Q2 2023 Fund Commentary

Equity markets moved higher during the quarter, in some cases sharply, but it was an uneven performance with narrow leadership, leaving many scratching their heads as to what it might imply for the end of the bear market and the likelihood of avoiding a recession altogether. The Nasdaq was the clear leader, pushing higher for the second quarter by 15.4%, and finishing the first half up a stunning 39.3%. While mega cap growth stocks were the leaders, much of the market remained stagnant, as evidenced by the resource and bank-heavy TSX Composite, which rose only 1.1% during the quarter. This lack of market breadth is concerning, highlighting an ongoing "tug of war" between the segment of the market that anticipates, at best, a slowdown, and at worst, a recession, and the few stocks that continue to surge on the back of AI-driven optimism, hopes for a Fed pause, increased Fed liquidity following the bank crisis, or whatever other rationale is needed to drive the chase for winners once again.

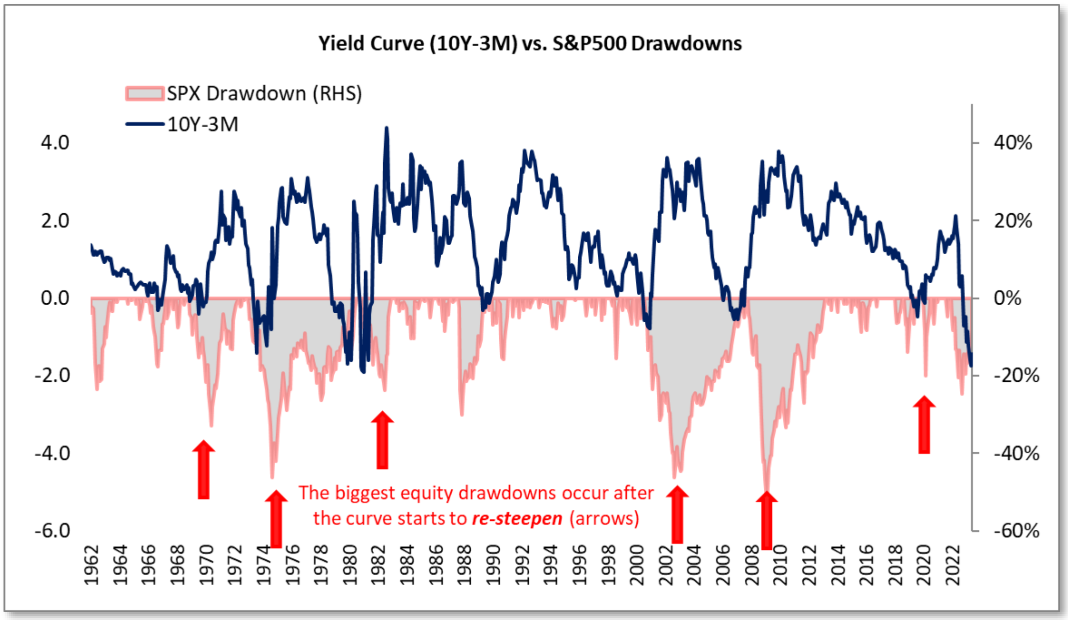
All the factors we typically invest in, such as value, momentum, low volatility, and quality, experienced a decline during the quarter. This left only growth-style investments as the winners. The challenge lies in the fact that these growth-at-any-price rallies pose difficulties for our approach, as we usually avoid owning expensive stocks. Furthermore, our higher volatility and lower quality shorts rallied alongside growth, following a frustrating "rinse and repeat" pattern.

We find ourselves in a tale of two markets, where economically sensitive stocks are anticipating a cyclical slowdown, supported by most hard data. Simultaneously, a narrow group of growth stocks is propelling the broader indices higher. The bond market, with the yield curve the most inverted it has been since the 1980s, appears to back up the view of a recession on the horizon. Meanwhile, investors of all kinds have been compelled to join the rally and move away from defensive positions. This shift may stem from a growing acceptance of the possibility of a "soft landing," but it is equally likely that job preservation concerns are prompting this change. It is nearly impossible to construct a sensible, diversified portfolio that can perform against an index primarily driven by just seven mega-cap tech stocks. This situation evokes memories of the frustrations experienced by managers during the dot-com bubble when Nortel dominated the TSX. Managers were caught in a bind, whether they purchased the necessary weight at exorbitant valuations that ultimately collapsed or maintained discipline and risked losing their jobs.

Are we on the verge of escaping a dreaded recession and entering a new bull market, or are we witnessing yet another bear market rally fueled by hope and hype, with the worst yet to come? It's impossible to say for certain, and compelling arguments can be made for both sides of the debate. However, what we can do is reevaluate the available evidence now that we have surpassed the 18-month mark in this period of 'investment purgatory' triggered by the post-Covid stimulus surge and the Federal Reserve's efforts to unwind it. Below we examine some of the most reliable recession indicators at our disposal.

