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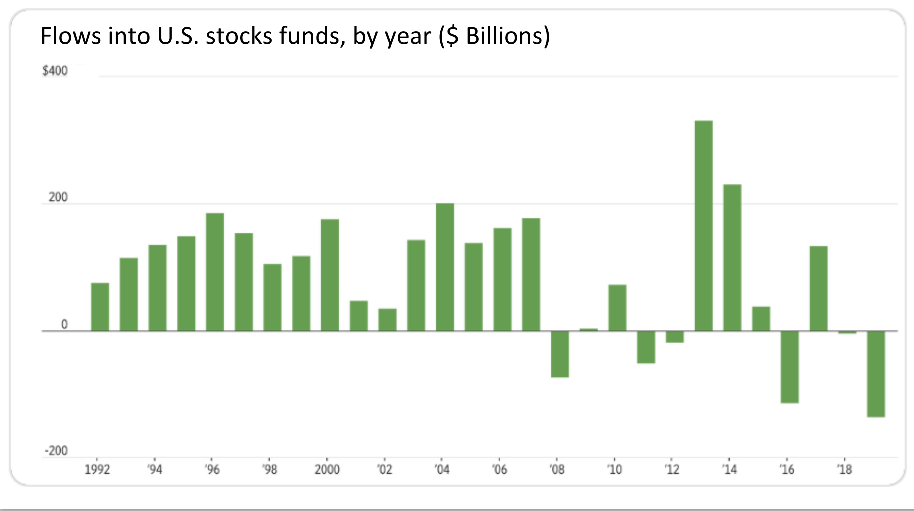
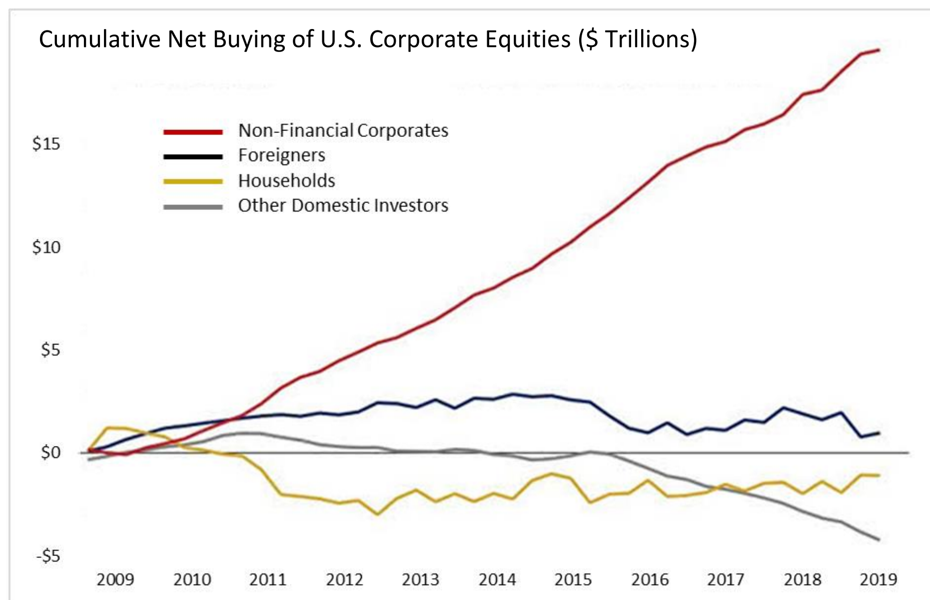
Q4 2019 Fund Commentary

Global equity markets rallied sharply during the quarter, picking up steam into year end as trade tensions between the U.S. and China eased, at least for the time being. In a complete reversal of 2018's mini bear market that saw both stocks and bonds lose money on the year, 2019 saw both asset classes post some of their best gains in years. One of the more remarkable features of the rally in equities this year is that it has occurred in the face of the largest outflows of U.S. stock funds by households on record (chart below).



