December 2021

To the Moon and Back

The Fulcra Credit Opportunities Fund returned 12.39 %[1] in 2021. This marked the 3rd best annual result since inception in 2009. Someone visiting the planet for the first time might think this an odd result given the presence of a global pandemic.

Rapid development of vaccines along with the unwavering monetary and fiscal support of governments kept the economic wheels turning and the hope of a return to normalcy alive despite the ever-changing virus.

Meaningful corporate bond positions that the Fund initiated at the onset of the pandemic (i.e. Ferroglobe and Spencer Spirit) and existing positions that we added well into the pandemic (i.e. Millar Western, Nuvista, Tidewater Midstream, and Wildbrain) were strong contributors to the Fund's 2021 performance.

Smaller positions purchased in 2021 both post- restructuring (Guitar Center) and pre-restructuring (Washington Prime Group) saw these companies reduce leverage with savvy new owner/operators.

In the case of Guitar Center, work from home increased demand for their products. As one of the largest buyers of musical instruments in the world, they have seen their business grow despite supply chain disruptions.

[1] Net after fees return

Washington Prime Group, on the other hand, saw their well-positioned outdoor malls turn into ghost towns once the pandemic set in, but prospects look good in our opinion. The opportunity: reduced debt, alternative use of retail square footage, and a pent-up demand for community interaction.

V1.0

Equity market performance over the last two years has been compared to the Internet bubble period that started in the late 1990s. This time around, however, has been a transformative period for the stock market as retail investors have become motivated by commission-free trading, ultra-low interest rates, work from home rules, government financial support, and social media investing platforms. Their direct participation in US equity markets saw a jump after the introduction of commission-free trading in 2013 by Robinhood. This increased further at the onset of the pandemic when it averaged approximately 20 percent of all stock trading in the US[2].

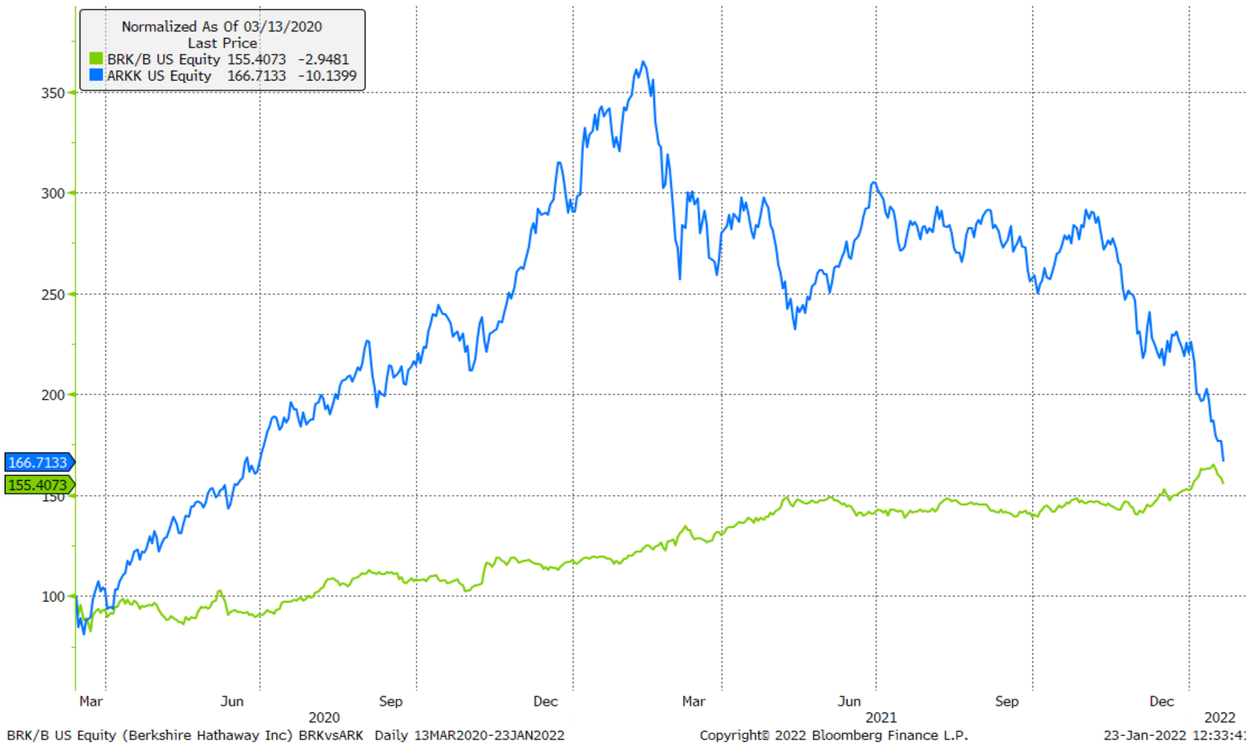
The "Dot Com" bubble of the late 1990s saw the Nasdaq Composite Index shoot up 200 percent in less than a year and a half only to see it fall below its 1998 starting level by September of 2001. In many investors' eyes, Berkshire and its steward, Warren Buffet, is the adult in the room when it comes to valuation and risk taking. Over this same period Berkshire stock traded within a range of 30% of its September 1998 price and at the end was up 17%[3].