The 10Y-3M yield curve

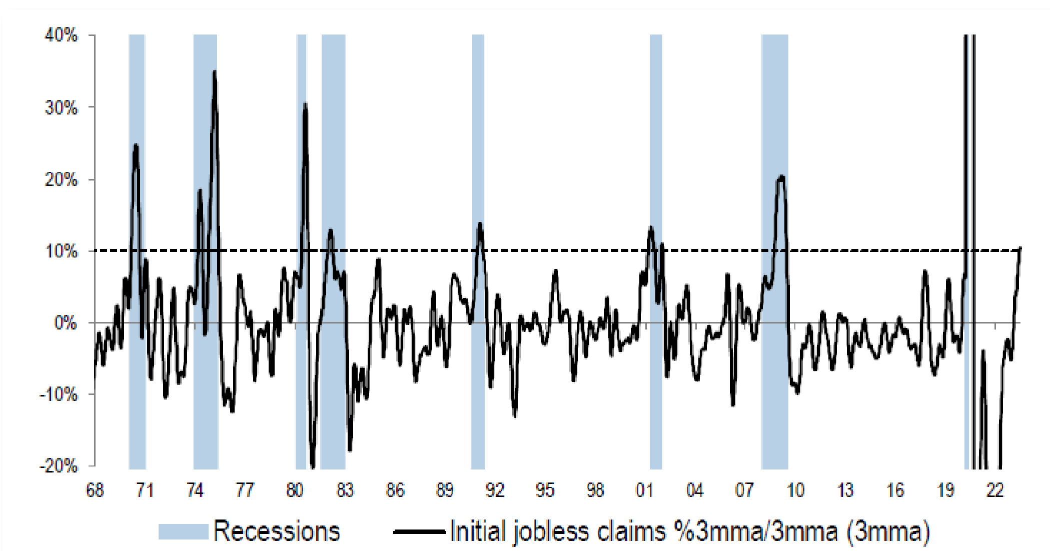
The yield curve, which represents the difference in yields between short- and long-term treasuries, is often cited as a near-perfect predictor of recessions. Fed Chair Powell is known to favour the part of the yield curve that looks at the 10-year note relative to very short-term 3-month bills. Using this part of the yield curve, which was the last to invert this cycle, we note that is has accurately predicted all eight of the last eight recessions. A recession has followed on average 12 months later (with a range as fast as 6 months, and as long as 17 months ahead of the 2008 financial crisis). This cycle, the curve inverted in late October of 2022, and would suggest we are on borrowed time based on this one indicator. The accompanying chart demonstrates equity drawdowns coinciding with these inversions. The current inversion is the most significant since the inflationary bear markets of the 1970s and 1980s, which reinforces its predictive relevance. Notably, the most severe stock market declines tend to occur *after* the yield curve has steepened above zero and is on the rise. This pattern makes sense as the recession takes hold after the Fed has maintained high short-term interest rates, subsequently cutting short rates swiftly in an attempt to mitigate the economic downturn. However, just like rate hikes, rate cuts require time to take effect, resulting in declining stock prices (a cautionary note for those hoping for rate cuts). Given the pain of the most recent bear market, it is sobering to think that another major leg down could be in front of us, but that is one of the paths we need to be prepared for if the history of the yield curve is any guide.



Source: Bloomberg

Jobless claims

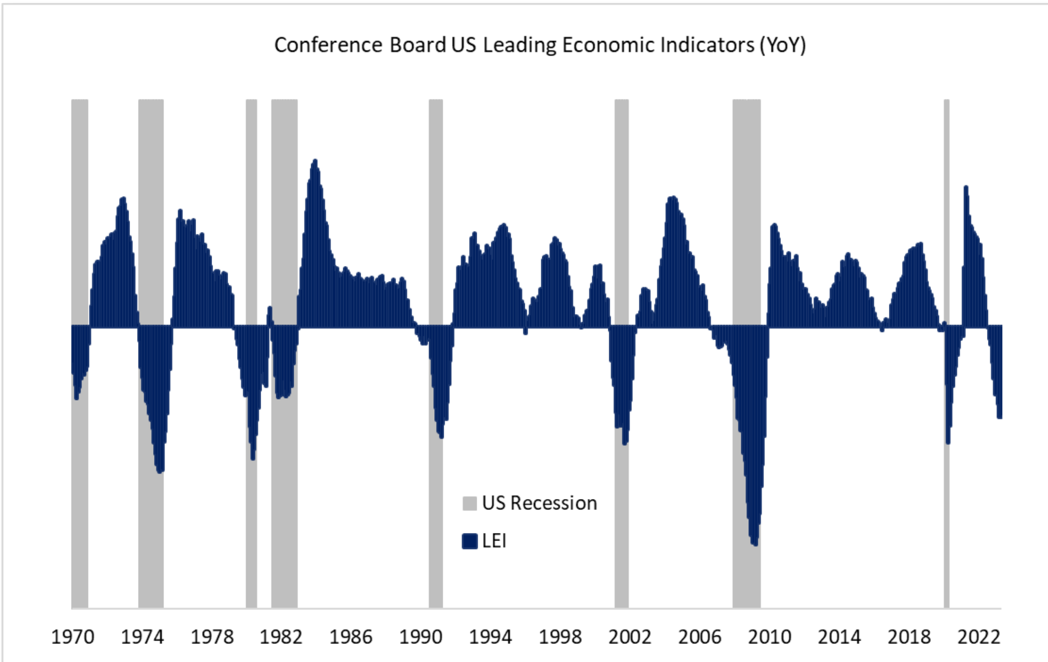
One of the strongest arguments against a recession is the robustness of the labor market, with unemployment rates at their lowest since the 1950s. Wage pressure has been a key concern of the Fed as well, as it views it as the stickiest part of the inflation problem. Though the Fed has expressed it in more diplomatic terms such as "labour market balance", their underlying desire is for a higher unemployment rate that curbs the need for employers to offer higher wages, thus mitigating the risk of entrenched inflation. From a predictive standpoint, what matters is the rate of change in initial jobless claims data. According to the chart below by J.P. Morgan, claims have surged by just over 10% on a quarterly basis, surpassing the threshold that has predicted every recession since 1968. While we'll give some latitude on this metric given the low starting point of unemployed, we can check the recession box here as well.



