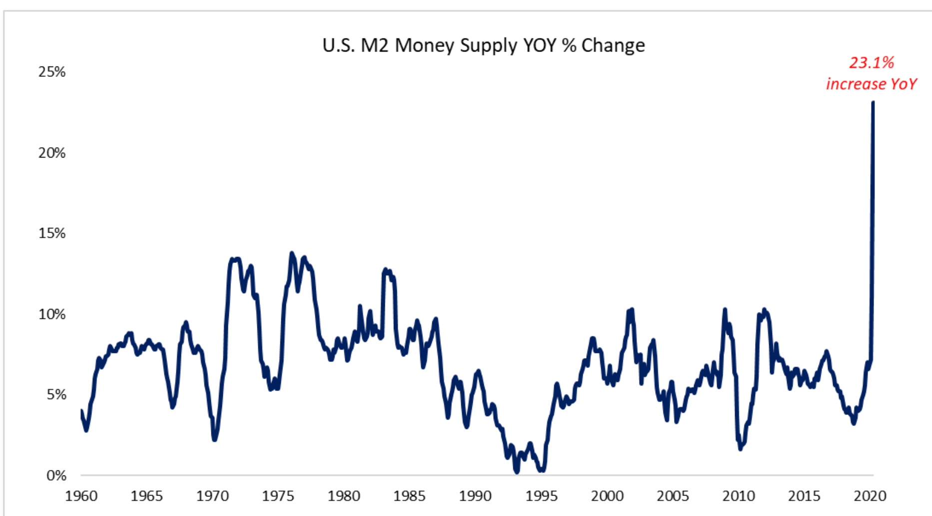
Q2 2020 Fund Commentary

Q2 of 2020 is another one for the record books, and we are running out of ways to say "unprecedented" or "never before seen". Charts for macro data like unemployment and money supply, or commodities like crude oil will have to be redrawn with an asterisk denoting how they moved so far off the charts as to become irrelevant when looking at the long-term history of economic cycles. After the sharpest quarterly decline in nearly a century, the Q2 rally was the largest since 1998, and if it ultimately turns out to be just a bear-market bounce, it would be the largest in history. On the other hand, if we find ourselves in a new bull market, that too would be the quickest recovery in terms of time passed, and the shortest recession on record. If nothing else, we should be open-minded to just about any possibility as it appears now is not the time to become inflexible and married to one's views of what the future holds.

Can there be too much liquidity?

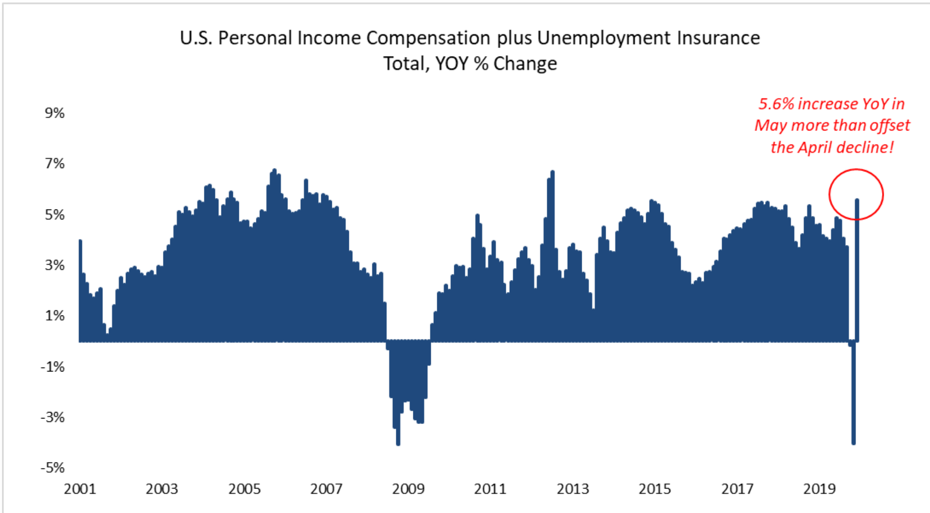
In our prior quarterly letter, we discussed some of the reasons we thought markets had fallen so far, and so quickly in March. A wave of forced deleveraging and an unwinding of numerous levered "carry" trades, combined with suddenly underwater derivative positions created a vacuum of liquidity. Markets ultimately bottomed once the Fed and central banks globally moved swiftly to provide truly unprecedented levels of liquidity, effectively standing ready to become the unlimited buyer of last resort. Balance sheet expansion has been massive, unconventional, and executed in a time frame that puts prior interventions to shame. There are a number of ways to illustrate this, but take a look at the year over year change in U.S. M2 money supply with data to the end of May – it's one of many examples of an "off the charts" event going back to when the series starts in the 1960s.