Recently, the financial press has been comparing Berkshire versus the latest tech-investor's proxy: ARK Innovation ETF. We decided to have a look.

[2] Bloomberg LLP
[3] Bloomberg LLP

Over 20 years ago, the ETF industry as we know it today didn't exist. In the last 10 years there has been a proliferation of specialized ETF's. Whether it is for their daily liquidity or access to a niche strategy, ETFs are a financial innovation that have found their way into both retail and institutional investors' portfolios.

V2.0



More recently, the ETF has collided with what might be described as new age technologies (i.e. AI, autonomous driving, genomics etc.) and manifested itself into a company like Ark Invest.

One can marvel at the level of ingenuity in many of the companies that comprise the Ark Innovation ETF. The largest constituent of the ETF, Tesla, has spawned a cult-like following for its legitimate mastery of reinventing the automobile into a technological and ESG must-have.

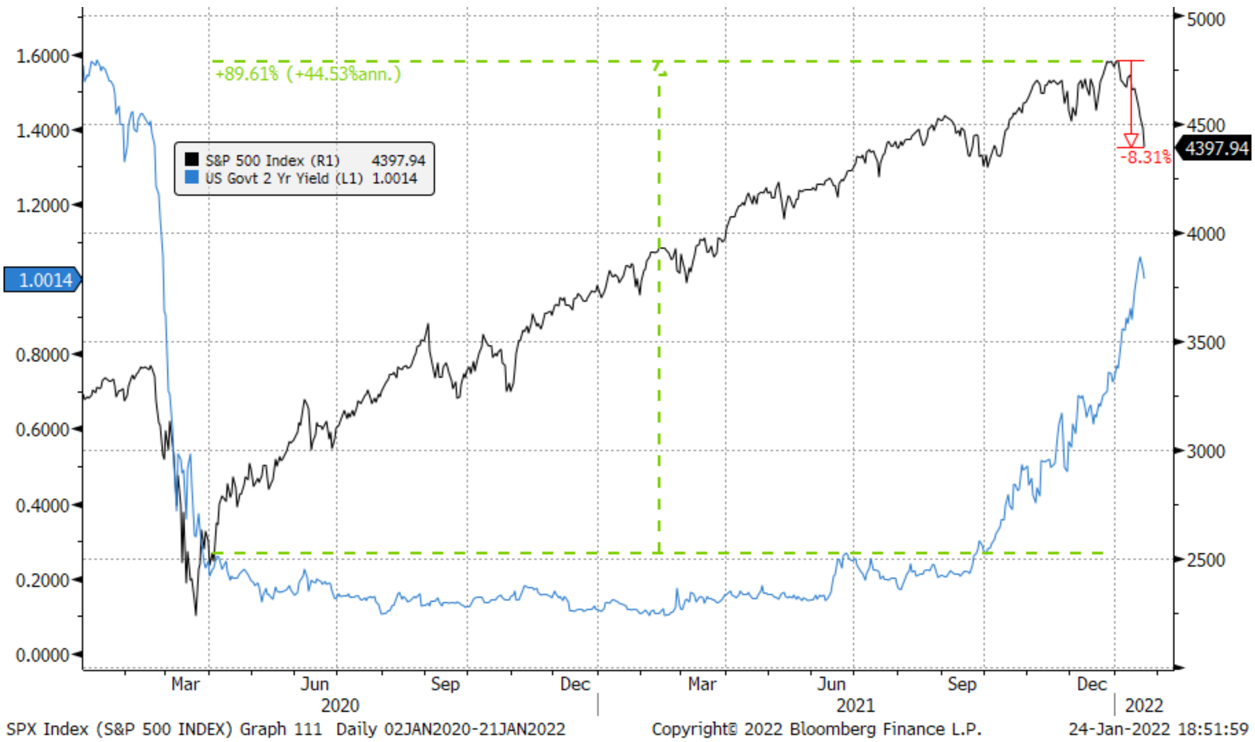
However, for all the innovation that may accrue from some of these companies, many will turn out to be poor investments. Even if they are long term winners many retail and institutional investors will not have the skills or patience to stay with the right ones long enough.

