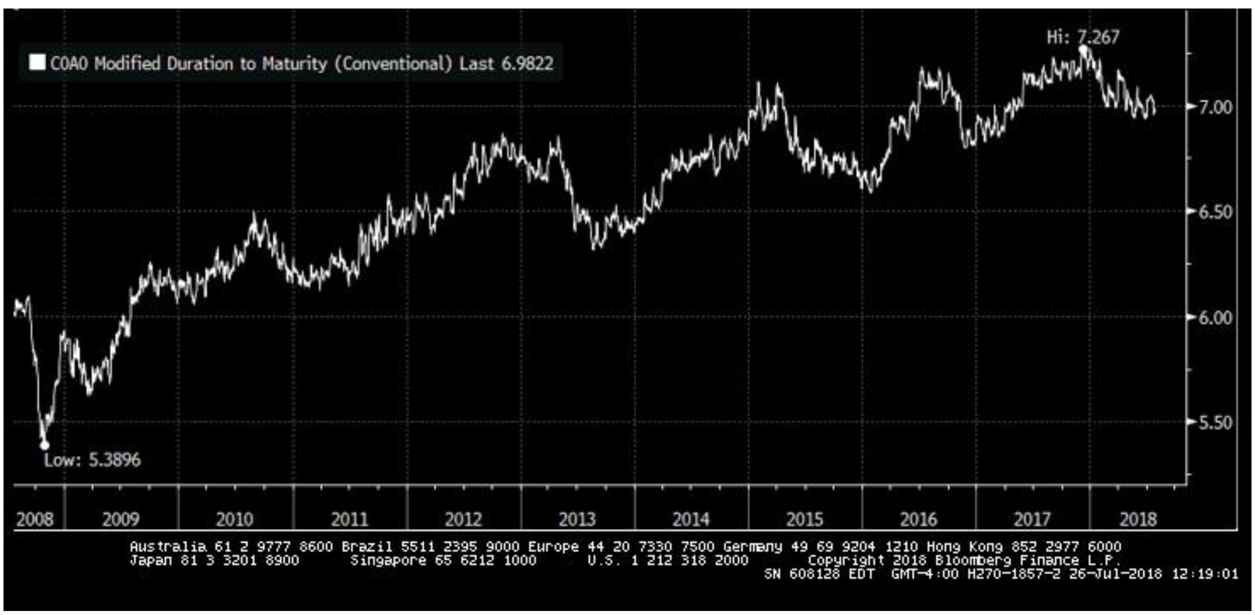
Lysander - Fulcra Corporate Securities Fund
Q2 2018 Commentary

Is Timing Everything?

Observers of the Investment Grade Market would answer affirmatively. Over the course of the first 2 quarters of the year the US investment grade Index[1] was down 3.1 percent while the shorter duration US high yield index[2] faired slightly better being up 0.08 percent.

If the year to date losses continue for the remainder of 2018, US investment grade will experience its 2nd worst year of performance since inception in 1973. Interestingly, the worst year of performance, 2008, was due entirely to widening risk premiums (spread). For the first half of 2018, a large contributing factor for the negative performance to date is the rise in government bond yields.

As the below chart highlights, the US investment grade market has seen the average bond duration rise steadily since the Great Recession (2008 -2009) to over 7 years. This means the US investment grade bond universe has become more sensitive to potential interest rate movements over the last decade.



In the first half of 2018, Treasury yields[3] went from 2.2 percent at the beginning of the year to 2.72 percent by the end of the 2nd quarter generating a negative 1.15% return over this period.

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[1] ICE Bank of America/ Merrill Lynch US Corporate Index
[2] ICE Bank of America/ Merrill Lynch US High Yield Index
[3] ICE Bank of America/ Merrill Lynch US Treasury Index

While the increase in Treasury yields explains some of the negative return for Inv Grade it was spread widening of 32 basis points that explained the bulk of the negative investment grade return year to date.

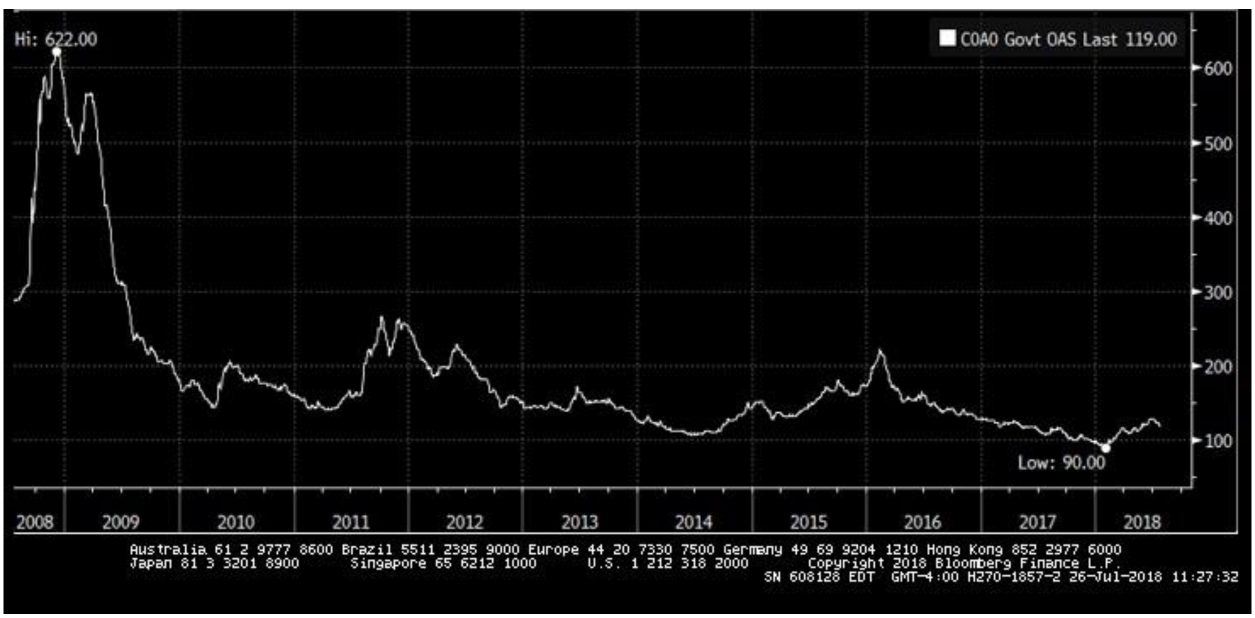
Investment grade investors have required a higher level of coupon to be persuaded to buy a new issue. This suggests that investors have been expressing a reluctance to buy investment grade corporates.

