Fulcra Focused Yield Fund
Q1 2015 Commentary

"You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basket case and couldn't help myself. So maybe I learned not to do it again, but I already knew that."

- *Stanley Druckenmiller, on buying tech stocks at the height of the dot-com bubble*

Amid today's skinny bond yields, we take note of a recent reminder of what can happen during extended periods of risk mispricing, even to a great investor.

The Fund's defensive stance in recent years has limited its investment returns. Mainly, our short duration has not kept up with the capital gains afforded to those invested in long maturity fixed income securities. These long-dated securities have appreciated in recent years from their high sensitivity to falling interest rates. But despite the macroeconomic concerns, we're not about to buy **expensive bonds** for measly investment yield to hope for even higher prices. We remain wary of the underappreciated risks in today's fixed income markets. We're not about to deviate from what we already know.

Negative Yields – Risk-Free becomes Return-Free

Strong monetary forces since the 2008 financial crisis remain central to today's investing environment. Around the world, government asset buying programs and zero interest rate policies continue to mark asset prices higher and drive fixed income yields lower. Mindless of the risks, many investors are following into these rate-sensitive securities, often through **indexed and benchmarked** investment products.

As seen below, many government bond yields no longer offer you real returns, even if you lend to these governments for a 10-year period. Most of the recent returns have instead come from price appreciation fueled by capital inflows. In Europe, investing in 5-year German and Swiss government bonds means earning negative investment yields, **guaranteeing** that the securities will be **"return-free"** rather than "risk-free."

Government Bond Yields

As of March 31st, 2015

	5 Year	7 Year	10 Year
United States	1.4%	1.7%	1.9%
Canada	0.8%	1.0%	1.4%
Germany	-0.1%	0.0%	0.2%
Switzerland	-0.4%	-0.2%	-0.1%
Italy	0.5%	0.9%	1.3%
Japan	0.1%	0.2%	0.4%

High Yield Bonds – Risk versus Volatility

Low and negative yields have steered capital towards high yield bonds. At a time when lower dealer inventories have reduced market liquidity, higher volume demands of popular ETF's and other index fund flows are regularly encountering capacity constraints in the high yield bond market. Since mid-2014, we have seen greater impact of capital flows on bond prices, creating higher volatility in the market and for our portfolio.

Higher volatility in our investment space will affect the Fund's returns day-to-day, and even month-to-month. But we'd like to remind investors that as we search for high yield opportunities, our focus is on **protecting against investment risk** rather than controlling short-term volatility. Beyond a company's ability or willingness to repay its debt to us, it is the **price we pay** and **fundamental valuation** that provides the margin of safety for our investments, and **protects our clients' capital**.

Valuing Distressed Securities – Opportunity versus Risk

When a company becomes financially troubled, we often see opportunity rather than despair. We certainly want our companies to meet their obligations to our investors. But should they become unable to address their debt burden, our investment is protected by our valuation and claim on the underlying business and assets.

If a company becomes insolvent, a restructuring process may either monetize our investment into early repayment of cash, or transform it into new debt or equity securities. Regardless of the form, **our original investment should be protected if we have done our securities valuation correctly.** In some instances, a restructuring process is a unique opportunity to breathe new life into a mismanaged business and for our investors to participate in equity ownership at favourable valuations.

Armtec Infrastructure – A Restructuring Opportunity

A current restructuring opportunity is our investment in Armtec Infrastructure bonds.

Armtec is a Canadian infrastructure company that specializes in pre-cast concrete and drainage solutions and operates across all provinces. The vast majority of Armtec's work is performed outdoors, so projects can be slowed during harsh Canadian winters. In recent years, this seasonality has worsened the liquidity situation for the company.

The Fund began buying Armtec's 8.875% bonds in the second half of 2011, and the cost base of our position is significantly below par. In 2011, Armtec had cut its dividend to equity investors, installed a new CEO, and accepted Brookfield Asset Management as its new first lien creditor. We were attracted to Armtec because of its ability to generate free cash flow, significant working capital and real estate.