Source: J.P. Morgan, Bloomberg

Leading economic indicators (LEI)

The Conference Board's leading economic indicators index is another historically successful tool for predicting recessions. This index combines the indicators previously mentioned, along with data such as new orders, building permits, leading credit, and consumer expectations. It too has never been wrong in predicting the last eight recessions. While small dips in the index below zero (like in 2015) haven't resulted in recessions and more likely indicate a slowdown, the current level of the index aligns with the onset of previous recessions or imminent recessionary periods. While it's a credit to the resilience of this economy, and evidence of just how far the fiscal and monetary stimulus unleashed after Covid can carry us, once again we have to give the edge to recession over soft-landing.

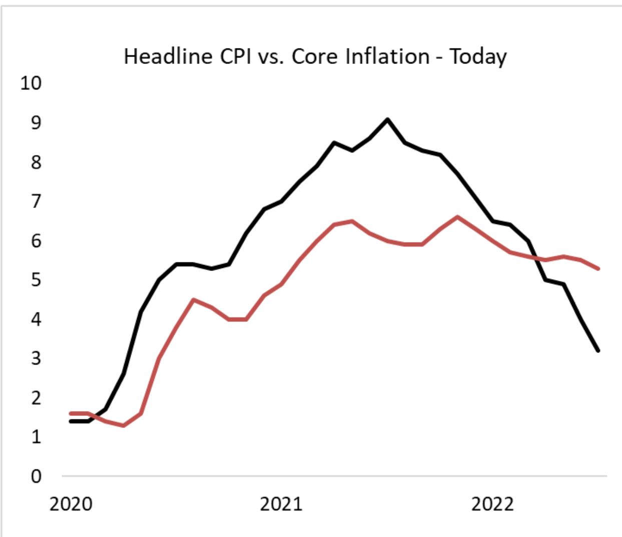


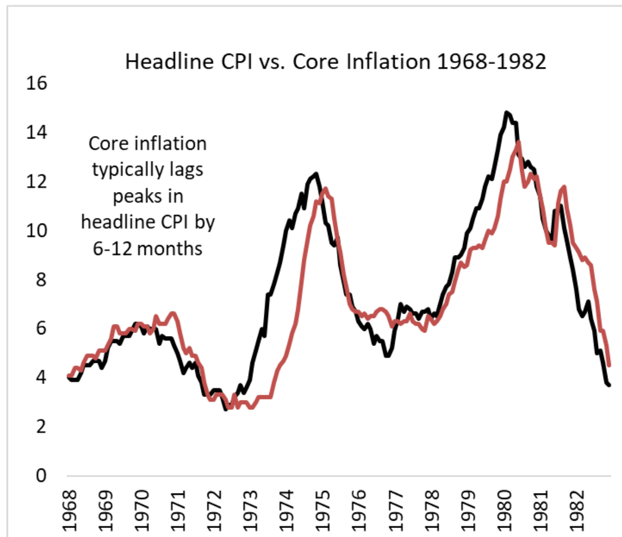
Source: Bloomberg

So, if much of the historically reliable data is pointing to recession, how and why is this market rally as strong as it is? One reasonable conclusion could be that this cycle is unlike any other in history, and there would be compelling arguments in favour of this. We have seen all manner of unique occurrences post-pandemic and we have been dealing with many formerly unprecedented events. It could be that old indicators fail as predictors under new assumptions. The other possibility, and one that is at least a major contributing factor to the rally, is that of positioning. Investors have been "stopped in" to this market, with sentiment and positioning moving from bearish and scared at the end of last year, to bullish and greedy today. The retail army has reengaged, adding some $1.8B/day in June, primarily to ETFs and tech stocks (Morgan Stanley), in contrast to being consistent sellers last year. At the same time, they have been sellers of non-tech single name stocks, further widening the spread of performance between the "haves" and "have nots". Systematic investors (CTAs, risk parity and vol controlled funds) who were either short, or at the low end of their allocation range, at the start of the year, have added some $150 Billion of US equities (Goldman). Hedge Funds, which also started the year near trough levels of exposure, have "re-grossed" their books, and now sit at 100% on a 5-year percentile rank for gross exposure, and have moved up their net exposure as well (Goldman). In short, there has been an influx of buying that have driven markets higher (at least cap-weighted indices) in a true melt-up scenario. The question now becomes: where will the next wave of capital come from? Will it be from the giant and growing pile of money market funds? Eventually, yes, but given the currently high interest rates, there doesn't seem to be a compelling reason just yet for a significant shift in those funds – leaving all eyes on the Fed's path from here.