As Investment grade corporate bonds are on average longer in duration than 6 years ago, the increase in interest rates in the first quarter simply reminded investors of that sensitivity, enabling them to ask for more compensation (higher coupon). Some investors may see this as a concern that economic growth is stalling and lead to credit metrics being negatively affected. We are not of this view.

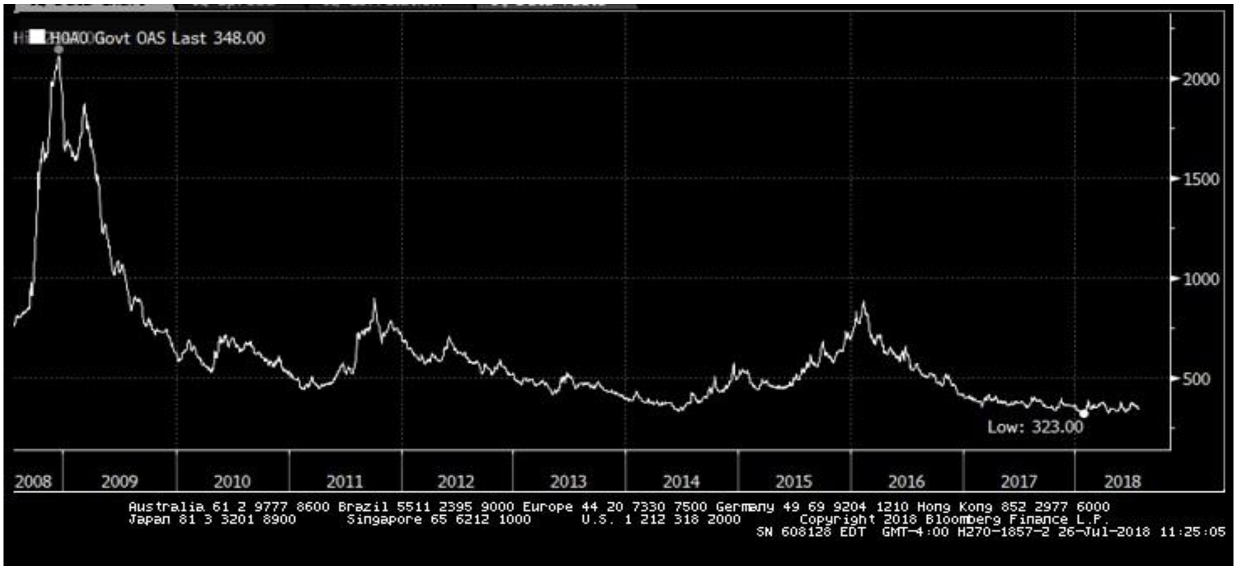
Nevertheless, it is important to mention that the overall quality of investment grade corporate bonds in the US, based on credit rating, has decreased over time as highlighted by the higher percent of bonds in the BBB category.

We believe both the investment grade and high yield corporate bond markets are rich. The spread graphs below show that earlier this year both markets hit their lowest levels in the last 10 years.

US Investment Grade Corporate bond spreads



US High Yield Corporate Bond Spreads



Despite a slight increase in spread levels over the last few months we don't think today is a good time to be taking on market risk.

Given that the Lysander-Fulcra Corporate Securities Fund has an absolute total return benchmark of 5%, we can choose to avoid this market risk by not feeling pressure to buy broadly held index bonds.

Fulcra's primary focus is protecting capital and locating idiosyncratic opportunities. To this point, Fulcra has recently found opportunities in the hard yield to call market.

As Exchange Traded Funds and many fund managers are fully invested, they generally need to sell an investment when they are hit with redemptions. One type of situation where we have seen selling is in "hard" yield to call bonds.

These are bonds where a corporate action has been sent to bond holders indicating that the company will be maturing the bond in 30 days at a predetermined price. At certain times this year, during periods of high yield outflows, there has been selling of these "hard" yield to call bonds.

Fulcra has been able to buy these bonds at annualized yields of 2.75 to 3.30 percent for a 2-3 week holding period. As there is little interest rate and credit risk we find these investments to be an excellent cash roxy and return generator that keeps the door open for us to still pounce on broad market and idiosyncratic opportunities.

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