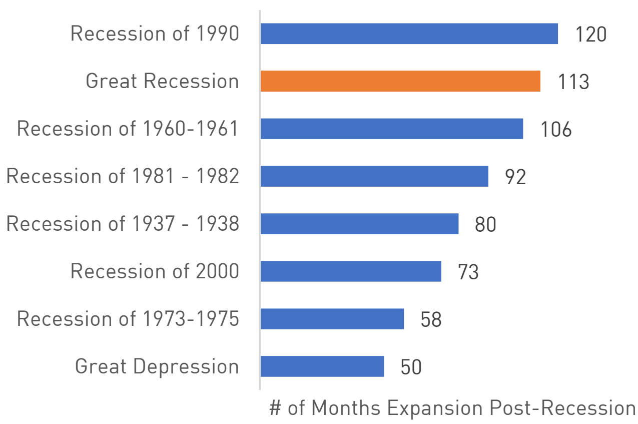
Figure 2: Investment Grade Credit Spreads Are Now Wider Than Median Levels



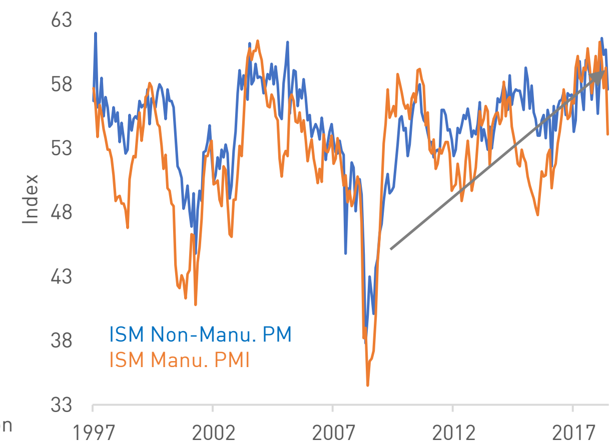
Source: Bloomberg

The data does not suggest we are at the end of the cycle yet. This has been the second-longest economic expansion since 1945 – and its lifetime has been prolonged by extraordinary monetary policy (Figure 3). Commentators are spending a lot of time trying to predict when this cycle will end. When thinking about this, it's important to note that cycles don't generally die of old age. Rather their demise is generally triggered by tangible catalysts. It is true that central banks are "normalizing" interest rates, but they are doing so at a very moderate pace. We are not yet seeing tighter bank lending or significant yield curve inversion. In Q4 softer than expected earnings for Apple were taken to be indicative of the impact of global trade headwinds impacting the U.S. economy. Since then however, U.S. Non-Farm Payrolls have been exceedingly strong, wage data has been firm, and ISM data have pointed to impressive growth (Figure 4). Should global trade risks moderate, we'd expect the earnings outlook to improve as well. Taken together, we believe this suggests a continuation of the cycle through 2019.

Figure 3 & 4: This has been an extended cycle… Yet the economic data continues to look strong



Source: NBER



Source: Bloomberg

The risk-reward proposition for credit is more attractive going forward. Global credit spreads moved significantly wider in 2018 and as such the forward outlook is much more attractive for returns in 2019. Even if we are not yet at the end of the economic cycle, we are clearly at a mature phase. Although it is not traditionally thought of in this way, recent academic literature has lent support to the contention that credit investments can be attractive substitutes for equity investments as the economic cycle matures. After all, credit investments offer a reasonable return profile, but without the potential risk of equity-like corrections. Investors looking to take some risk out of their portfolios at this point may want to think about viewing credit strategies this way, particularly given the improvement in the opportunity set following a challenging Q4.

We hope you have found this commentary useful and would welcome any comments or questions you have.

Performance Commentary – RP Debt Opportunities

RP Debt Opportunities ('DOF") lost 2.25% in Q4 taking the strategy to -0.29% for the year. Closing the year, the portfolio has a gross running yield of around 4.60%. Much of this yield is generated by applying a modest amount of leverage to a portfolio of short-dated investment grade corporate bonds. While we have some longer-dated positions where we believe there is compelling value, given the macro backdrop we have reduced or eliminated many of these positions, waiting for a better entry point.

There was much discussion during 2018 of the risk inherent in the BBB market. To recap the argument briefly – since the global financial crisis, the amount of BBB-rated corporate debt outstanding has grown significantly. Much of this debt is rated BBB low, which is investment grade - but only just. Analysts worry that when the economic backdrop deteriorates, many BBB rated companies may lose their investment grade rating. This may then precipitate significant price declines as bonds change hands from investment grade investors to high yield investors.

We acknowledge that this growth in BBB-rated corporate bonds is something to be mindful of. However, at this juncture we believe that downgrade risk is higher among A-rated issuers than it is among their BBB-rated peers. Over the last 12 months BBB credit spreads have widened, in part to take account of downgrade risk. From a fundamental perspective, net leverage remains on an upward trajectory for A-rated issuers, while it has stabilized for their BBB-rated counterparts. Many highly-rated IG firms continue to utilize their ample debt capacity to maintain / increase shareholder returns and continue to pursue M&A opportunities. In contrast, many BBB-rated issuers have shifted to a "debt reduction" mindset, and are more focused on improving balance sheet metrics so they can defend their ratings. During Q4 we saw two issuers – General Electric and Anheuser-Busch – lose A ratings an get bumped down to BBB territory. Credit spreads were impacted materially by this development. While we recognize the growth of the BBB sector, we would make the point that within that category there are opportunities as well as threats and that at this point the greater risk may be elsewhere.

