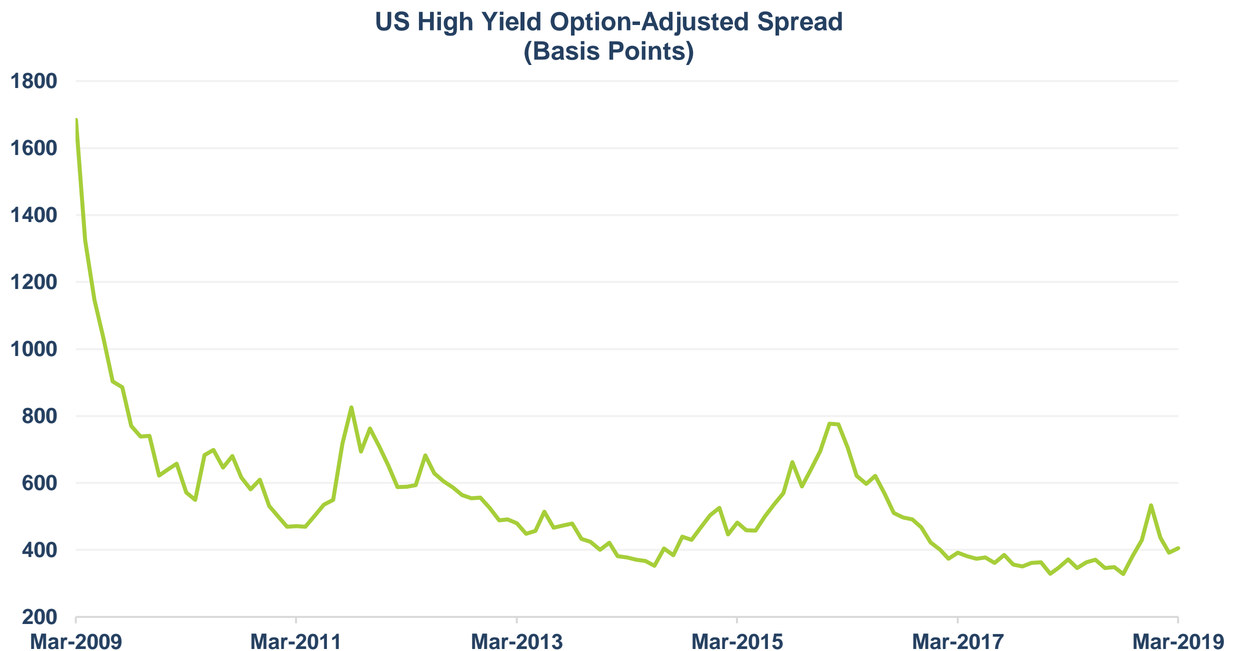
FULCRA
ASSET MANAGEMENT INC.

Ludicrous Mode

The high yield corporate bond market got out of the gates of 2019 like "The Stig"[1] testing the 0 – 60 mph capabilities of a Tesla S. The first quarter performance of the high yield corporate bond market[2] was an astonishing 7.41 percent. If you exclude the performance of the 2nd and 3rd quarters of 2009 which were up a staggering 23.20 percent and 14.82 percent respectively, this year's first quarter performance was the third best quarterly performance since the high yield index's inception in 1986.

Since February 2017 the spread on high yield had stayed consistently below 400 basis points until risk aversion took hold of markets in November 2018. However, the strong year to date performance of the index has moved to a level we would suggest does not represent good value.

As of April 18th, the high yield index is up 8.55 percent year to date, with an effective yield of 6.14 percent and a spread[3] of 373 basis points.



Admittedly, the index has left us in the dust year to date. However, our concentrated approach allowed us to add to existing positions in the quarter at very attractive prices despite the quick snap back of many of the corporate bond issues that make up the index.

[1] https://en.wikipedia.org/wiki/The_Stig
[2] ICE BofAML US High Yield Index
[3] Option Adjusted Spread

Fulcra Asset Management Inc. | Suite 950 – 609 West Hastings Street, Vancouver, BC | V6B 4W4
Tel: (604) 683-8362 | Fax: (604) 683-8368 | Email: info@fulcraam.com | Website: www.fulcraam.com

One such example is the bond of Montney natural gas producer Canbriam Energy. The USD $350 million 9.75 percent coupon bond due November 2019 fell from a price close to par in the 4th quarter, to the low $80s by the end of March.

During this most recent market sell off, the coinciding drop in price of Canbriam bonds is not viewed by us as negative feedback on our fundamental process but an opportunity to contribute to higher future returns with less risk.

This simple rule of fundamental value investing can be easily forgotten during periods of negative volatility. It requires the discipline of relying on fundamental knowledge to overcome and take advantage of the emotional swings of the market.

Given our conviction of Canbriam's business and valuation we made it the largest position in the fund by the end of the first quarter. At March 31st the Fulcra Credit Opportunities Fund's bond investments were yielding 10.1 percent with a duration of 1.8 years versus 7.9 percent and 1.7 years at the end of last year.

Is it just coincidence that Oaktree agreed to be sold to Brookfield?

As quickly as the pool of distressed opportunities increased by the end of 2018, it was taken away in the first quarter of 2019. Given the announcement in the middle of March that Oaktree had agreed to be acquired by Brookfield, we wondered whether the evaporation of an investment opportunity left Howard Marks and crew frustrated.

After all, the distressed index of bonds[4] as a percent of the total US high yield index has remained very low.

Source: ICE BAML US Distressed High Yield Index via Bloomberg

[4] A distressed bond is defined as trading with a yield spread of over 1,000 basis points

As discussions had been taking place between Oaktree and Brookfield since late last summer, clearly Oaktree was not just "throwing in the towel". Our desire to rationalize this transaction is driven by seeing a successful independent investment manager, that we've admired for years, decide that its independence is no longer a competitive advantage.

Maybe we shouldn't be surprised by this outcome given that Oaktree had already decided several years ago to go public. This take private step with Brookfield is just another in the evolution of value maximization for the founders. As the stock had been trading close to its IPO price from 7 years ago, we suspect some shareholders were pleased to see the Brookfield transaction. Investors in some of Oaktree's funds, quite possibly, did better than the Oaktree shareholder during this 7-year time frame. Isn't it supposed to be the other way around!?

Another possible contributing factor to Oaktree's decision can be gleaned from Mr. Mark's first commentary since the Brookfield announcement (https://www.oaktreecapital.com/docs/default-source/memos/growing-the-pie.pdf). In it he discusses the erosion of public trust with capitalism. Stepping into the hands of a friendly like-minded Canadian investor could be viewed as strategic cover from the building anti-capitalism wave in the US.

While there are likely many contributing factors that went into Oaktree's decision, one is certainly not the potential shrinking pool of future investment opportunities in credit. Since 2009, the par amount of US high yield corporate bonds has almost doubled. As well, the growth and popularity of leveraged loans amongst retail investors and covenant lite loan structures will likely create fantastic opportunities for investors with the skill and mandate to capture it.

Not that Brookfield asked, but we really like our independence and though in our 10th year of operation look forward to the next 10 years of opportunities. As always, please send comments/questions our way on this commentary and/or the Fulcra Credit Opportunities Fund.