Fulcra Focused Yield Fund
Q2 2015 Commentary

The Fulcra Focused Yield Fund has returned +0.76% year-to-date.[1] While we have protected our clients' capital through various market situations, we expect to do better. Particularly when **ongoing market volatility is providing opportunities.**

In recent years, we have been patient when the market has lacked opportunities. As such, the portfolio had high weightings in cash and short-term investment grade securities. Over the past year, however, the Fund's **weighting in high yield bonds and loans has increased** from 54 percent to 74 percent.

Much of the growth in the high yield weighting has come from **near-term event-driven situations** that will likely be repaid early. Currently, 15 percent of the Fund's high yield weighting is expected to convert to cash by year-end.

The Fund's portfolio currently has an **8.2% yield to maturity** and low interest rate sensitivity with a **duration of 2.1 years**.

Opportunistic High Yield is Not the High Yield Market

Amid vocal concerns about the high yield market, we are asked if we can still find opportunities in high yield corporate bonds. As active investors, we can. Market volatility provides us with trading opportunities to invest in fundamentally sound credit securities at more attractive valuations and yields.

We would like to highlight some **differences** between the Fulcra Focused Yield Fund and the general high yield market.

Difference #1: FFYF has low interest rate sensitivity

We don't know when the Fed will raise interest rates, but we have managed the Fund to return yield without much interest rate sensitivity. The Fund's stated duration of 2.1 years is **extremely**

[1] Class B, net of fees.

low when compared against other fixed income funds. With the number of early redemption candidates in our portfolio, we would point out that our interest rate sensitivity is even lower.

Difference #2: Low valuation helps protect against credit risk

We cannot predict the turn in the credit cycle, but we protect our clients' portfolios during such a turn by making investments at low valuations. The S&P 500 equity index's EV/EBITDA multiple of 12 times dazes us. Rather, we are used to investing in companies that we like at **much lower valuations**.

A turn in the credit cycle also creates distressed debt investing opportunities for the Fund. Our **low duration portfolio recycles investments back into cash at high frequency**, enabling us to **opportunistically reinvest** when securities that we fundamentally like trade at attractive prices.

Difference #3: FFYF is not an ETF or Index Fund

We share the concerns about using exchange-traded funds (ETFs) or index funds to invest in the corporate bond market. We hope you will agree that your investment with us is **very different** from an investment in these **indiscriminant money-lenders** that weight their portfolios based on the biggest borrowers.

A comparison of our Fund with ETFs shows that there is little overlap. Compared with the two large US high yield corporate bond ETFs, the Fund's portfolio contains only **seven bonds of the 796 bonds in JNK** and **five of the 1,020 bonds in HYG**.[2]

Our Kind of High Yield – Early Redemption Bonds

Much of the portfolio's high yield investments are **early redemption candidates**—bonds that pay a high coupon and have the potential for early repayment.

Our top two holdings—*Atlantic Power 9% bonds due November 2018* and *American Achievement 10.875% bonds due April 2016*—are prime examples of how we search for **high-yielding event-driven opportunities** that are supported by fundamental valuation. At quarter-end, the two holdings represented **8.5 percent** of the Fund's "high yield" weighting that will soon convert back into cash.

[2] JNK is the SPDR® Barclays High Yield Bond ETF with $10.5 billion market capitalization at June 30th, 2015. HYG is the iShares iBoxx $ High Yield Corporate Bond ETF with $14.5 billion market capitalization at June 30th, 2015.

Atlantic Power 9% bonds due 2018

For Atlantic Power 9% bonds, we found comfort in the **asset coverage** of the security. The utility company owns a wide portfolio of power assets in North America and recently sold its wind assets. Immediately after the transaction closed, the company announced that the sale proceeds will be used to redeem early this high coupon bond at the call price of 104.50.

The bonds are currently priced at 104.50, and the Fund will continue to earn interest at the 9% coupon rate until our **4.8 percent** position is returned as cash on July 26^{th}.

American Achievement 10.875% bonds due 2016

For American Achievement 10.875% bonds, we find comfort in the **business valuation** of the company. The company operates in an oligopolistic industry that sells graduation products—yearbooks, class rings, cap and gown. As a mature industry, the three main players generate steady EBITDA and substantial discretionary cash flow.

The American Achievement 10.875% bonds were trading at a discount price of 95.25 at the end of the second quarter, but has since moved towards par after the company announced that it expects to complete a refinancing in August. These bonds are callable at 102.72 before October 15^{th}, 2015, and callable at par thereafter, so the company could possibly wait until October to redeem our bonds. Regardless, the Fund continues to earn the 10.875% interest, with increasing likelihood that our **3.7 percent position** will be returned as cash in the upcoming quarter.

Markdowns have Increased Earning Potential

The Fund's lack of return year-to-date has **overshadowed the increased earning potential** of this portfolio which currently has an 8.2% yield-to-maturity. We are confident that many of our positions with negative markdowns will **revert back** when they approach a repayment catalyst event or their respective maturity dates.

Westmoreland Coal LIBOR (1% floor) + 6.5% term loan due 2020

One example is our 2.4 percent weighting in the Westmoreland Coal first lien term loan. Over the past quarter, the term loan weakened from a price of $100 to 97.50, and has weakened even further since the end of the second quarter to 94.5.

Westmoreland's securities often trade with general coal industry sentiment, but we believe that its **utility-like operations** make its term loan an attractive investment. Its mines sit adjacent to its utility customers, giving each utility a **tremendous cost advantage** over power generation by any other fuel source, including natural gas.

Westmoreland's long-term customer contracts shield it from coal price fluctuations, locking in reliable margins for high free cash flow—its stock is currently priced at an attractive 33% free cash flow yield. The term loan has an **excess cash flow sweep** covenant that takes much of that cash generated each year to pay down a portion of the loan at par.

As a result of recent price weakness, we have **added to our position**. We continue to like our investment in the Westmoreland term loan—it is backed by a utility-like business that generates high free cash flow that is required to be used to pay down the Fund's position in the term loan.

Volatility is Opportunity

While the Fund has only returned +0.76%[3] year-to-date, we expect the Fund to realize more of its yield potential going forward. We can't predict when interest rate hikes or fund flows will pressure the corporate bond market. But volatility is opportunity.

We like high yield, for the **atypical opportunities** it can present.

Best Regards,

Matt Shandro
President, Fulcra Asset Management Inc.

[3] Class B, net of fees.