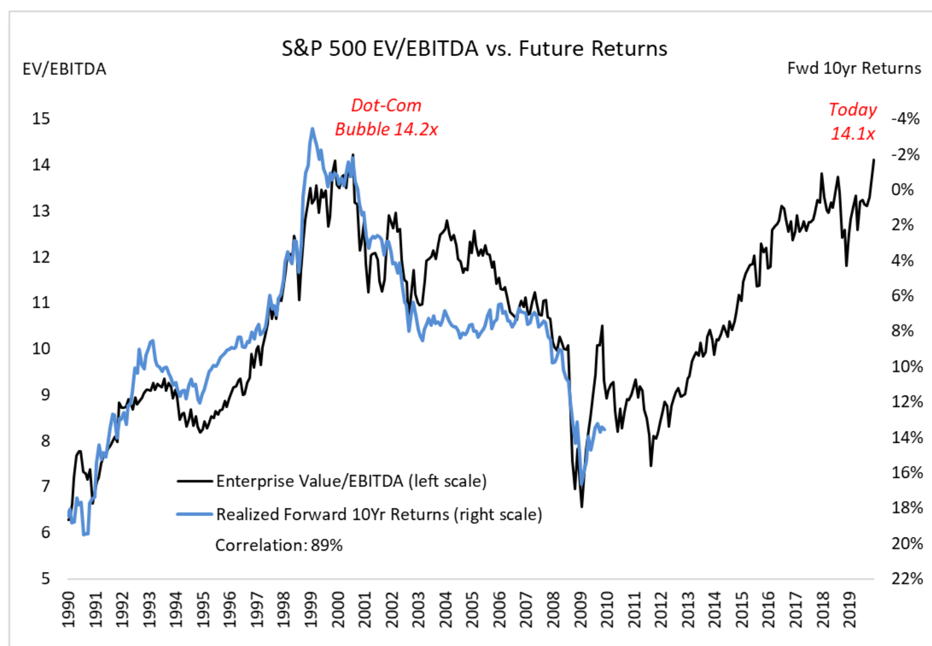
Source: Refinitiv/Lipper, Wall Street Journal

Given this reality, who has been the buyer of stocks all year? Continuing a decade long trend (chart below), corporate buybacks were the primary buyers of equities, fueled by cheap, available debt, and favoured by firms over other uses of cash like dividends and capital expenditures.



Source: Oxford Economics, Macrobond

Another interesting feature of the market's ascent is that is has been driven entirely by multiple expansion, with earnings essentially flat year-over-year. In fairness, earnings had tough comps vs. 2018 when tax cuts gave a meaningful boost, and the multiple expansion this year is in part recapturing some of the contraction that occurred in the 2018 sell-off. That said, there is no doubt that we are ending the year at the higher end of historical earnings multiples, and dot-com levels for other measures like market-cap to GDP (one of Warren Buffett's favourite bubble indicators) , and S&P 500 EV/EBITDA multiples. Given this backdrop, we have a few observations: first, in order to sustain these market levels, companies had better start producing earnings growth again soon, and second, history would suggest that the forward returns from owning pure equity "beta" exposure is more likely to fall into the low single-digits, or even negative, over the next decade (chart below). What we should expect is that there will be more opportunities at the sector and style level for active managers, particularly if the recent recovery in "value" stocks has legs, driven by a reflation and improving global growth picture.



Source: Bloomberg, EHP Funds

Q4 was another challenging one for long/short managers (and an overall challenging year relative to what seemed like "easy" overall market gains). The momentum sell-off that started in September persisted throughout Q4, driven in equal parts by the decline in defensive longs that had been in an uptrend, and the aggressive rally in lower quality, higher leverage, high beta stocks that had been in a downtrend. Our average short position rose nearly 3x as much as our average long position during the quarter, with the highest beta stocks up a stunning 21% on average, in contrast to the lowest beta stocks which were almost exactly flat over the last 3 months. "Factors", as measured by looking at their "pure" market-neutral returns, added little to no value on average in 2019, particularly in the U.S., where Momentum, Value and Low Volatility factors all ended in the red in a volatile year for style-based investing. Over the last 20 years, only one other year (2010) saw a similar decline in each of the "big 3" factors in which we invest. The volatility of factors themselves has risen to a 20-year high, and we suspect