In the two periods of technological investing excitement highlighted in the graphs above, a constant remains: Value investing, as represented by Berkshire, can generate results that would please even the future SpaceX passengers colonizing Mars… yes, it will be a very long time.

And here's our Point

While the behavior of technology equity markets since the start of 2022 is mirroring that of the internet bubble over 20 years ago, it is the current value of broader indices like the S&P500, the real low level of interest rates and the high level of inflation that concerns us.

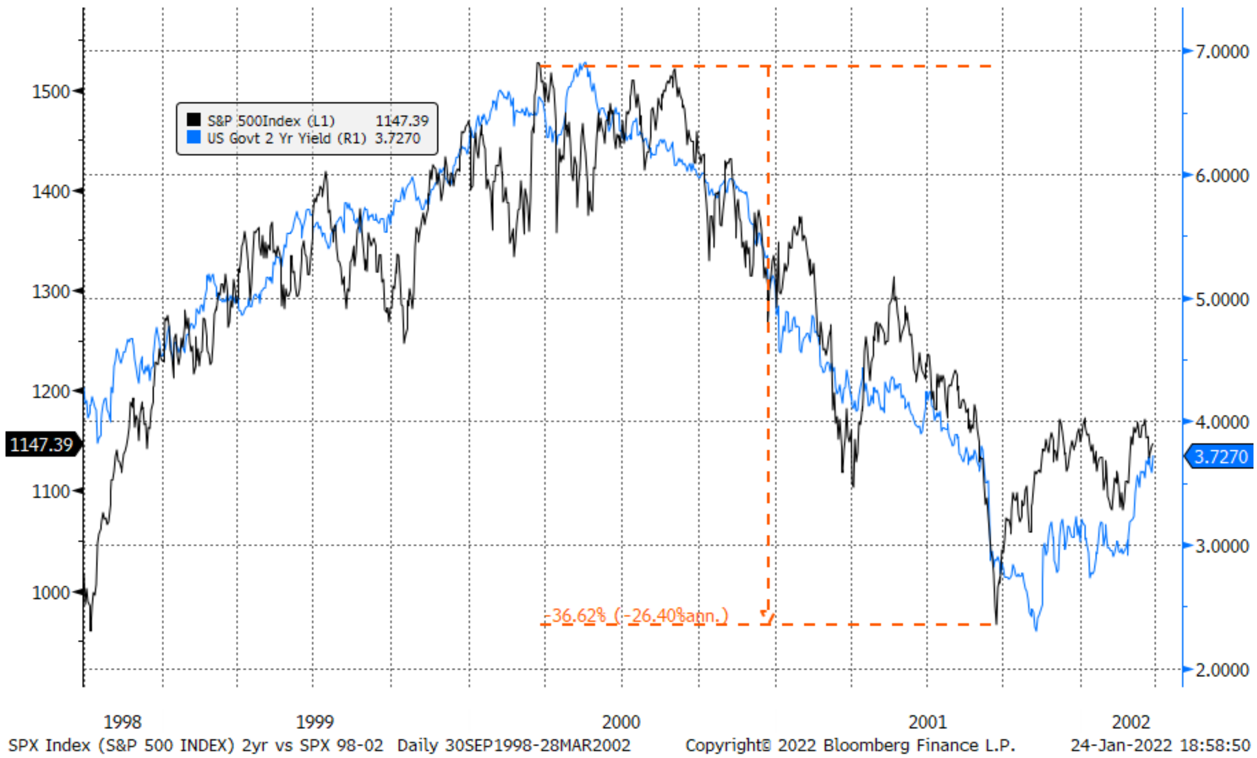
The S&P 500 index is down 8 percent since its record high on January 3rd, 2022. Despite this drop the S&P500 sits at a forward Price/Earnings multiple of 20 times next year's expected earnings. This is in the 95th percentile of the index– **still very expensive.**



