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Know when to hold 'em, know when to fold 'em

Kenny Rogers' timeless ballad "The Gambler" synthesizes in a simple mantra the essence of risk management.

The largest managers in the USD $125 trillion+ global asset management industry just don't seem to be able to simply walk away or "fold 'em". In the risk management profession, we don't think we're quite at the "knowing when to run away" part of the market cycle but the rapid rise in interest rates since the beginning of 2022 can't go unnoticed forever.

It seems like we are getting to a point in this interest rate/business cycle where a pivot of what to hold or fold is upon us. Here are some of the reasons why we think that:

- High Yield index credit spreads have compressed to a level that could **limit continued bond price gains** due to further spread tightening.
- The S&P 500 index price to earnings multiple is back in "dot com boom" and "crypto mania" bubble territory which could **limit further stock price gains** due to earnings multiple expansion.
- Short-term interest rate futures traders have gone from pricing in **over three rate cuts** to only a **67% chance of one** cut by the time the Federal Reserve meets in June.
- **Medium/long term interest rates have moved steadily higher** in both Canada and the US during the quarter and thus far in April.

Given these market dynamics and our primary focus of the preservation of investor capital, we have been treading cautiously.

We ended last quarter's commentary with a warning that market participants were ignoring the possibility that interest rates wouldn't fall in the near term and the potential for an earnings recession.

While interest rates did indeed surprise to the upside in the first quarter, we have yet to see a broad slowdown in earnings growth for reporting issuers.

So, while we are not forecasting an imminent earnings recession, merely reminding our fellow investors that price is what you pay and value is what you get, we'll leave you with a quote from the aptly named Paul "Bear" Bryant, one of the winningest coaches in college football history:

Offense sells tickets. Defense wins championships.

Portfolio Highlights – Q1 2024

We ended the first quarter with a higher percentage of the portfolio in our "dry powder bucket" (short term government bonds) and increased allocations to higher rated, short duration corporate bonds.

It is worth acknowledging that when short-term interest rates were near zero, there was a considerable opportunity cost in maintaining dry powder. Today, we're able to earn a respectable return on capital while we wait for the market to provide us with better opportunities (and a larger margin of safety).

Our current tactic of maintaining relatively high levels of unencumbered capital does not mean that we have been sitting on our hands. On the contrary, we found some very interesting special situations and catalyst-driven investments during the quarter.

Due to the strength of the new issue market and the high level of interest rates in short duration risk-free bonds, the secondary market opportunity for short high quality corporates has been compelling. While generally exceptionally short (i.e. under 1 year in duration) we are finding investments with yields in the 7-8%+ range.

We also continue to see fundamental value in the stressed/distressed names that we own and view recent price volatility as another sign of weakening market sentiment and not a change in the underlying investment thesis. These special situations should have little correlation to the broader market and may potentially warrant further investment in the event of a liquidity-driven sell-off.

As always, we maintain a disciplined approach to managing our portfolios. Deep fundamental research, stringent risk control and non-index security selection remains the name of the game. Our value investing principles continue to force us to work hard to find investments that offer both an adequate margin of safety and potential for uncorrelated index-beating returns.

While we are not ignorant of the trending news of the day, we do spend a lot of mental energy filtering out noise and looking for signals. The modern struggle is not for more information - it is for more attention.

With that in mind, let's look closer at two important market signals that we mentioned earlier – high yield index credit spreads and S&P500 price-to-earnings ratio:

High Yield index credit spreads:

S&P 500 Adjusted Price to Earnings Ratio:

*Data provided by Bloomberg

As you can see from the charts above, we are not at the most extreme levels in the history of these two valuation metrics, but we are certainly nowhere near “buy low” territory. High yield spreads of 320

basis points currently are well below the long-term average of 565 basis points and the observable Price / Earnings ratio today of 24 times is well above the average of 19.2 times.

In these market conditions you will typically see value investors become more conservative and investment bankers become more aggressive. IPOs, debt refinancing packages and M&A activity can heat up at this point in the cycle and these are all catalysts that create investment opportunities for us.

While our playbook will focus on defensive strategies as it relates to broad market exposure, we certainly think that idiosyncratic niche situations will arise in the coming months. This may sound familiar, and we are glad you noticed! We feel like kids in an investment candy shop and are very excited about our current and prospective investment options.

As a reminder, we converted the fund offering documents from an offering memorandum to a simplified prospectus at the end of last year. This change provides greater visibility into the fund for both current and prospective investors and eliminates the need for subscription agreements.

We value all of you and thank you for your continued support. Referrals are the greatest compliment and we're happy to connect with anyone that you think would benefit from investing with us.