that no small part of this increase, as well as the sharpness of the short-covering rally, is due to underperforming, over-levered long/short fund managers that have faced redemption pressure. Gross unwinding of risk ultimately becomes a self-fulfilling cycle of losses that in turn drives further redemptions. Hedge funds collectively had US$87 billion of withdrawals during the year, requiring multiples of that figure (accounting for leverage) to be unwound in the market, and it's likely that many others have pared back or abandoned allocations to underperforming styles or factors much as they did in the dot-com boom of 1999/2000. We're thankful that in this tough environment for long/short, our process derives returns from multiple, uncorrelated sources including Credit and Merger Arbitrage, and that our approach of gearing up fund beta into market rallies mitigates some of the pressure from rising short positions. As much as we ask ourselves "why exactly do we have shorts again?" during periods like the last few months, we are quickly reminded of just how valuable they can be in markets like Q4 of 2018 in terms of reducing or eliminating drawdown and generating better risk-adjusted returns in the long term.

Where to from here?

As we look through all the recent noise, we do see what we think are some themes emerging for the medium term. While our process, by definition, doesn't try to make predictions, but rather adjusts risk and positioning as markets change, the turn of the year lends itself to reading the tea leaves to a degree. So, in no specific order here are our best guesses for how 2020 might play out:

1. Value stocks should do well given relative valuations and a tendency to outperform in a backdrop of monetary expansion and a steeper yield curve. The last decade in general, and the last few years in particular, have seen value stocks suffer in an environment of declining rates and low economic growth. As central banks work to reflate this mini-cycle, we could see a year similar to 2013 or 2016 where reasonably priced stocks became the market leaders, and expensive defensive and growth stocks lagged meaningfully. One of the things we watch closely is the cross-correlation of momentum stocks to other investment styles. Momentum is a measure of where the money is flowing, and rising correlations to other styles is an indicator of "where the puck is going". In recent months, the correlation of momentum to value stocks has been increasing (albeit from being almost perfectly negatively correlated), while the correlation of momentum to defensive low volatility stocks is declining. These regime shifts take time, and can persist for many quarters once trends flip and money managers reallocate capital from one style to another.

2. We expect inflation pressures to increase as the labour market reaches full capacity and wages rise, and as a decade of underspending in new commodity supply finally moves input costs higher. The Fed has already warned they'll let inflation "run hot", and the market is poorly positioned for this possibility. We expect EM and countries with commodity and strong manufacturing exposure (like Canada and Europe), to finally outperform the tech-heavy U.S. market. Given extremes in U.S. valuations versus those in Europe and Japan, it would not be surprising to see EAFE markets deliver better returns even if inflation remains muted.

3. With a U.S. election on deck, we expect continued market-friendly actions from the Trump administration, such as continuing improvement in U.S.-China trade relations. Industrials, which have suffered due to this overhang, should see a tailwind.

4. A steeper yield curve from a mini-cycle reflation should help financials, while at the same time rising yields and improving growth should take the shine off very expensive growth stocks and bond proxy sectors like utilities and REITs.

5. We expect a robust year for merger activity as corporations with powered-up paper and sluggish organic earnings look to grow through acquisitions. While total deal value was the 4th highest on record in 2019, the number of deals actually declined, and we wouldn't be surprised to see 2020 hit new highs on both measures. Private equity is starting 2020 with a record US$1.5 trillion in unspent capital (versus US$450 billion in PE deals in 2019), and a supportive high yield debt market should allow them to push deal activity above pre-crisis levels.

While our predictions for 2020 would suggest we're optimistic for the continuation of this extended bull market, we'd be remiss not to mention the nagging worries. As mentioned earlier, valuations are indeed high in the U.S. and are priced for perfection. Earnings misses are unlikely to go unpunished in coming quarters. It would also be fair to say that this might be "as good as it gets" in terms of employment gains for the cycle, with the next leg of improvement coming in the form of wage increases. While the yield curve has steepened with the Fed rate cuts and is no longer inverted, it's worth noting that most prior recessions actually occurred *after* the yield curve had inverted and then steepened, much as it has today, and so it would be wrong to signal the all-clear on this data point alone. The 2020 election in the U.S. will almost certainly add volatility and drama, and an outcome like a socialist democrat victory could change business confidence quickly. Even in an election year we don't expect Trump's tweet-induced volatility to subside – the next global flashpoint seems always just around the corner. In short, there are always a host of worrying offsets to any bullish narrative, and the uncertainty is one of the core reasons we have a repeatable, consistent process of managing risk that adapts as market realities change.