Is the Fed really going to hike again?

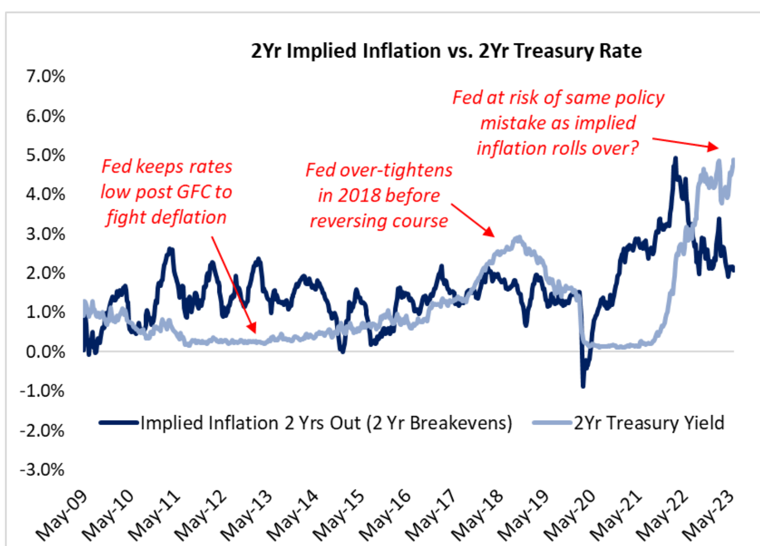
The US Federal Reserve made a curious move by pausing rates in June, only to indicate that they intend to resume hiking in July and anticipate the need for two more hikes. If they truly believed in the necessity of those hikes, why not proceed with them immediately? We believe the Federal Reserve is likely more concerned about the "long and variable lag" that their hiking campaign has on the economy, and they may actually be done with rate hikes. However, they might be cautious about explicitly stating this to avoid further fueling animal spirits and renewed speculation in the markets. While headline inflation has declined meaningfully, with a number of its formerly problematic components like Food and Energy, Durable Goods and Rents all in deflation on a 3-month annualized basis, the argument for higher hikes has been "sticky" services inflation. Looking at past periods however, this is the expected pattern. In the charts below, we can see headline inflation materially lower at an expected 3.2% (using the very accurate Cleveland Fed nowcast for the most recent data point). Core inflation remains "hot" at 5.3%. However, as we can see from the analog of the 1970s and early 80s, once headline inflation turns lower, core follows just as fast 6-12 months later.





Source: Bloomberg, Cleveland Fed

Moreover, when updating the chart (right) illustrating the comparison between 2-year rates and 2-year inflation expectations derived from the bond market, it becomes apparent that the Federal Reserve may be making a policy error by persisting with further rate hikes amidst the current situation of notably positive real yields. This concern is amplified by the fact that they also intend to continue with their quantitative tightening measures, which drain liquidity from banks. Simultaneously, the most recent survey conducted by the Dallas Fed on these very banks revealed that "Credit standards and terms continue to tighten, and loan pricing continued to rise. Bankers' outlooks remained pessimistic, with contacts expecting an increase in nonperforming loans over the next six months." Consequently, we speculate that

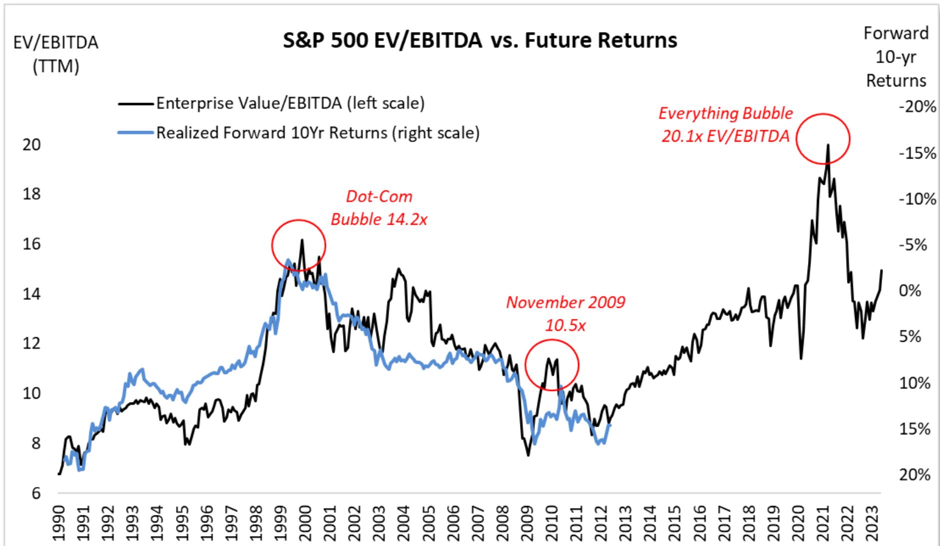


Source: Bloomberg

this pause in their actions is aimed at allowing everyone some breathing space and awaiting additional corroborative data regarding the trajectory of inflation.