Source: Bloomberg

This liquidity, combined with the lowering of interest rates back to the zero-bound, has allowed companies to paper over their challenges in the near term. Q2 saw the largest corporate debt issuance ever, in both investment grade and high yield markets, as well as the largest equity issuance ever (including secondary equity, IPOs and equity-linked convertible debt), running at a pace nearly 6x as much as the average quarter over the prior five years. The Fed's unlimited backstop has effectively provided bridge financing for companies to make it through to the other side of the pandemic.

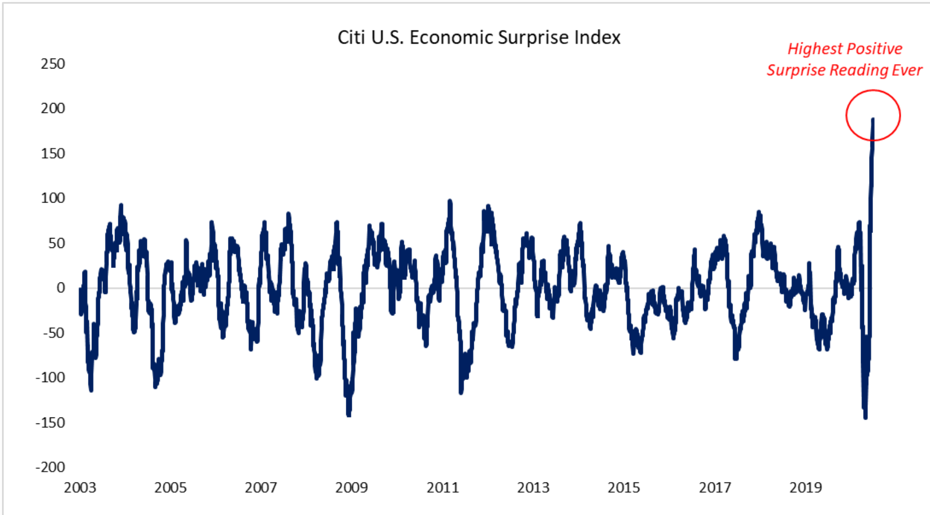
In addition to corporate support, unemployment benefits and payroll protection programs were passed in record time by various governments globally, and are doing an admirable job of backstopping the masses of suddenly unemployed. In the U.S., stimulus cheques for every household plus unemployment benefits have had a rather remarkable effect not seen in any other recession. This chart shows the total of personal income plus unemployment insurance payments, including the effect of the various programs designed to protect workers. Remarkably, total income has gone *up* during the shutdown, with lost income more than replaced by enhanced unemployment payments and stimulus cheques.



Source: U.S Bureau of Economic Analysis with thanks to Bloomberg, Macro Tourist

All this stimulus, while arguably necessary to avoid plunging the global economy into an outright depression, is having some unusual side effects, and rewriting the rules of the usual recession "playbook". Personal savings rates have skyrocketed as cash has shown up in bank accounts coupled with slower spending due to shutdowns. Retail sales, which initially plunged the most on record, have since rebounded sharply, as have mortgage applications for new homes and online searches for new car purchases. Demand for some typically cyclical consumer discretionary items is also off the charts – SeaDoo maker BRP Canada, for example, can't make enough of its watercraft products to keep up with increased demand. We can also argue that the stimulus is at least partially responsible for some of the increased speculative investing we have seen. Closed casinos, no sports to bet on, "free" government money and zero commission trades have combined to reignite retail day-trading activity not seen since the dot-com boom of the 1990s. New retail account openings, trading volume at online brokerages, and small-trader call option buying are "off the charts" as a result. The "Robinhooders", a nod to the free trading app popular with millennials, have made shorting the junkiest securities a hazardous occupation as they descend on low-dollar priced stocks, temporarily driving up market caps of otherwise worthless companies. There is perhaps no better example of this speculative excess than the phenomenon of bankrupt car company Hertz trading up so much post-filing that they attempted to sell $500mm of admittedly worthless stock prior to the SEC deciding that wouldn't be in the best interest of the mostly retail buyers.