We enter 2020 with the Funds at the higher end of their risk ranges, and with all regional markets "risk on". Our Credit Momentum strategy is allocated to high yield debt as it remains in a steady uptrend, in contrast to defensive U.S. long bonds which are at risk of rolling over. We continue to rotate away from more defensive stocks and towards cyclical ones in financial, industrial and consumer discretionary sectors as their price and earnings trends continue to improve. Despite recent grief from rallying shorts, we feel we are well positioned for what is typically the next leg of major regime shifts, where investors come back to higher-quality, value-oriented stocks. As always, we stand ready to quickly adjust risk lower if market conditions worsen in order to protect the valued capital of our investors. We wish everyone a successful 2020, and as always appreciate your trust in us as allocators of your hard-earned dollars.

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Fund Specific Commentary

Summary of Returns (F-Class)

Fund	1M	3M	YTD	1YR	Inception
EHP Foundation Alternative Fund	0.6%	0.3%	3.0%	3.0%	4.1%
EHP Foundation International Alternative Fund	0.9%	1.4%	4.6%	4.6%	6.2%
EHP Global Arbitrage Alternative Fund	1.3%	2.3%	7.7%	7.7%	12.3%
EHP Advantage Alternative Fund	-0.4%	1.1%	6.1%	6.1%	3.2%
EHP Advantage International Alternative Fund	1.2%	-0.2%	7.1%	7.1%	3.9%
EHP Select Alternative Fund	0.9%	3.0%	5.2%	5.2%	2.1%

Defensive / Conservative Funds

EHP Foundation Alternative Fund

The Fund was up 0.3% over the quarter, with long/short equity strategies providing little in the way of contribution as losses on shorts essentially matched gains on longs. Our Credit Momentum strategy had gains as we remained positioned in U.S. high yield debt throughout the quarter, which continued to march higher alongside equity markets despite yields backing up. Merger Arbitrage provided gains in the quarter as well with a number of attractive opportunities in both the U.S. and Canada. The Fund's multi-strategy approach as well as our ability to tilt toward a slightly positive beta in our equity strategies proved helpful in a tough quarter for traditional market-neutral approaches. More recently, high dividend-paying stocks have become synonymous with "value" given that growth stocks typically don't pay a yield, and expensive bond-proxy sectors like utilities are now realizing historically low dividend yields. We enter 2020 with the Fund positioned for a continuation of the emerging value rotation, with a focus on quality, dividend-paying stocks in industrials, energy, and health-care sectors, while remaining underweight expensive utilities and growth stocks.

EHP Foundation International Alternative Fund

The Fund was up 1.4% during the quarter with good returns coming from the long side of the portfolio, predominantly in Europe and Japan, which were only partially offset by losses on short positions. The U.K. detracted from returns as their ongoing Brexit saga and yet another election caused a fair bit of volatility in that market. Our Credit Momentum strategy had gains as we remained positioned in both high yield debt and emerging sovereign debt throughout the quarter, which continued to march higher alongside equity markets despite yields backing up. The Fund's multi-strategy approach as well as our ability to tilt toward a slightly positive beta in our equity strategies proved helpful in a tough quarter for traditional market-neutral approaches. More recently, high dividend-paying stocks have become synonymous with "value" given that growth stocks typically don't pay a yield, and expensive bond-proxy sectors like utilities are now realizing historically low dividend yields. We enter 2020 with the Fund positioned for a continuation of the emerging value rotation, with a focus on quality, dividend-paying stocks in discretionary, industrials, and financial sectors, while remaining underweight expensive utilities and growth stocks.