Catch-up or Catch-down?

While we have legitimate concerns about the warning signs from recession indicators, there are some positive factors to consider.The resilience of the services economy and the Federal Reserve's pause in rate hikes can't be ignored, and valuations overall have come off the 2021 "everything bubble" peak. Below we update one of our favoured long-term estimates of potential market returns which shows that EV/EBITDA (trailing 12M) for the S&P 500 has decreased from a peak of 20.1x to a still-high but less extreme 14.5x. Unfortunately, the implied forward 10yr returns are right around zero given this starting point. Much of that high valuation, however, is driven by the big weights of the tech sector, with that sector back up to 2021 levels at 21.4x EV/EBITDA, the 3rd major valuation peak since the Covid stimulus in 2020. For context, the tech sector troughed at 5.3x in 2016, taking a full 14 years to reach that level after the dotcom bubble top! If we look at the more cyclical parts of the market, we see valuations of only 4.7x for energy (vs. average troughs of 4.0x in the prior two recessions), 11.4x for materials (vs. average troughs of 7x), and PE Ratios for the financial sector at 13.7x vs a bottom end around 10x. All this to say, that while overall market valuations are not that compelling, the relative valuations between sectors are, making the case for a long/short approach (which has not worked well lately), that can take advantage of an eventual mean reversion between the haves and have-nots. In a "catch-down" scenario, we would expect to see most stocks fall, much like in the 2000-2003 post-bubble market, but for the most expensive stocks to fall much further than their already cheaper counterparts in cyclical sectors. In fact, that '00-'03 period was one of the very best for long/short funds that took advantage of shorting expensive and declining tech and broad markets, while holding long mostly stable cyclicals. In a "catch-up scenario" the economy avoids a recession, or it is shallow and short lived, much like the 2015 slowdown. We could envision an end to the war in Ukraine and a rebuild of that country, or a much talked about, but not yet evident stimulus from China as catalysts for this type of renewed economic growth in the manufacturing and resource sectors. In this case, as expected growth returns to a broad set of stocks, the impetus to pay very high multiples for growth stocks typically shifts to a desire to buy cheap cashflows from cyclical value stocks that suddenly look too cheap. While we can't know which path the market will take, our funds should be well positioned for either, in contrast to the current "growth at any price" rally that seems to find new ways to challenge us. We believe patience and discipline will be rewarded, as it has been historically.



Where to from here?

If "cautiously pessimistic" is actually a thing, it would probably best describe our current positioning, reflecting the challenge of respecting the recently strong market action (never ignore price) but also considering the fact that economic data and earnings expectations remain at odds with this price action. In our long/short equity funds, this has generally meant a mixed risk profile, with Europe, the UK, Australia, and Canada being "risk off," although not by much, while the U.S. and Japan are "risk on" due to their strong markets. Credit markets have remained stable despite higher rates, and we are long high-yield bonds in both our equity and credit funds. We should point out that most of our risk triggers (both on and off) are not far from current market levels, and it wouldn't take much to push our funds back into a defensive position if, in fact, the calls for a recession are correct. At the same time if the market does broaden out in a “catch-up”, our funds will quickly move to take advantage. This endless chop around key levels has been one source of frustration for us as the tug-of-war of views has played out. From a sector perspective, we remain biased towards cheaper stocks that have already priced in a slowdown and, in some cases, a recession, mostly found in energy, materials, and financials. We also have a bias towards defensive consumer staples as the least expensive among that group. Industrials, discretionary, and reasonably priced tech have moved up the ranks, but we continue to avoid or be net short certain parts of the real estate market and interest-sensitive utilities.

We have been immensely frustrated with recent returns in our North American equity long/short funds, and while we understand the market conditions that have caused us grief, we can respect that clients may be less forgiving in the face of alternatives, like the Nasdaq surging higher at the same time as we're struggling. We've always believed that funds that run a consistent process will have periods where they outperform and periods when they don't, but it is incredibly important for managers to stay true to that process and avoid the temptation for style drift. This isn't to say that improvements to the process can't be made — they absolutely should, and we continue to research approaches to improve our results. But we also believe we owe it to our clients to avoid doing things where there is strong historical evidence against it (like buying tech stocks at historically elevated valuations). As always, we will remain patient and disciplined in terms of applying our process, following an approach that relies on actual market changes rather than forecasts of such. We thank you as always for continuing to trust us with your investment dollars.

Fund Specific Commentary

Summary of Returns as of June 30, 2023 (F-Class unless otherwise denoted):

Fund	1M	3M	YTD	1YR	3YR	Inception
Defensive/Conservative Funds:						
EHP Foundation Alternative Fund	-0.6%	-1.8%	-3.8%	-4.1%	1.2%	1.7%
EHP Global Arbitrage Alternative Fund	-0.9%	-2.5%	-0.3%	0.1%	2.5%	4.8%
EHP Strategic Income Alternative Fund	0.6%	0.3%	1.9%	4.7%		1.6%
EHP Multi-Asset Absolute Return Alt. Fund[1]	0.6%	-0.3%	-3.4%	-7.8%		2.7%
Core/Moderate Funds:						
EHP Advantage Alternative Fund	-1.9%	-5.0%	-10.9%	-7.3%	0.1%	1.1%
EHP Advantage International Alternative Fund	1.1%	-1.3%	1.4%	-2.6%	0.2%	0.7%
EHP Select Alternative Fund	-1.7%	-5.6%	-9.6%	-11.0%	1.8%	3.5%
EHP Global Multi-Strategy Alternative Fund[1]	-1.0%	-4.3%	-5.4%	-5.9%		-1.8%
Specialty Funds:						
EHP Global ESG Leaders Alternative Fund	4.0%	0.6%	0.8%	2.1%		2.6%
EHP Tactical Growth Alternative Fund*	June 30th NAV: $9.674					

