



October 23rd, 2018

The Rise of the 3 Lettered Monster

The Fulcra Credit Opportunities Fund's Q3 performance was relatively flat at 0.67% but intra quarter was quite volatile as July (+1.51 %) benefitted from AIMIA, while August (-0.87%) saw a lot of that given back through our Rite Aid and Dundee preferred positions.

In July, the Fund's position in AIMIA bonds and preferreds' benefitted, to the tune of 1.03%, from Air Canada and its bank partners announcement to buy the Aeroplan loyalty program from AIMIA. In August, however, the mutually agreed decision by Rite Aid and Albertson's to not pursue a merger and Dundee management indicating on a Q2 call that they would consider issuing stock to meet the preferred's maturity in summer of 2019 "conspired" to drag the fund down 1.19% that month.

We used the strength in AIMIA's bonds and preferreds to trim our position during the 3rd quarter. With AIMIA bonds priced over \$101 and the preferreds priced at an equivalent \$88 we find the preferreds a more compelling investment given that there is close to the bond equivalent of \$10 in cumulative dividends owed. And while Rite Aid bonds and Dundee preferreds both dropped in price during the quarter we only added to our position in the Dundee preferreds.

Rite Aid's recent failed merger with Albertsons saw the bonds and stock fall during the quarter. While the company is significantly less levered prior to its asset sale to Walgreens in 2017 there is a lot of investor fatigue. Combined with the perceived risk of a smaller company and the time of year when tax loss selling emerges, this position is technically heavy so we may look to add at a better price point. Furthermore, we do believe that the pharmacy benefit manager business and pharmacy patient prescriptions are assets that cover the bonds completely given such recent transactions as Walgreen's purchase of some of Fred's, Inc. patient prescription files.

We added to Dundee Series 5 preferreds after the 2nd quarter results conference call in August, when management reminded investors that the company can redeem the preferreds with stock at a floor value of \$2 per Dundee Corp. share. With the stock trading around \$1.50 at the time of the conference call it



was obvious, given the over \$7 drop in the price of the preferreds, some investors were surprised by this notice. While we choose to value the company's public and private investments cautiously, we believe there is value more than the dollar amount of preferreds outstanding.

Watch out for the C.L.O. in your backyard

This year, supply of US investment grade and non-investment grade corporate bonds has been weak. Investment grade issuance will in fact see its first annual decline since 2010 while high yield bonds will see almost a 30% year over year drop in issuance.

While supply of high yield and investment grade corporate bonds has dropped off this year demand has not. This has had the effect of driving spreads in high yield bonds close to their all-time lows.

Despite the drop off in fixed coupon bond issuance this year, it has been a boon for leveraged loans. When interest rates go up so does the coupons of loans, making them a very popular investment during times like today. With spreads low in corporate fixed income bonds and interest rates moving higher demand is strong for leveraged loans.

While retail investors' appetite for leveraged loans has increased over the last few years, the biggest driver of demand for leveraged loans is C.L.O.'s (Collateralized Loan Obligations), the step child of the great recessions' C.D.O.'s (Collateralized Debt Obligations). While C.D.O.'s were considered by many the reason poor and even predatory residential mortgage underwriting was allowed to flourish; C.L.O.'s are considered to be the corporations' ticking time bomb equivalent.

The flag waving title of this commentary aside, we prefer to take a more pragmatic approach to looking at the real and perceived risks of the leveraged loan market. Yes, the percent of covenant lite loans, as a percentage of total loans, has increased dramatically over the last 6 years. However, our bigger concern is the current rise in rates which has the potential to squeeze company's cash flow by increasing the cost of debt which could lead to a pickup in default rates.



While being in the senior part of the capital structure can protect investors “relatively” better than junior bondholders, the increased issuance of loans versus bonds suggests that more leverage exists at the top part of the capital structure in the form of loans. This is analogous to just reshuffling the deck chairs and may in fact create more volatility once the default cycle picks up.

C.L.O.’s as structured investment vehicles have guidelines (covenants) on what the manager of a C.L.O. can and cannot buy. For example, they are limited in owning a certain percentage of loans rated below “B-“ and, in some cases, if the average price of the loans in the C.L.O. portfolio falls below a certain price, for example \$90, the C.L.O. cannot buy loans in the secondary market... even if the manager thinks they represent good value.

In other words, during periods of negative volatility the largest owner of loans, C.L.O.’s, will be unable to buy loans in the secondary market. A similar situation arose back in the spring of 2009 when the loans traded at a lower price than the bonds of the same company. Given that loans are senior to bonds this should not fundamentally happen but it did because of the inflexibility of C.L.O.’s. This time around C.L.O.’s represent around 50% of the market for leveraged loans compared to approximately two thirds a decade ago. However, the emergence of retail investors as investors in the leveraged loan space may not necessarily provide the diversity that the loan market needs and may in fact allow the 2009 experience to be repeated.

It is important to remember that the leveraged loan market is a fraction of the size of the mortgage market so problems in loans won’t necessarily transfer to the broader market like mortgages did starting in 2008. However, we do suspect that there is a reasonable probability that future opportunities for Fulcra may arise from the rigidity of C.L.O.’s and their inability to respond to volatility.

While awards only highlight past successes, and we were told as children not to brag, the Fulcra strategy does require patience so, on balance, we are pleased to announce that the Fulcra Credit Opportunities Fund won first place in the Best 5 Year Return for the Credit Focused Category of The 2018 [Canadian Hedge Fund Awards](#). Old news for sure but we aren’t discouraged being reminded that patience, whether buying or selling, can be the foundation for generating absolute returns that are uncorrelated to broad market indices.