EHP Global Arbitrage Alternative Fund

The Fund was up 2.3% over the quarter, as existing deals continued to close on schedule and without any deal breaks in the portfolio during the period. A more robust deal environment emerged in the later part of the quarter

as private equity buyers put their large capital pools to work, and a strong high yield debt market supported acquisition activity. There were a number of subscription receipt financings during the quarter which can often provide a good rate of return for arbs, particularly if the sub-receipt trades up post-listing and retail holders are happy to sell for a profit without too much concern for the discount to the common shares. Historically, sub-receipt deals also have the advantage of very high close percentages, and low downside to the receipt deal price when there is a break, making them additionally attractive to arbs. Arb spreads in general remained tight despite a rising rate environment, but there were a number of competitive bid situations and top-ups that provided additional returns. We would note that the average EV/EBITDA multiple for leveraged buyouts has risen to all-time highs at 11.2x, fueled by cheap debt and lots of private equity cash to put to work. The M&A cycle typically ends when the first of these deals fail to close (often because they can't access the debt markets) and we remain ever vigilant for early warning signs of this eventuality. We held just over 113 positions in aggregate over the quarter and enter Q1 2020 with 61 active positions in the Fund. SPACs represent approximately 13% of NAV exposure, and we took advantage of selling in suddenly unloved Cannabis SPACs which, in some cases, are now yielding a guaranteed ~5% annualized return (unlevered), assuming they never consummate a deal, and with the option of a much higher annualized return if they do complete a transaction in a shorter time frame.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was up 1.1% during the quarter, with returns from our long/short equity strategies coming entirely from Canadian equities as both value and momentum styles had gains in our market. Given its cyclical nature, we use a faster momentum cycle in Canada, and the Fund was able to reposition into more value-oriented securities while avoiding some of the pain from an aggressive global short-covering rally. Our U.S. long/short equity strategy on the other hand, was challenged to provide any gains in a market where our shorts went up 3x as much on average as our longs in the quarter. Momentum, quality and low volatility factors were all lower during the quarter, with high beta shorts up a remarkable 21% during the period. Interestingly, growth stocks rose during the quarter, rebounding from their Q3 sell-off, ignoring both the rising yield curve and the bounce in deep cyclicals driven higher by short-covering. Our Credit Momentum strategy had gains as we remained positioned in U.S. high yield debt throughout the quarter, which continued its march higher alongside equity markets despite yields backing up. We enter 2020 with the Fund at the higher end of our risk ranges in both Canada and the U.S., with an ongoing rotation away from low volatility and growth stocks, and towards more cyclical value stocks in financials, industrials and consumer discretionary sectors. Energy weights are increasing but are still below market weights as we await a continuation of recently improving price trends.

EHP Advantage International Alternative Fund

The Fund was down -0.2% during the quarter, with returns from long positions in Europe, the U.K. and Japan more than offset by short positions which were up on average 3x as much during the period. The aggressive short-covering was global in nature as long/short managers continued to be forced out of more defensive positioning while the market "beta" rally picked up steam. Momentum and low volatility factors were down during the quarter in international markets while value and quality provided some positive returns. Our Credit Momentum strategy had gains as we remained positioned in both high yield and emerging sovereign debt throughout the quarter, which continued to march higher alongside equity markets despite yields backing up. We enter 2020 with the Fund

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at the higher end of our risk ranges in all regions, and with an ongoing rotation away from low volatility and growth stocks, towards more cyclical value stocks in industrials, consumer discretionary and "old tech" sectors. Energy weights are increasing but are still below market weights as we await a continuation of recently improving price trends.

EHP Select Alternative Fund

The Fund was up 3.0% during the quarter, with strong returns from long positions in more value-oriented stocks and sectors, which outperformed both the broad S&P TSX Index as well as higher volatility, lower quality short positions. The Fund in general is biased towards cash-flowing value stocks, and notable performers during the quarter included higher quality energy stocks such as Gibson Energy and CNQ, as well as recovering value stocks like CI Funds and Linamar. The Fund is well positioned to outperform in a market that continues to rotate toward more reasonably priced consumer discretionary and industrials, and as industry fund flows continue to move out of expensive bond proxy utilities and REITs. Energy stocks continue to move up the ranks for the Fund, entering 2020 with a near market weight for the sector for the first time in years.

Disclaimers

Returns are for "F" class series of the Funds, are annualized and since inception unless otherwise noted, and are net of fees and expenses. Statistics are calculated using monthly returns. Partial year returns are unaudited. Index statistics use total return indices. The composition of the Funds' portfolio could differ significantly from the index due to the investment strategy employed, and includes differences such as use of credit strategies, use of equal weight positions, use of short positions, varying fund net exposure, varying currency exposure, and investing in small capitalization stocks. Source for all index data: Bloomberg.

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