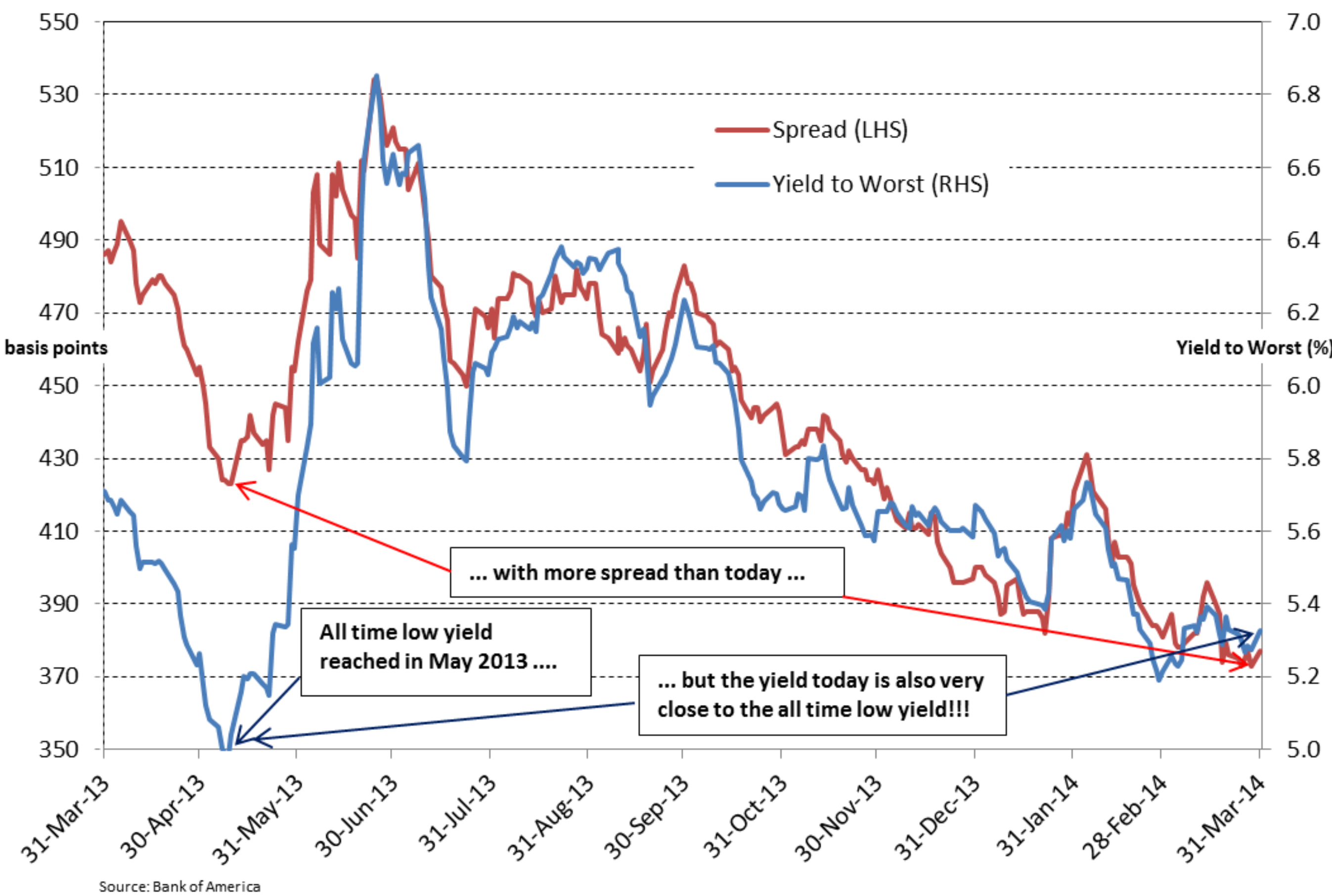
# Q1 2014 Commentary

It may be no surprise for investors to hear us say that the valuation of credit markets have become worryingly tight. As of the second week of April the US High Yield Index is yielding 5.2 percent, compared to the all-time low of 4.9 percent reached in early May of 2013. Despite this, High Yield investors are now receiving less incremental yield, 364 basis points, than the 425 basis points in May.