As ever, there were winners and losers during the quarter in the portfolio. One noteworthy winner was a relative value trade we structured in the major U.S. banks. Early in the quarter, we believed that the additional compensation investors were being paid for owning subordinated bonds rather than senior bonds was too small. This differential had narrowed from an average of 45 bps to around 25 bps – in large part owing to a lack of issuance of subordinated bonds and a general "reach for yield". Our analysis on the likely recovery rates for senior versus subordinated debt suggested that subordinated debt should have been trading at a wider spread on a relative basis, as did comparison with pricing in other jurisdictions. We established long positions in senior debt and short positions in subordinated debt such that we would lose money as the difference continued to narrow, but profit if the differential widened. As market sentiment shifted in Q4, higher quality senior debt experienced less spread widening than subordinated debt, and we were able to exit this position with the differential closer to 55 bps.

A detractor to performance were our positions in Technology companies. As a sector, there are fears that the Technology sector has peaked owing to an explosion in cloud computing, in addition to more general fears around global economic growth and trade tensions. An example would be a position we had in semiconductor manufacturer Micron Technology. In December management announced they had missed revenue expectations and guided down on future earnings. As a result the equity came under pressure which filtered through to credit valuations. Our investment in the company had been premised on our belief that the company would pursue a strategy of reducing leverage over time. Given this change in management strategy we exited this position.

Performance Commentary – RP Select Opportunities

RP Select Opportunities ("SOF") returned -3.46% in Q4 taking the strategy to 0.14% for the year. The gross running yield of the portfolio sits above 7.60%.

From a positioning perspective, the strategy remains focused predominantly on the U.S. market, although we fully hedge currency risk. At year-end credit leverage registered at 1.4x. The average term to call / maturity of the portfolio is 3.8 years. From a ratings perspective, the majority of positions are clustered in the BBB and BB categories. This tends to be a sweet spot for us – a segment of the market where credit analysis is rewarded and where active management can be fruitful.

Non-Investment grade credit came under significant pressure in Q4, having held in relatively well year to date. High Yield Bond and Leveraged Loan ETFs experienced outflows, meaning that ETF managers were forced to sell securities irrespective of price. Even higher quality product was not immune to the weakness, as often managers took advantage of the better liquidity that tends to accompany higher quality securities. There was particular weakness in cyclical sectors such as homebuilders, chemical, and resource companies. Going into 2019 we expect the issuance of high yield bonds to continue to be light as borrowers continue to look to the covenant-lite leveraged loan market as a source of funds.

Within the portfolio, our short positions in subordinated debt issued by mid-cap European banks were positive contributors to performance. Unlike U.S. banks, Eurozone banks have in general been slow to rebuild capital, reduce NPLs, and have relatively poor liquidity profiles. As such, as the Euro area economy weakens we believe many of these institutions are poorly positioned to manage their balance sheets. Our focus for shorts have been subordinated instruments with features which mean these securities have equity-like risk. These securities have tended to be issued by banks that are domiciled in jurisdictions with weak regulatory frameworks.

During the quarter, some of our highest conviction investments were a drag on performance. A good example is CIT Group Inc. This is a firm that has transformed itself over several years from a specialty finance firm into a regional bank with very strong capital levels, low NPLs, and an improving risk profile. The firm has benefitted from ratings upgrades from Moody's and Fitch in recent months (from Ba2 to Ba1 Positive and from BB+ stable to BB+ Positive, respectively). We still believe the company will transition to an investment grade rating profile in 2019 and that this will act as an impetus for compression in credit spreads given the borrower trades approximately 200 bps back of investment grade rated regional banks. Despite this thesis and our high conviction level, credit spreads on CIT debt moved wider in Q4 consistent with other financial issuers. We maintained our position in these securities, confident that our thesis has not changed.

Performance Commentary – RP Fixed Income Plus

RP Fixed Income Plus ("FIP") returned -0.77% in Q4 taking the strategy to -0.49% for the year. The gross yield of the portfolio currently stands at 3.63% which is significantly higher than was the case at the start of the year (2.15%). The focus in this strategy remains capital preservation by actively managing duration and credit risk. Through the cycle we still believe the 3% return target is appropriate, particularly given the increase on the running yield of the strategy over the last couple of quarters.

From a positioning perspective, the main change quarter over quarter was reflected in the credit exposure of the strategy. Against a volatile backdrop, we further reduced the credit risk in the portfolio, exiting a number of positions in the U.S. market. Many of these positions were in the Financial and Industrial sectors. The intent is to gradually redeploy the capital we have available based on the opportunity set. Although we continue to have exposure to BBB rated credits in the portfolio, the focus is on larger and better quality corporations within this broad category. As of year-end around two-thirds of the exposure of the portfolio is to CAD-denominated securities.

During Q4, the best performing securities in their portfolio were those issued by the highest quality corporate and provincial issuers – Province of Alberta, Enbridge Inc., BMO. This reiterates the point that this was not a backdrop where finding value was rewarded – rather there was a flight to quality and better quality investments outperformed. Conversely, the positions that dragged on performance in Q4 were lower rated and/or more bespoke securities. For a number of these positions we have a research-driven thesis as to why there is value in those investments. Unfortunately, from time to time the macro picture dominates and this hard work is not rewarded. However, as the market stabilizes we will look for opportunities to establish positions at more attractive valuations.

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