*Under NI 81-012 rules no returns may be shown until 1 year of track record

Defensive / Conservative Funds

EHP Foundation Alternative Fund

The Fund was down 1.8% during the quarter, with losses from credit and Canadian equity long/short, offset by small gains in U.S. equity long/short. Market breadth has remained extremely narrow, although it showed tentative signs of broadening out in the final few weeks of the quarter. That said, a handful of the largest tech stocks account for the bulk of the gains for the S&P 500. Canadian stock markets were lacklustre, up just over 1% for the quarter, held back by cheaper cyclicals and financials that continue to price a recession. From a factor perspective, value, momentum, low vol and dividend yield styles were all down on a market neutral basis, while growth was the sole style to have gains. The chop and whipsaw that has been a hallmark of the last 18 months continued during the quarter, and was seen in both equity and credit markets. As the Fed draws closer to the end of its hiking cycle, we anticipate that longer-term trends (whether up or down) may reassert themselves.

Our Credit Momentum strategy had small losses over the quarter as yields moved higher in response to renewed inflation fears, and we saw a few false starts for high yield. As we've been suggesting, we believe that flight-to-safety duration will prove to be a useful tool if we do enter a recession. At the end of the quarter, we hold high yield bonds and will add as the choppy trend is confirmed.

From a sector perspective, the Fund has moderate net exposure to high dividend paying stocks in healthcare, industrials, cheaper tech and materials stocks, while underweight utilities and consumer discretionary where yields are lower or less sustainable. The Fund enters Q3 with markets mixed in terms of risk, and with an estimated beta to equity markets of approximately 0.2.

EHP Global Arbitrage Alternative Fund

The Fund was down 2.5% over the quarter as we experienced a few losses from deal breaks or challenges, including a failed management buyout for Canaccord Financial, a deal break with TD walking away from its purchase of First Horizon (although losses were contained due to a put / call structure described in our last update), and a sell off in a number of healthcare deals as the FTC challenged yet another deal (Horizon Therapeutics) on untested legal grounds. The FTC has become the bane of merger arb in recent years, as they are happy to fight deals they don't even appear to expect to win in court, presumably in an effort to stop new deals from ever being contemplated. Partial gains came from a blend of deals closing during the quarter, continued accretion to NAV for our SPAC portfolio including from some early SPAC redemption opportunities.

Merger arb spreads are attractive in our view, with some new and uncomplicated deals offering yields north of 8%, while deals with more risk have much wider spreads. We continue to try to avoid deals with regulatory risk as our odds of being "timed-out", which is a part of our risk process, increases materially. New deal flow has been adequate, but we are mindful of the risk that tightening credit conditions can pose, especially if it results in a recession, and stand ready to decrease merger risk and add defensive treasury duration in that event.

The Fund participated in 57 traditional arbitrage opportunities, and holds 26 positions as of the end of the quarter. SPACs now account for approximately 22.7% of the Fund, represented by 122 positions, although we have a handful of more concentrated SPAC common share allocations where we feel there is value in the option value of an interesting deal being consummated, and where that option was acquired for free. A handful of SPACs have launched during the quarter and, with terms that are attractive enough to warrant us taking a new issue allocation as first day trading, has generally been positive.

EHP Strategic Income Alternative Fund

The Fund was up 0.35% in a range-bound second quarter. High yield average yield traded in +/- 8.5% range, although treasury yields widened by about 60bps, as high yield spreads acted as a buffer tightening by about the same amount.

The core long/short credit strategy had an 84bps positive contribution (our selection in the Insurance and Energy sectors being more notable contributors), credit momentum had a 37bps negative contribution while the risk arbitrage bucket had a small 5bps negative contribution.

The Bloomberg Barclays US Aggregate Bond Index declined by 0.84% with treasury yields widening, while the Bloomberg Barclays US Corporate High Yield Bond Index was up 1.75% in the second quarter. Within high yield, CCC credits were up +4.7%, B credits +1.9% and BB up +0.8% in what was a lower quality rally for credit. The second quarter issuance volume more than doubled year-over-year, pricing more than $53 billion. However, supply, excluding 2022, was still the lowest since 2009 as the Federal Reserve continued its aggressive tightening policy, renewing concerns about a recession and a spike in default rates.

High yield spreads finished the quarter 390bps over treasuries, and remain in the wider half of their historic range (most of the time high yield spreads trade in the 300-400 basis points range). With the all-in yield at 8.5%, high yield credit is expected to deliver attractive long-term returns.

