Q3 2014 Commentary

Credit investors experienced significant volatility in the 3rd quarter with the US high yield corporate bond market down 1.9 percent. While the Fulcra Fund was down 0.14 percent[1] over this same time frame, with duration of approximately two years, the Fund has not benefited from the drop in government bond yields that has unfolded over the course of 2014. As an example, the 10-year US Treasury bond price was up 6.6 percent during the first nine months of the year.

This drop in yield has many sources, not least of which is anemic economic growth. And while there are many moving parts to this discussion we are agnostic to duration and will continue to be focused on picking up yield at a price that is attractive, based on the absolute return characteristics of the bond and wherewithal of the issuer.

While credit valuations have been frothy, we are never one to turn down a good shot of caffeine. Specifically, on August 26th when Burger King made an offer to acquire Canada's own Tim Horton's (THI), the three bonds that THI has outstanding dropped one half to 5 points in price. The bonds fell due to an expected increase in debt being used by Burger King to acquire THI. However, because 3G, the owner of Burger King, will become the new owner of Tim Horton's, a change of control clause in the bonds will be triggered and Burger King will be required to make a bid for the THI bonds. The Fulcra Fund has over a 6 percent position in Tim Horton's bonds.

We believe the return parameters of this investment are very attractive. The Fund expects to earn approximately 3 percent to the expected close late in December and well over 10 percent if the transaction is rejected. While many may patriotically opine for Tim Horton's independence, highlighting its strategic importance, we attribute a very high probability to the transaction being approved. Nevertheless, upside from a failed transaction is something the Fund doesn't have to pay for.

While investors should always be looking for cheap options, they are usually less obvious than the THI example above. The table below shows bonds that the Fund owned/held that were either called or tendered early thus far in 2014. These bonds possessed attributes that suggested they wouldn't see their maturity date: large cash balances from a recently completed asset sale, restrictive covenants and/or high coupon debt.

[1] Class B, Net of Fees

FULCRA
ASSET MANAGEMENT INC.

Security	Coupon Rate	Weighting	Maturity Date	Taken Out	Months Before Maturity
Harland Clarke	9.50%	2.10%	15-May-15	6-Mar-14	14
Telus Corporation	5.95%	1.79%	15-Apr-15	8-Sep-14	7
Shaw Communications	6.50%	1.69%	2-Jun-14	18-Feb-14	3
Tembec Corporation	11.25%	1.52%	15-Dec-18	26-Sep-14	50
Chorus Aviation	9.50%	1.42%	31-Dec-14	20-Jun-14	6
Simmons Foods	10.50%	1.11%	1-Nov-17	29-Sep-14	37
National Money Mart	10.375%	1.00%	15-Dec-16	14-Jul-14	29
Chesapeake Energy	9.50%	0.87%	15-Feb-15	23-Apr-14	9
Dollar Financial	3.00%	0.86%	1-Apr-28	11-Jun-14	165
Cameco Corporation	4.70%	0.66%	16-Sep-15	16-Jul-14	14
North American Energy Partners	9.125%	0.34%	7-Apr-17	8-Apr-14	35
MI Developments	6.05%	0.24%	22-Dec-16	5-Aug-14	28
Miramax	6.25%	0.20%	20-Oct-21	20-Aug-14	86

In the current market environment, the Fund owns many bonds that we believe offer a good yield to a definable end date. The 9.5 percent bonds of Reliance Water Heater are one such example. We believe these bonds will be called close to their first call date later this year. Currently, they are priced to yield over 10 percent to the mid December call date. Reliance possesses a dominant market share in Ontario where the majority of single detached homeowners rent rather than own their water heaters. The parent company is investment grade and the business generates a substantial amount of free cash flow.

Another attractive investment is the 10.75 percent Westmoreland bond. The company has recently entered into a process to become a master limited partnership (MLP), after having completed the purchase of Sherritt International's coal business. In order for Westmoreland to complete the MLP transaction, the company will have to tender for the bond or call them at their first call date in February 2015. If the company doesn't, the total return will increase. A prospect we are very comfortable with, given that the free cash flow yield through the bonds, after paying interest on the bonds, is close to 10 percent. Beside this attractive valuation, Westmoreland is an appealing investment due to the cost protected long-term contract pricing it has with its base load utility customers.

In our opinion, current market volatility, should begin to create opportunities that we have been waiting for. While the timing and make up of changes is fluid, we are cautiously optimistic that investment prospects are improving. As always, please let us know if you have any questions or comments.

Best Regards,

Matt Shandro

President, Fulcra Asset Management Inc.