## High Yield – A Year in Perspective



Source: Bank of America

The reason the yield is higher despite spreads contracting is because US Treasury bonds are up in yield. US five year Treasuries currently yield approximately 1.6 percent versus 0.65 percent last May.

Despite the increase in Treasury yields since last spring, we do, however, find it interesting and somewhat concerning that Treasury yields are actually down since the beginning of 2014 in the face of the US Treasury Department continuing on its path of tapering its purchase of government bonds.

With the S&P500 down to flat so far this year there is clearly a hint of risk aversion that has crept into markets recently….**except credit markets** which have ground tighter in yield spread.

With equity markets at all-time highs (credit risk), government yields still very low (interest rate risk), and concerns about slowing global growth (deflation risk), credit markets have much to be worried about in our opinion.

Having said that, maybe we should have put the market part of this commentary at the end ☺

While it is true that we currently find credit markets generally unappealing, there are corners of the credit universe where idiosyncratic opportunities can be found; that protect investors from both interest rate and credit risk.

M&A, asset dispositions, and restructurings can be the source for such bond and / or loan investments.

## Harland Clarke – Asset Disposition

The fund purchased in July 2013 the bonds of a US private company, Harland Clarke, when it sold one of its US divisions to Canadian company Davis & Henderson (DH: TSX) for $1.2 billion. Along with the company's annual $ 150 million of free cash flow, the company possessed lots of flexibility to pursue options to either de-lever or make an acquisition.

The fund purchased Harland Clarke's 9.5 percent bond due May 2015, the first piece of debt due in Harland Clarke's capital structure. The price we paid was $100.5 which resulted in a yield to maturity of 9.4 percent for a bond with a duration of less than 2 years.

**Harland Clarke 9.5% Bond due May 2015**

| | |
|---|---|
| Amount Outstanding | $221 million |
| Price Paid | 100.5 |
| Yield to Maturity | 9.4% |
| Duration of YTM | 1.83 years |
| Yield to Worst | 8.1% |
| Duration of YTW | 30 days |
| Current Yield | 9.4% |

Two reasons this bond offered such an attractive yield is that it was callable at par and management could make an acquisition which could put the future refinancing of this short bond at risk. However, another more likely outcome of an acquisition, in our opinion, would be the refinancing of these short maturity bonds.

Just before Christmas, Harland Clarke announced the $1.9 billion purchase of Valassis Communications and in March 2014 the fund's Harland Clarke 9.5 percent bond position was called. The return for this 8 month investment was approximately 8.5 percent.

**Sorenson Communication – Restructuring**

Sorenson, a private company, is the dominant provider of communication services to the US deaf community. The company generates revenue by being reimbursed for the services it provides through a fund that is administered by the Federal Communications Commission. The company has a $ 550 million loan and a $ 735 million bond outstanding.

The Fund purchased the loan in May of 2013 with a yield of 9.5 percent. Our attraction to the loan, in addition to the yield, is the high level of certainty of receiving our capital back due to the low leverage of 2.3 times and the high level of free cash flow generation.

| **Sorenson Communications Term Loan (Libor + 850 bps)** | |
|---|---|
| Amount Outstanding | $546 million |
| Yield to Maturity | 9.5 % |
| Maturity Date | October 31st, 2014 |
| Current Yield | 9.5% |

However, the friction in the bottom part of the capital structure between the bond holders and the private equity owners was the catalyst for the company to restructure before the maturity of the debt. The completion of the Sorenson restructuring is expected in the 2nd quarter with the loan to receive par and the bond approximately 85 cents on the dollar.

In a recent trip to New York we had the opportunity to hear the Chairman of Oaktree capital Howard Marks speak. As a longtime fan of his commonsensical approach to investing we thought it would be appropriate to highlight a point he made in his most recent memo "Dare to Be Great II" (http://www.oaktreecapital.com/memo.aspx). It rings true here at Fulcra as it is something we remind ourselves of day in day out: "If your portfolio looks like everyone else's, you may do well, or you may do poorly, *but you can't do different.* And being different is absolutely essential if you want a chance at being superior."

Best Regards,

Matt Shandro
President, Fulcra Asset Management Inc.

Fulcra Asset Management Inc. | Suite 415 – 1090 West Pender Street, Vancouver, BC | V6E 2N7
Tel: (604) 683-8362 | Fax: (604) 683-8368 | Email: info@fulcraam.com | Website: www.fulcraam.com