We continued to run our systematic portfolio management process in Q2 albeit at a still reduced churn given the wider bid-ask spreads and implied trading costs. Last quarter's news flows are a testament that while markets seem to want to rally, we are not out of the woods yet and we get comfort in our ability to quickly adapt to changing market regimes. Moreover, our basket of short bonds have a higher probability of default, providing protection should the current tightening policy trigger a default cycle.

We enter Q3 of 2023 with credit risk at the higher end of its range, with duration of 3 and net yield of 7.3% (including the estimated yield from SPACs). The Fund's largest sector exposure is Financials at 21% (with no bank exposure) followed by Energy at 12%.

<u>EHP Multi-Asset Absolute Return Alternative Fund</u>

The Fund was down 0.3% over the quarter, with small losses coming from volatility strategies and small gains coming from trend and relative value strategies.

In commodities, performance was slightly positive for trend, relative value and volatility. In equities, trend was a positive contributor while volatility was a negative contributor. In currencies, relative value was a negative contributor to performance while trend was slightly positive. In fixed income, relative value was flat while trend was slightly negative.

Heading into Q3 of 2023, we are positioned to provide an active hedge against volatile environments caused by inflation or recession and diversifying absolute returns to replace equity and bonds within the Fund's portfolio. Equity positioning is currently neutral, and we are ready to take advantage of a higher volatility environment should recession or inflation fears resurface. Current positioning in bonds, based on trend and relative value, is biased short with a relative preference for Japanese, European and Australian bonds versus British and Canadian bonds. In currencies we favour the value and trend of EUR and GBP versus AUD and CAD. Commodity trend and relative value currently favour the long end of curves over short, with relative value positioning providing continued active inflation protection, with long positions in agricultural commodities and some shorts in industrial metals. As always, the Fund will actively adapt positioning to changes in markets and volatility that will inevitably come with developments regarding supply, demand, inflation, central banks, COVID, geopolitical tensions and otherwise.

Core / Moderate Funds

<u>EHP Advantage Alternative Fund</u>

The Fund was down 5.0% during the quarter, with losses from credit, Canadian equity long/short, and US Dollar exposure, partially offset by small gains in U.S. equity long/short. Market breadth has remained extremely narrow, although it showed tentative signs of broadening out in the final few weeks of the quarter. That said, a handful of the largest tech stocks account for the bulk of the gains for the S&P 500. Canadian stock markets were lacklustre, up just over 1% for the quarter, held back by cheaper cyclicals and financials that continue to price a recession. From a factor perspective, value, momentum, low vol and dividend yield styles were all down on a market neutral basis, while growth was the sole style to have gains. The chop and whipsaw that has been a hallmark of the last 18 months continued during the quarter, and was seen in both equity and credit markets. As the Fed draws closer to the end of its hiking cycle, we anticipate that longer-term trends (whether up or down) may reassert themselves.

Our Credit Momentum strategy had small losses over the quarter as yields moved higher in response to renewed inflation fears, and we saw a few false starts for high yield. As we've been suggesting, we believe that flight-to-safety duration will prove to be a useful tool if we do enter a recession. At the end of the quarter, we hold high yield bonds and will add as the choppy trend is confirmed.

From a sector perspective, the Fund has exposure to cheaper cyclicals that have already discounted a growth slowdown in energy, financials and materials, with increasing exposure to industrials and higher quality tech. Staples represent the largest defensive allocation, while we are avoiding or are net short more rate sensitive utilities and real estate. The Fund enters Q3 with markets mixed in terms of risk, and with an estimated beta to equity markets of approximately 0.5.

<u>EHP Advantage International Alternative Fund</u>

The Fund was down 1.3% during the quarter, with gains led by a surprising strong Japanese market, as well as both longs and shorts in the UK. Those gains were more than offset by losses in credit and European long/short equities. As of the end of the period, European, UK and Australian markets moved to a "risk off" position as their trends showed signs of weakening. Despite the strong headline index performance, we are becoming incrementally more concerned about European economic growth, with our indicators showing a more marked slowdown than in other regions, at odds with the market performance.

Our Credit Momentum strategy had small losses over the quarter as yields moved higher in response to renewed inflation fears, and we saw a few false starts for high yield. As we've been suggesting, we believe that flight-to-safety duration will prove to be a useful tool if we do enter a recession. At the end of the quarter, we hold high yield bonds and will add as the choppy trend is confirmed.

From a sector perspective, the Fund is positioned in the cheaper, higher quality parts of the market, including discretionary, materials, industrials, and financials. We remain allocated to defensive staples where we see more reasonable pricing vs. the supposedly defensive tech stocks. We continue to be net short in real estate, a sector where we continue to be concerned about their ability to refinance high debt levels given the current environment. The Fund enters Q3 with markets mixed in terms of its risk range, and with an estimated beta to equity markets of approximately 0.5.

<u>EHP Select Alternative Fund</u>

The Fund was down 5.6% over the quarter, with losses coming from both long and short positions, as cheaper more economically inclined stocks continued to reprice for a slowdown or recession, and lower quality more speculative stocks were bid higher once again. The Fund's bias to cheaper cyclical stocks in energy and basic materials while avoiding or shorting expensive and unprofitable tech stocks, was a challenge in an environment that saw aggressive short covering/buying in tech (up 19.4% during the quarter) and selling of energy and materials (down 1.0% and 7.2%, respectively, during the quarter).

