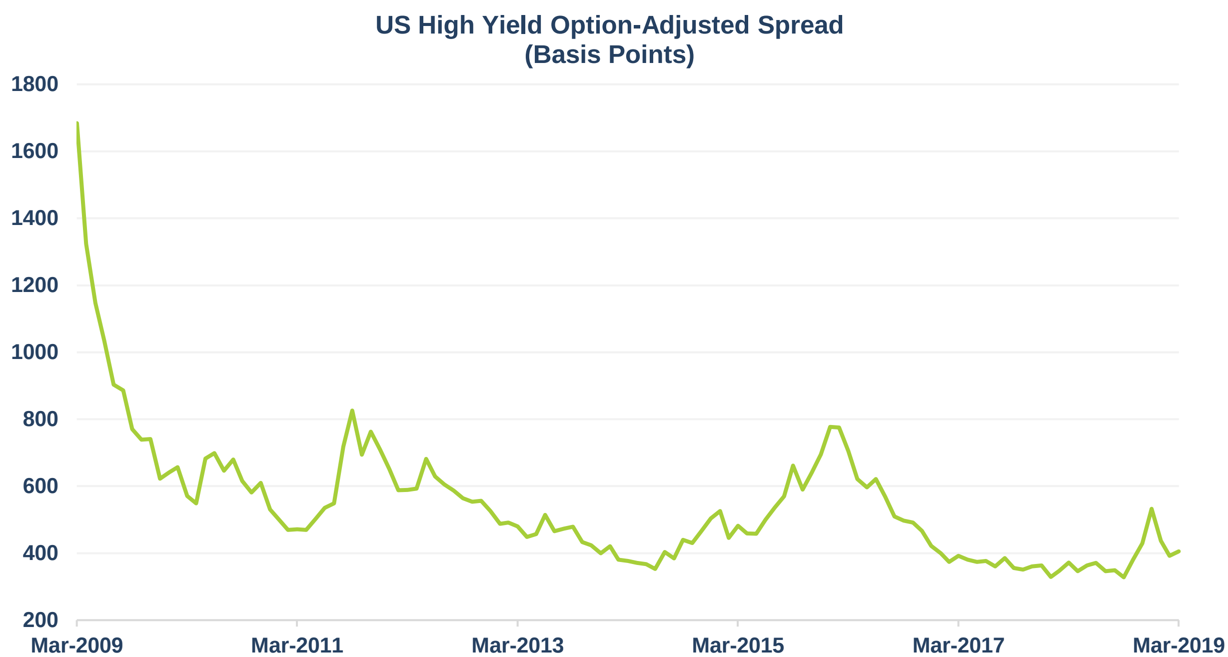
April 2019

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 ICE BofAML US High Yield Index (the "High Yield Index") was an astonishing 7.41%. If you exclude the performance of the second and third quarters of 2009 which were up a staggering 23.20% and 14.82%, 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 High Yield index has moved to a level we would suggest does not represent good value.

As of April 18, 2019, the High Yield Index is up 8.55% year-to-date, with an effective yield of 6.14% and a spread (option adjusted) of 373 basis points.



Source: ICE BAML US High Yield Index via Bloomberg

Admittedly, the year-to-date performance of Lysander-Fulcra Corporate Securities Fund (the "**Fund**") paled in comparison to that of the High Yield Index. However, our concentrated approach allowed us to add to existing positions during the first quarter in 2019 at very attractive prices despite the quick price recovery of many of the corporate bond issues that make up the High Yield Index.

[1] https://en.wikipedia.org/wiki/The_Stig

One such example is the bond of Montney natural gas producer, Canbriam Energy Inc., an existing position in the Fund. The USD$350 million 9.75 % coupon bond due November 2019 fell from a price close to par in the 4th quarter in 2018 to the low $80s by the end of March 2019. During this most recent market sell off, the coinciding drop in the price of the Canbriam Energy 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. Given our conviction of Canbriam Energy's business and valuation, we made it the largest position in the Fund by the end of the first quarter in 2019.

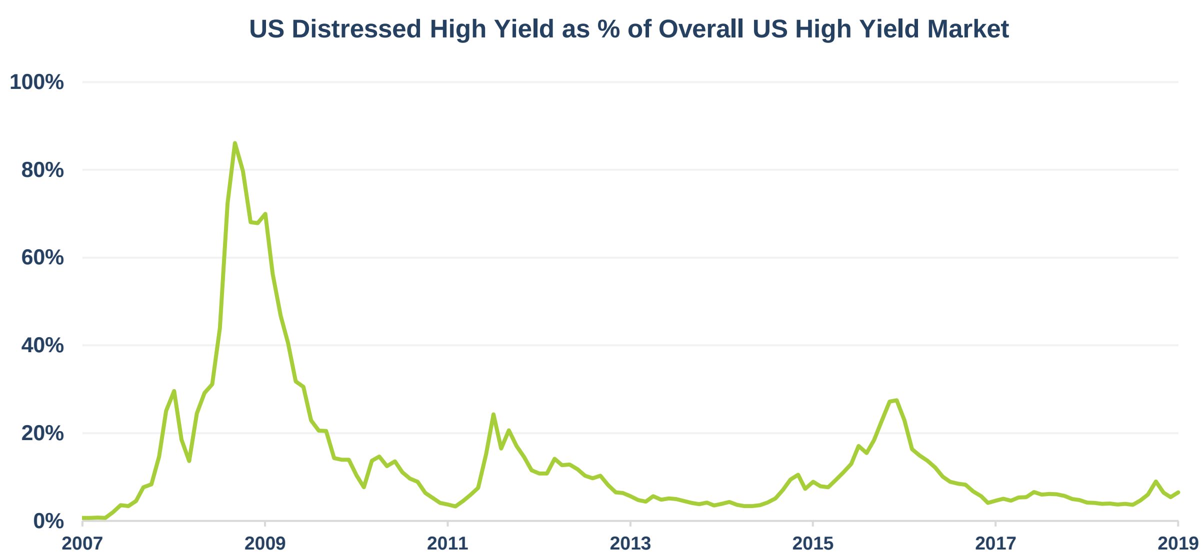
This simple rule of fundamental value investing can be easily forgotten during periods of negative volatility. It requires the discipline of relying on fundamental knowledge to overcome and take advantage of the emotional swings of the market.

As of March 28th, 2019, the Fund's bond investments were yielding 8.1% with a duration of 1.5, versus 8.2% and 1.7 years at the end of 2018.

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 2019 that Oaktree had agreed to be acquired by Brookfield, we wondered whether the evaporation of an investment opportunity left Howard Marks and his crew frustrated.

After all, the US Distressed High Yield Index of bonds[2] as a percent of the total US high yield index has remained very low.



Source: ICE BAML US Distressed High Yield Index via Bloomberg

[2] 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 summer in 2018, clearly Oaktree was not just "throwing in the towel". Our desire to understand this transaction is driven by seeing a successful independent investment manager, that we've admired for years, decide to give up its individuality.

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 is just another in the evolution of value maximization for the founders. Furthermore, we suspect some shareholders, as the stock had been recently trading close to its IPO price from 7 years ago, were dissatisfied with performance and supportive of the Brookfield transaction. Quite likely, an investor in some of Oaktree's funds 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 to agree to be acquired by Brookfield, 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 as well as 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 Fund.

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