FULCRA
ASSET MANAGEMENT INC.

December 17, 2015

Fulcra Focused Yield Fund – November 2015 Update

Headlines coming out of credit markets are currently very bad. High yield[1] corporate bonds currently yield 8.9%, versus 6.7% at the beginning of the year. The negative returns this year in high yield have created negative fund flows, exasperated by yearend tax loss selling which in turn drives negative sentiment amongst managers who are fearful of redemptions.

This volatility leads to a lack of critical thinking and execution, despite yields the high yield market has not seen in several years. Managers and investors today, with available cash and committed clients, have the opportunity to take advantage of prices that can set the groundwork for attractive future returns.

Investment grade[2] corporate bond returns for the year are negative 0.67 %. With the 25 bps increase to the Feds Funds rate in the books, a path to higher interest rates has begun. Yet, investment grade bonds are yielding 3.7% with duration of 6.7 years. As the Fed has indicated a 2018 Feds Funds rate of 3.25%, long duration bonds may continue to have difficulty fighting this head wind.

While the Fulcra Fund has not avoided the volatility as well as hoped, year to date down almost 5% to the end of November, it is important to highlight how the high yield markets' funds flow / tax loss selling is creating real bargains. Westmoreland Coal Company and Harland Clarke, two positions in the top 10 of the Fund, are good examples of opportunities that exist in high yield today.

Westmoreland Coal Term Loan

Due to the poor performance of the Fulcra Fund, we deserve a lump of coal this Christmas. However, there is consolation yet if the coal that we receive comes in the form of the term loan issued by thermal coal producer, Westmoreland. And Fulcra Fund investors stand to benefit.

The Fund has been invested in Westmoreland since 2012. Unfortunately, 2015 has been unkind to the coal industry. While Westmoreland is not your typical transportation constrained coal company, the Fund's investment in Westmoreland's term loan is down over $30 pts since the summer. This has contributed negative 1.5% to the Fund's performance this year.

[1] Bank of America Merrill Lynch US High Yield Index
[2] Bank of America Merrill Lynch US Corporate Index

Furthermore, as of last week, the loan was priced in the portfolio at $60, to yield 21% to the December 2020 maturity. While the yield of the term loan is undeniably attractive, it is the fundamental investment merits of the business and free cash flow covenant of the term loan that set this particular coal investment apart. Westmoreland is one of the few coal companies in North America that can compete against natural gas at prices below $2/MMBtu. This is made possible due to the close proximity of its customers and the associated long term (10 yrs+) cost plus contracts.

At a price of $60, the term loan is trading at 2.2x the previous twelve months cash flow. Furthermore, every 2nd quarter of its fiscal year, term loan investors receive 50 to 75% of the previous year's free cash flow towards a par pay down of its investment.

Bonds Drop 7 points Despite Ratings Upgrade

The Harland Clarke 9.75% bonds due August 2018 are a top 10 position in the fund. The company provides outsourced services to financial institutions in the US. Fundamentally these bonds are cheap, trading at 3.2x cash flow and were upgraded to BB- by Moody's on December 3rd. Flying in the face of the ratings agency, these bonds are down 10 points over this recent high yield market sell off to yield 13.3%. While the Harland Clarke bonds have contributed negative 19 bps to the Fund's performance in December, the drop in the bond price is out of proportion with the company's credit fundamentals and represents a very attractive price.

Oil & Gas, The Fed, and Fund Flows

The perfect elixir of anxiety is being served up for investors: falling commodity prices and concerns over the fallout of a more hawkish Fed. Overall, the drop in oil and natural gas prices has had a negative impact on our Fund this year as we have been hit by some direct exposure to the sector. The recent drop in the price of oil and natural gas over the last month has put further pressure on this sector.

The unseasonably warm weather in the eastern part of the continent, along with natural gas storage levels well above the 5 year average, and approaching the limit of storage capacity, has combined to drive natural gas prices down to levels not seen since the late 1990s. In a recent macroeconomics conference call, Goldman Sachs suggested that the price of WTI could possibly hit $20 sometime in the spring of 2016 but attached a fairly low probability as even the best of the conventional oil producers are only breakeven at this price on a cash cost and S,G & A level (not including finance costs).

At the point of maximum pessimism, bargains can arise. We believe that high yield is entering this zone as the trifecta of falling commodity prices, higher interest rates, and negative fund/ ETF flows create an environment for undeniably attractive return opportunities. While we do not know where the bottom is, we know that bonds are on sale right now. With 20% of the fund in cash we are very excited about executing on some bargains like those highlighted above and boosting the return prospects of the Fund.

Best regards,

Matt Shandro
President, Fulcra Asset Management Inc.