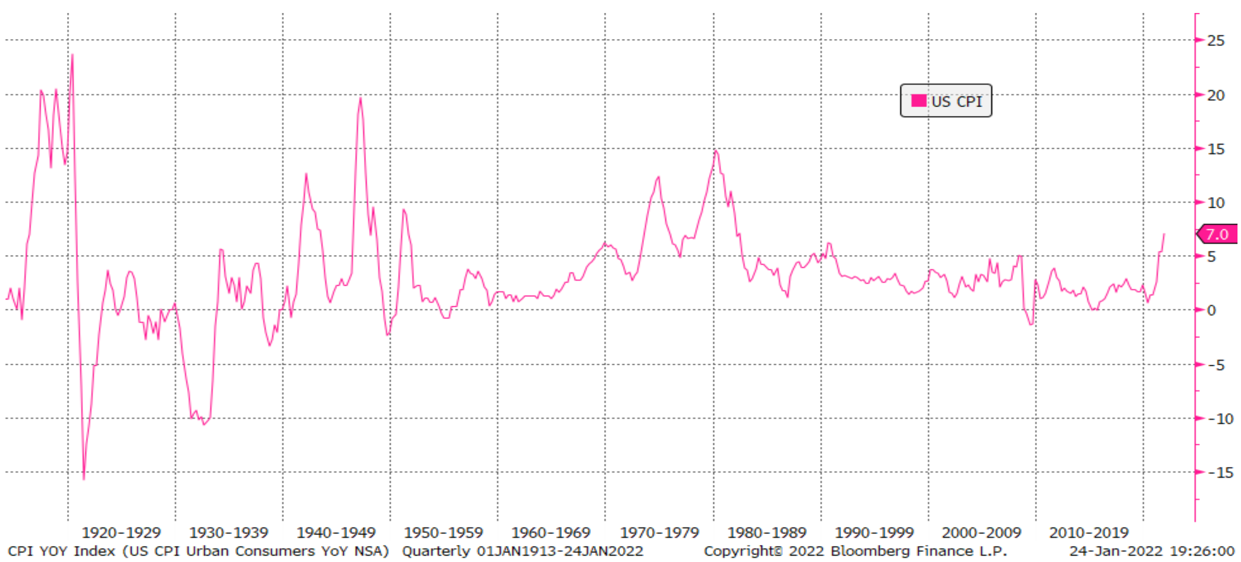
The graph above shows the performance of the S&P 500 and the 2-year Treasury yield since the start of 2020. As overnight rates were cut at the onset of the pandemic, 2-year yields stayed flatlined and did not disrupt the index's ascent until the beginning of this year when the 2-year yield hit 1 percent.

Since the start of the pandemic to its peak, the S&P 500 was up almost 100 percent and since its Feb 2020 former peak up over 40 percent.

In comparison, let us look back at the 36 percent fall in the S&P 500 from its March 2000 peak to its September 2001 low. Over this period, the 2-year Treasury went from a yield of 6.7 percent to 4.25 percent. Two decades ago, interest rates were high enough central bankers could cut them to help stave off a recession. **No such luxury today.**



With interest rates still extremely low and the US Consumer Price Index annual inflation measure at 4 decades high, central bank actions and earnings guidance in the coming weeks could help paint the picture for the rest of the year. More volatility than over the last two years seems like a certainty.



Back to Earth

Enough high-flying stock talk. The graph below shows investment grade and high yield corporate bond spreads since the start of 2020. With all-time low government bond yields and near historic corporate spreads, Investment Grade and High Yield corporates are providing investors less yield than ever.

Like their equity index brethren, the ICE BofA High Yield Index stands to have a challenging year. The High Yield Index, with a yield to maturity of 5.3 percent and duration of 4.2 years, is mathematically in trough with market expectations of 4 interest hikes by the Federal Reserve over the next 12 months. Yet if the economy manages through this period of remarkably high inflation and rising interest rates High Yield corporate bonds could turn out to be the best of the fixed income bunch.