The opportunity at Armtec has been the possibility of executing better on the bid process and cost management of its projects. We thought that operations could improve with new management thinking they would move away from previous management's decision to win contracts at all costs.

However, the execution of Armtec's business has not improved and Brookfield has become more entrenched through a covenant breach / reset process that has now given them the confidence to attempt to gain control of Armtec without compensating other stakeholders.

We believe that Armtec's business has significant value beyond Brookfield's senior position. Even in a liquidation scenario, the real estate and excess working capital would cover the Fund's investment at much higher levels than where the bonds are currently priced. While we have been wrong on the company's ability to raise cash flow margins, the opportunity still exists.

The current Brookfield proposal puts our Armtec investment at risk, and the markdown has impacted the Fund's recent return. Nevertheless, there is an opportunity for our valuation to prevail.

Fulcra Focused Yield Fund – A Unique Investment Product

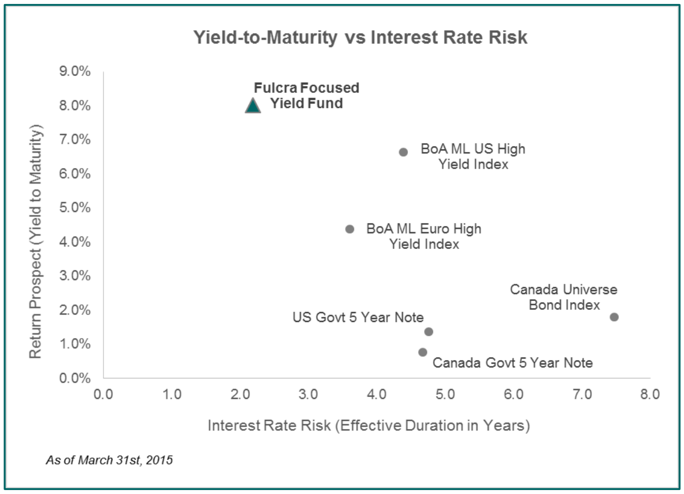
In the current environment of low yields, investors may want to **reassess their fixed income strategy and durations**. The Fulcra Focused Yield Fund stands as a unique investment vehicle that looks for high yield opportunities while protecting against many of today's risks.

We believe that the Fund is an attractive investment product for the following reasons:

1. **High yield with low interest rate risk** – Since the fall of 2014, the Fund has taken advantage of greater market volatility to increase weightings in undervalued high yield investments while remaining defensive against interest rate risk. Reflecting this shift, the Fund's weighting in cash plus short-term investments has declined from 46 percent in June 2014 to 28 percent currently. While this means greater day-to-day volatility for the Fund, we have opportunistically **increased its yield going forward**. The Fund's **yield-to-maturity is currently 8.0%[1] with an effective duration of 2.2 years[2]**. As illustrated below, this is a unique investment proposition when compared to other fixed income alternatives.

[1] Calculated before fees.

[2] Duration has been calculated to maturity dates. The duration measured to expected redemption dates would be lower. Since a material part of the portfolio is invested in early redemption candidates and pending merger situations, we believe that the duration calculation of 2.2 years **overstates** the Fund's interest rate sensitivity.



2. **<u>Ability to invest in smaller issues and special situations</u> –** We find many opportunities in securities below the reach of large funds and index products. Although we may have size envy of the $10 billion high yield bond funds, **we do not envy the challenges they are facing to invest selectively**. As a niche fund, we are finding opportunities in smaller issues and special situations that offer **attractive yields with less correlation to the general market**.

3. **<u>Unconstrained investment mandate with low management fees</u> –** The Fund's ability to invest across a broad spectrum of asset classes and situations is an advantage. We examine corporate securities through a capital structure lens, and are able to provide our investors with exposure to **opportunities in high yield, distressed and equity securities, all within one fund and with efficient fees**.

We have recently spoken in-depth to several clients about our portfolio investments. Please reach out should you wish to be updated with more details as well.

Best Regards,

Matt Shandro
President, Fulcra Asset Management Inc.

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