



Round, Round, We Go

Trooper's hit from the 1970s could be the theme song for the current political and economic state of affairs. On one side you have the US-China trade war, Trump Impeachment proceedings, BREXIT, a slowing German economy, the Federal election in Canada (honorable mention), low commodity prices, and slowing US industrial activity (see US-China trade war). On the other side, sits the S&P 500 Index at an all-time high, supported by the US consumer which is still in very good shape due to all-time low unemployment and, despite a recent drop (see US-China trade war), robust consumer sentiment.

The US-China trade war is the obvious elephant in the room and with a US election next fall, politics could have a significant influence on the global economy and capital markets. Against this backdrop, with equity indices at all-time highs and interest rates close to all-time lows, we tread cautiously, aware that a resolution of removing this proverbial elephant will trend towards two very different outcomes. An initial positive resolution of tariff removal / trade war truce could restore corporate and consumer confidence and maintain equity market strength with the caveat that interest rates will need to go higher! The opposite would be more tariffs and the continuation of deteriorating economic relations between the 2 largest economies in the world. A period of stagnant or declining economic conditions would likely ensue and with-it, rising risk premiums and lower stock market returns.

Fixed income markets enjoyed strong performance to the end of September in 2019. The US High Yield market¹ (4.4 year duration) is up 11.5 percent as credit spreads² narrowed 131 basis points to 402 basis points. This performance was also aided by the 89 basis point drop in the yield of the US 10 year Treasury bond to 1.79 percent thru the end of September. In Canada the Investment Grade index³ was up 7.98 percent for the first 3 quarters of the year.

The Fulcra Fund returned 0.65 percent after fees in the 3rd quarter and 4.53 percent with an average duration of 1.8 for the first 9 months of the year. Our increasing bias to keep the Fund's bond investments on a short leash (see pie chart) is to minimize any potential interest rate volatility and keep dry powder available for mispricing's we suspect could be close at hand. We conducted extensive due diligence on several new companies through the summer and early fall whose bonds we would be excited to add to the portfolio given the right opportunity.

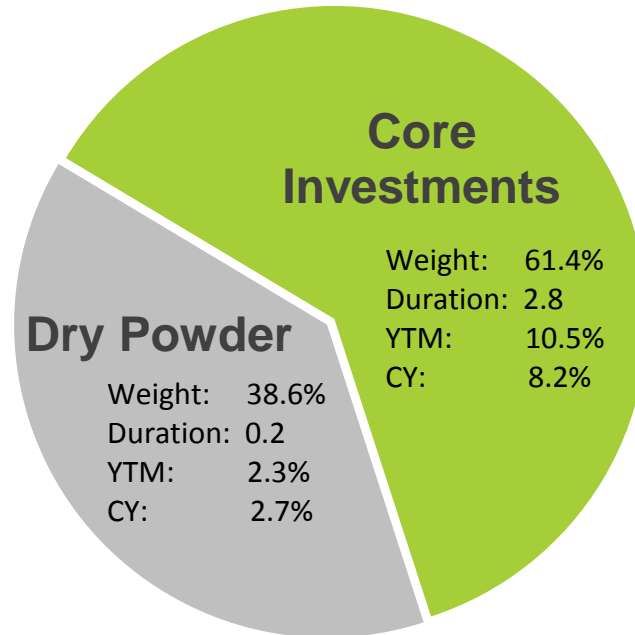
¹ ICE BofAML US High Yield Index

² Option Adjusted Spread

³ ICE BofAML Canada Corporate Index

Combined

Duration: 1.8
YTM: 7.7%
CY: 6.3%



An integral part of the Fulcra Fund’s absolute return credit mandate is to avoid expensive/costly index mispricing’s that can build up due to macro influences, such as a drop-in interest rates. Occasionally, however, these macro forces can create technical pricing discrepancies in the capital structures of companies which Fulcra looks to benefit.

US Bond / Loan mis-pricings

Over the last 5 years, as the global economy has long recovered from the 2008/2009 recession, loose financial standards in loan and bond structures have emerged. Some companies have been able to issue “secured” debt with 1st and 2nd lien’s that act more like veils. These loans and bonds either don’t possess covenants or have ones that are so weak that they leave the investor with little recourse if cash flow drops. While bonds can be purchased by a diverse set of investors (individual investors, mutual funds, hedge funds, and institutions) loans are primarily owned (over 50 percent) by Collateralized Loan Obligations (CLO’s). CLO’s are investment vehicles that investment in the loans of non-investment grade corporations. They primarily get their investment capital from institutional investors (i.e. pension funds etc...) and as a result the credit rating agencies are heavily involved in the monitoring of the credit risk of CLO’s. Specifically, CLO’s will have their overall credit risk measured by what is referred to as the Weighted Average Rating Factor (WARF). If the factor rises in value, it means the overall loan portfolio is getting too risky and the CLO manager will have to sell lower rated loans in the CLO portfolio.



Earlier this year loan prices were hit hard like most risk assets as a result of the broad market sell off in the 4th quarter of 2018. However, a recent drop in loan prices over the last several weeks has been driven by CLO's selling lower rated loans in order to reduce their overall WARF scores. This has resulted in driving the prices of some loans, where an issuer has pari-passu bonds outstanding, to prices where the loan is trading cheaper than its bond counterpart. The Fulcra Fund currently owns the term loan of PetSmart which is due in March 11, 2022 and trades at a yield of 6.41 percent compared to the pari-passu bond that is due June 1, 2025 and trades at a yield of 5.86 percent.

While this nuanced structural behavior in the loan market is nothing like the vacuum loans traded into in late 2008 and 2009, even a minor adjustment of these institutional rigid structures can create selective investment opportunities for the sensible investor.