FULCRA
ASSET MANAGEMENT INC.

Q4 2014 Commentary

Nobody knows whether oil will be $20 or $80 a barrel in a year's time. However, it is a certainty that if you buy and hold a 30-year Canadian government bond today, you will receive a yield of just over 2 percent … 2.02 percent to be precise. Despite this being the lowest yield ever, driven by the almost 26 percent increase in the 30-year bond price, interest rates could quite possibly fall further as deflation concerns are being fanned by dropping commodity prices. Comparatively, the Fulcra Focused Yield Fund starts 2015 with a yield above 7 percent and duration of 2.1 years.

The Fund's near-term performance has been negatively affected by its exposure to oil and gas as well as companies whose business is indirectly influenced by the sector. Although the Fund has always held a healthy dose of investment grade corporates, they have always been less than two years in duration. As such, this part of the portfolio did not benefit much from declining interest rates, and did not offset the Fund's energy exposure in the past quarter.

Many market pundits have suggested that low interest rates fueled the shale oil and gas production growth in the U.S. by promoting the issuance of debt by companies looking to fund their drilling programs. While the outcome of financial engineering has indeed helped create a funding source for the drillers, it was also drilling technology over the last decade that made it physically possible to drill what were historically difficult reservoirs. Financial and technological engineering worked together to create a disastrously over supplied oil bear market.

Paramount Resources

We have used this opportunity to selectively add some energy exposure. For example, the Fund has built a position in Paramount Resources $370 million 8.25 percent bonds due December 2017. This bond currently yields approximately 10 percent in the fund and is attractive, in our opinion, due to expected large production increases, a low cost structure, equity market capitalization close to $3 billion versus total debt of approximately $1.2 billion, and strong support from the Riddell family in the event that an equity raise is required in a protracted low oil price environment.

Energy-related volatility has carried over into the New Year, but many attractive opportunities are appearing away from the commodities space. This has allowed us to add to existing positions at attractive yields. Two examples follow:

Horizon Lines

Horizon Lines, a Jones Act container carrier that serves the Hawaii, Alaska, and Puerto Rico trade lanes entered into an agreement in November to be acquired by Matson. We recently added to our positon in the 11 percent 1st lien bonds, and expect the transaction to be completed in the third quarter of this year. The total return to the expected close will be over 10 percent. The downside, in the event the deal does not go through, is limited because leverage through this bond is just over 2 times cash flow and is positioned at the top of the capital structure.

American Achievement

American Achievement is one of the top three suppliers of graduation products (year books and class rings) in the United States. The Fund recently added to its position in the 10.875 percent bonds due April 2016 and are currently priced in the Fund to yield 14 percent to maturity. We like this business because of the consistent cash flow that is supported by its strong relationships with its high school and college clients. Furthermore, in the past two years two competitors of American Achievement have attempted to buy it. Their overtures, however, were rejected by the Federal Trade Commission in the U.S. Despite these bids not being approved, it supports the valuations that result from these top graduation product suppliers possessing strong market presence.

The start of 2015 has brought all-time low government bond yields and more deflation concerns than at any time since early 2009. Energy, commodities, oil exporting countries default concerns, and the European Union QE experiment will likely dominate news headlines well into the year. We believe this is a good opportunity to be selectively adding to risk by buying loans and / or bonds of companies that are immune from many of these concerns but whose securities have traded down in sympathy.

Please reach out to us with any questions or concerns you may have. All the best to a healthy and prosperous 2015!

Best Regards,

Matt Shandro
President, Fulcra Asset Management Inc.