October 14, 2016

Fulcra Credit Opportunities Fund

Q3 2016 Commentary

We are happy to report that in the third quarter the Fulcra Credit Opportunities Fund returned 9.2%, to take the fund's year to date return to 22.7% after fees. While pleased with our current returns and future prospects, it is incumbent upon us to impress that our expectations for our returns over the business cycle are in the 7-9% range, thus marrying well with the Fund's 7.6% annualized return since July of 2009.

We think we're well positioned for the road ahead. The Fund maintains a very low duration of 1.75 years, the current yield remains high at 8%, cash balance is close to our historical 15% - prepared for opportunities, and the weighted average price of bonds is just under 82 cents on the dollar - providing ample capital appreciation potential.

While our contrarian nature and "boutique" size allows us the advantage of nimbleness when it comes to security selection, discipline and patience continue to be the hallmarks of our fund. A couple of investments to help highlight this point, were top contributors to the Fund's performance in the quarter.

Collectively, the largest contributor to performance in the third quarter has been the consumer lending arena. We own two separate lenders CNG and Speedy, and together they contributed 170 bps to the Fulcra portfolio in the third quarter. We have owned the bonds of these two companies for several years, and added to positions in the space over the last year, as uncertainty surrounding impending CFPB (Consumer Finance Protection Board) rules drove the bond prices of astutely managed businesses below the value of their net finance receivables – i.e. after all charge offs. Even if these companies were going to go out of business we felt very comfortable that we would generate an attractive return. Here was a situation where uncertainty and fear drove bond prices well below a conservative valuation of the liquid assets of the business.

How to position the Fulcra Fund

As we move into the final quarter of the year, one of our chief challenges outside of day to day portfolio management remains how to position ourselves in our clients' portfolios. We have long talked about the return correlation of our credit portfolio to stocks and since our securities have a maturity and pay a coupon, it's a considerably less volatile proposition than owning an equity.

Asset allocation, in the traditional sense, involved allocating a percent of fixed income in your portfolio corresponding to your age. However since that 2-3% return on your fixed income investments in the current environment will have you dipping into your capital when it is time to pay your bills, perhaps it's time to rethink that equation.

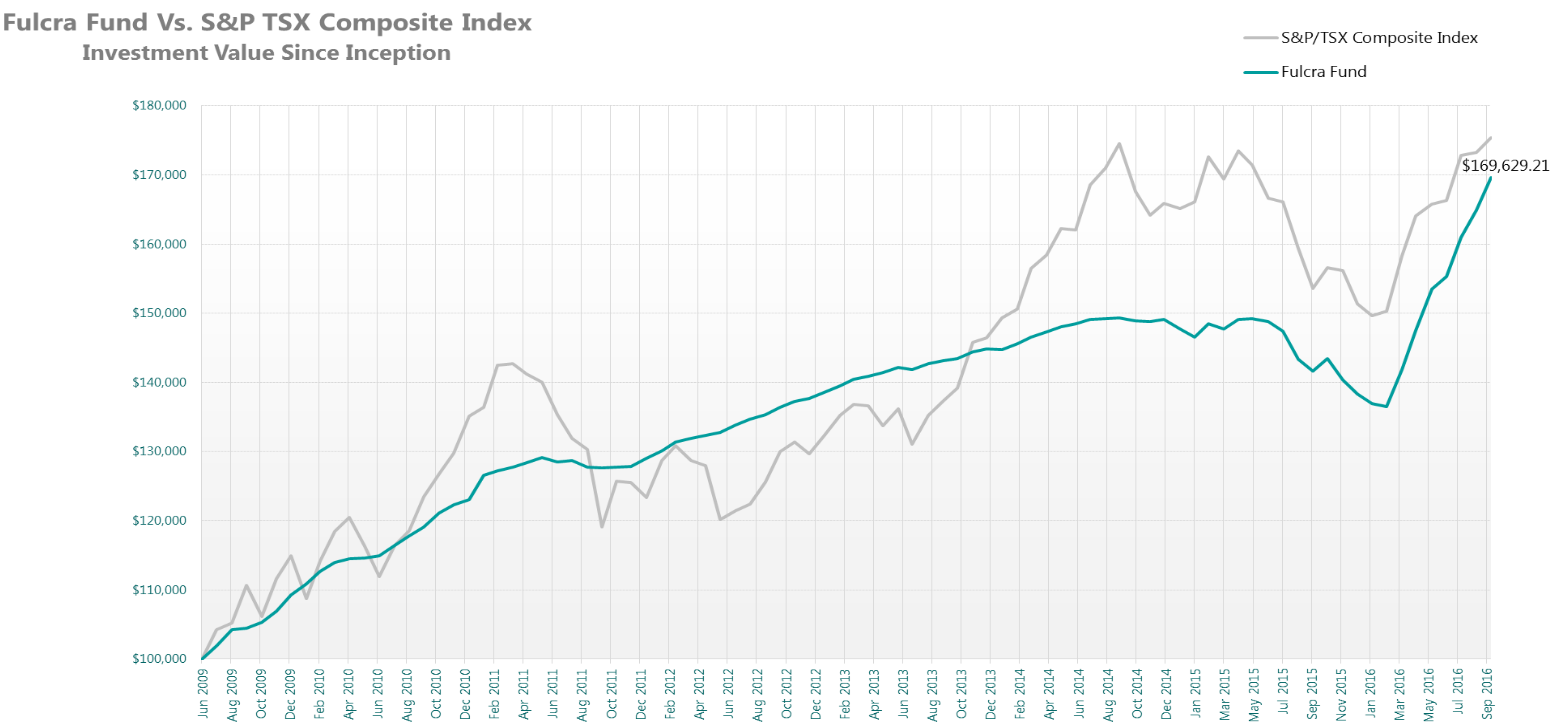

Figure 1: Fulcra Fund Vs.S&P TSX Composite Index

As illustrated below, with 12 odd trillion dollars of debt globally trading at negative interest rates, the conundrum for the fixed income investor is magnified. In all likelihood the fed will continue its glacial path of interest rate hikes in December, but the question that remains to be answered is: with global economies being so dependent on cheap debt, how much room do they have to manoeuver? There's little doubt that sooner rather than later rates will start to rise in the United States.

The dilemma is how do I get my fixed income portfolio working for me in what looks like a very low rate environment (despite some increases), for a few years to come. We may not see an investment grade bond pay an 8% coupon again for a very long time.

Figure 2: Worldwide debt with negative yields. Reprinted from Negative-Yielding Bonds Jump to Almost $12 Trillio*n,* In *Bloomberg*. Retrieved October 12, 2016, from http://www.bloomberg.com/news/articles/2016-10-02/negative-yielding-bonds-jump-to-almost-12-trillion-after-ebbing.

A well run concentrated portfolio of corporate credits solves many of these issues. Low duration, no leverage and strict investment weightings discipline within the portfolio lessen your risk considerably. We think you should consider your exposure to the Fulcra Credit Opportunities Fund not as a more risky fixed income investment, but a considerably less risky equity investment.

When we return to the high interest rate and high inflation world of the past, Disco will be back and Matt promises to put the white suit back on!

Until then, we look forward to your questions.

Best regards,

Fulcra Asset Management Inc.