FULCRA
ASSET MANAGEMENT INC.

Winding Road

Macro Musings

Since the beginning of the year, the threat of higher interest rates has played out. The result has been a bond / growth stock rout for the ages, despite the US Federal Reserve (the "Fed") only active at the turret for the last 5 months.

While equity valuations have been clipped, the fundamental adjustment happening at businesses due to higher labor, material, and financing costs, likely needs time for its full impact to be felt.

The path of where we are going is always uncertain. Obvious enough, yet the presence of the "Fed Put" (the concept that the Fed will reduce interest rates if stock prices drop dramatically) mindset over the last 13 years has possibly created a complacency that investors should now square up to.

Inflation seems to be the sole standard bearer (opposed to both full employment and inflation) for today's Fed, given its historic ascendency. For sure, the investment environment has moved to a more uncertain and complicated backdrop.

Macro of Micro-opportunities

Flexibility aka liquidity is an important advantage Fulcra believes investors should build into their fixed income tool kit. The buy and hold strategy for stocks does not always apply to credit investing given the contractual nature of bonds. That may sound counter-intuitive but just like stocks, the price of corporate bonds fluctuate frequently.

FULCRA ASSET MANAGEMENT

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Unlike stocks, however, bonds do not "contractually" benefit from any excess profits that companies generate. As a result, paying up or continuing to own expensive, perceived "contracted" safety does not make much sense in many cases, for corporate bonds rated BBB[1] or below, in particular. Furthermore, many corporate bond fund managers have inflexible investment policy mandates that limit or outright restrict their ability to invest or continue to hold a corporation's bonds.

The importance of the 'Buy' decision is an important contributor to generating differentiated performance. Instead of building a portfolio around a corporate bond index, duration historically being a limiting characteristic, we focus on credits that we like at the right price. Prior to this year, however, the credit risk premium (spread) was at an all-time low while government bond yields were at their near lows. Not a great period to be fully invested in the benchmark.

Fast forward to the middle of 2022 and the universe of opportunities has expanded dramatically. While the yield of longer duration bonds have improved, Fulcra's focus will be on the event driven nature of the secondary market. Earnings volatility driven by inflation / supply chain challenges, technical selling (forced), central bank policy guessing, credit rating changes, etc. will continue to expand the universe of opportunities. Over the next couple of years, the ability for many companies to adapt to this new reality will take many twists and turns.

The current twist in the market created a unique opportunity in the bonds of Seaspan Corp. Late in the 2nd quarter, Lysander-Fulcra Corporate Securities Fund (the "Fund") purchased the company's 6.5% coupon bonds due Feb 2024 at an 8.9% yield to maturity. This bond is a near "investment grade" credit and Seaspan is one of the largest independent owner / lessor of containerships globally. As such, we were excited to add this position to the Fund. At the time of purchase, Seaspan's pari-passu bonds due 5yrs later in 2029 were only trading with 30-50 bps more yield.

As a major marketplace for the financing of the shipping sector, the Scandinavian capital market system has also issued many of these bonds in USD. However, recently the strength of the USD vs Norwegian Kroner has increased the cost of hedging for many Nordic / European funds which has only been exacerbated by the weakness in the overall credit market. The Fund was able to move on this secondary market opportunity due to available liquidity.

[1] S&P's global ratings

An event driven opportunity that the Fund had been buying through the first two quarters of the year are the bonds of KAR Auction. This is a great example of the inefficiency of markets. The recently completed sale of the ADESA US physical auction business to Carvana allows KAR management to execute on their publicly disclosed ambition to deleverage the balance sheet. Yet the only bonds due to be taken out were trading at the end of the 2nd quarter $5 points lower than the Fund first purchased a few months ago. In a worst-case scenario these bonds would be called at $101.281 in May of 2023, generating a 11.2% return to the Fund despite the indicated yield to maturity being 6.6% and 2 years longer in duration.

Looking down the twisting road, the energy and retail sectors possess some interesting opportunities. The discrepancy between the excessive free cash flow generation of some oil and gas producers / service providers and the price credit investors are willing to pay for shorter duration bonds appears wide.

Within retail, many low levered companies, both large and small and leaders in their field, have swooned recently in large part due to an overall "perception" of how the increase in borrowing costs will affect consumer behavior.

Where the road goes, no one knows. Yet, undeniably, it has become a more target rich environment.

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