The Fund is biased to buying higher quality, cheaper stocks, and on that measure the portfolio is holding very cheap companies overall with strong balance sheets. The Fund is well positioned for a cyclical recovery, with exposure in energy, materials, and an increased allocation to consumer discretionary. At the same time, given our overall bias to high quality, cashflow positive stocks that are priced for a meaningful slowdown, vs. holding short, low quality expensive stocks that have not, a recession that causes the repricing of the expensive stocks in a manner similar to 2000-2003 would also be beneficial to the Fund. We remain short real estate and utilities where increased funding costs are likely to compress future earnings.

EHP Global Multi-Strategy Alternative Fund

The Fund was down 4.3% for the quarter. As a “fund of funds”, the Fund holds interests in a number of our EHP alternative mutual funds, with a tactical approach to rotating assets to more defensive strategies as markets become more volatile, and our risk triggers are hit. The Fund entered Q2 mixed in terms of our risk ranges, with a blend of strategies reflecting a mix of “risk-on” and “risk-off” markets globally. We enter Q3 in a similar position, with the underlying funds mixed in terms of risk exposure, waiting for a clearer signal of market direction from the noise of repetitive whipsaw. Both merger arbitrage and credit allocations are showing some of the best opportunities currently, while North American equity long/short has struggled with persistent whipsaw and style factors working against us as described in the fund commentaries above.

Specialty Funds

EHP Global ESG Leaders Alternative Fund

The Fund was up 0.6% for the quarter, with gains on higher quality longs more or less offset by losses on our shorts in expensive or unprofitable technology, and other lower quality equities. Our Credit Momentum strategy had small losses over the quarter as yields moved higher in response to renewed inflation fears. As we’ve been suggesting, we believe that flight-to-safety duration will prove to be a useful tool if we do enter a recession. At the end of the quarter, we have no credit positions as treasury markets have resumed a downtrend.

The Fund utilizes a simplified risk model that uses the MSCI World Index as its primary risk-on/risk-off indicator. We’ve had the good fortune of avoiding the whipsaw that has plagued our other equity funds this year, as well as owning high-scoring ESG companies that carry a defensive tilt, meaning a lower overall fund beta than our non-ESG funds, that have had exposure to more volatile energy and materials sectors.

The Fund enters Q3 risk-on, with its highest exposures to defensive staples, and reasonably priced, high quality, high ESG scoring companies in industrials, consumer discretionary and financials. We are avoiding expensive technology sectors, and are sightly net short utilities and real estate where we see continued financing risk for these typically debt-heavy sectors.

The Fund’s objective is to select longs from a universe of global stocks that are considered “ESG leaders” in their sectors as defined by MSCI. From this universe of ~700 global companies, we apply our time-tested approach of buying those that score well on value/quality, momentum, and low volatility measures. Our shorts comprise global stocks that are expensive, declining and volatile, and excludes any company considered an ESG leader as defined by MSCI. More details on MSCI’s methodology can be found here:

https://www.msci.com/eqb/methodology/meth_docs/MSCI_ESG_Leaders_Methodology_Nov2020.pdf

EHP Tactical Growth Alternative Fund

We are pleased to report that we launched the EHP Tactical Growth Alternative Fund on May 1st with a seed investor. The Fund offers a unique approach to macro and growth investing, and is our first to use “alternative” data sources to determine prevailing economic trends that influence securities prices. Investors understand that different macro environments favor certain investments. For instance, rising inflation is generally unfavorable for bonds but can benefit commodities and related stocks. Similarly, slowing economic growth tends to have a negative impact on equities, particularly cyclical ones. The challenge has always been in determining which regime the market is in, and more importantly, where it is going next.

The Fund utilizes "alternative" data for major economies such as the U.S., China, and Europe. This alternative data encompasses real-time indicators like industrial pollution growth rates from satellite images, estimates of manufacturing based on utility outputs, shipping data from major ports, and scraped price data from websites worldwide, among others, and has high historical correlation with actual economic results. By combining this data with indicators like central bank liquidity, credit metrics, and volatility, the Fund generates "nowcasts" for growth and inflation, and then dynamically adjusts its asset allocation, favoring growth sectors like Tech, Energy and Materials during "growth on" regimes, and rotating towards defensive assets like Treasuries, the U.S. Dollar, and volatility during "growth off" regimes.

The Fund enters Q3 in a defensive position, as we are seeing pronounced weakness in China following its post-Covid reopening, and no signs (yet) of hoped for stimulus. In the U.S., growth is moderate at best. Inflation appears to be falling at an accelerated rate, which while good for bonds, can mean that demand is falling faster than anticipated. Services inflation is also showing signs of decline from highs in our data. The advantage of the approach is that the Fund can move very quickly if on-the-ground data inflects higher, and there is a good chance that China will feel that it needs to do more to stimulate its slowing economy. If so, we would not be surprised to see a renewed bid to commodity sectors.

EdgeHill Partners is the investment manager to the EHP Funds offered under offering memorandum, and is an affiliate of EHP Funds Inc. The Funds are available only in those jurisdictions where it may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or investment advice.

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