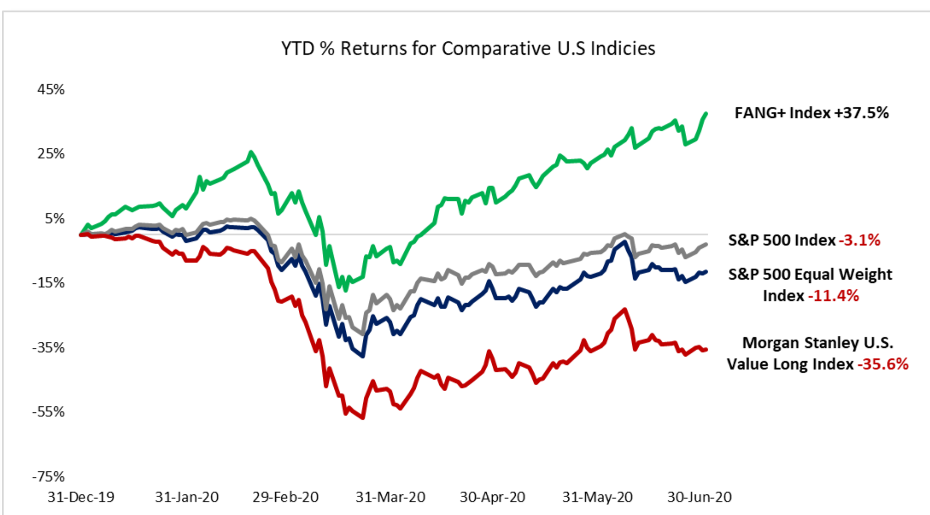
Suffice to say, all this liquidity has made the business of prediction additionally difficult. Companies have been unwilling or unable to provide guidance, and the dispersion of analyst estimates has increased materially as a result. Macro estimates have been off the mark by a wide range – as evidenced by the Citi U.S. Economic Surprise Index which has gone from the largest negative reading to the highest positive by a wide margin in just a few months:



Source: Bloomberg

A tale of two markets

The market rally has certainly not been spread evenly across stocks and sectors. In some ways it has been a tale of two markets, with the "haves" - stocks with defensive characteristics like high quality consumer staples, or technology growth stocks, who's businesses have been largely insulated from the pandemic, and the "have nots" - who have been more directly affected by the shut downs, typically in value-oriented or cyclical sectors. Ironically, this has pushed the already wide performance and valuation gap between "growth" and "value" even wider, driving overall market valuations, which were already at peak multiples before the pandemic, to even higher levels. The largest of these growth stocks are exerting an enormous upward pull on the market-cap weighted index. The Top 5 tech companies (MSFT, AAPL, AMZN, FB and GOOG/GOOGL) now account for more than 20% of the total market cap of the S&P 500 Index, pulling up the overall returns to down just 3.1% on the year, while the "average" stock in the index remains down 11.4%. Long-suffering value stocks, largely comprised of financials and energy stocks, remain left for dead, off their lows, but still down 35.6% on the year:



Source: Bloomberg

The positive read on this ever-widening divergence is that for those who have felt they have "missed" the rally, there are still ample returns available in the lagging sectors *if* we are truly in the next bull market, and the economy can reaccelerate as a result of re-opening. There have been fits and starts of value stocks outperforming as the narrative shifts towards a quick reflation or potential for a vaccine, only for them to fall back as optimism is tempered by setbacks given new virus outbreaks. The back and forth has caused extreme levels of factor volatility, with wild swings in momentum, low volatility and value indices year to date. If nothing else, we expect the bumpy ride will continue as it will be unclear for some time whether the stimulus provided so far will ultimately prove to be too much, stoking fresh asset bubbles or even inflation, or not enough to jump start an already tired economy.

Where to from here?

As risk managers that rely on measuring trends, volatility and understanding historical precedents, the last two quarters have been exceedingly challenging to navigate. Seemingly every prior "boundary" of risk measurement has been tested or exceeded, and in most cases in record time frames. Our risk-gearing process has been put to the test as to how quickly we can adjust to avoid drawdowns and then re-engage a new uptrend, but overall, we have been pleased with the results. Pandemics are obviously not "normal" events and so we are thankful to be able to rely on our systematic process and not emotion when navigating these markets. The jury is still very much out, in our opinion, on what might come next for markets. While we don't expect another liquidity "crash" given the backstop from the Fed, it's also hard to envision a smooth return to work and an immediate rehiring of the mass unemployed. Valuations are very high in many parts of the market, and the unintended consequences of stimulus money that must go somewhere may have yet to fully play out. We need to be open to a wide variety of outcomes, including ones that might make little sense on the surface.

In terms of current EHP Funds' positioning, while directional risk is now close to the higher end of our ranges, we are not far from levels that would cause us to reduce risk again quickly. From a style and sector perspective, we are fairly balanced between the potential for a cyclical reflation that would be common after emerging from recessions, and the possibility that markets fall back again as bankruptcies and job losses pile up. Our process of seeking out reasonable valuations plus strong price trends, leads our exposures towards defensive consumer staples and high-quality tech, but also to more cyclical industrials and consumer discretionary. Weak relative trends have us avoiding REITs and utilities, as well as "deep value" energy and materials while we wait for either improved cash flows, and/or stronger price momentum. While growth stocks have out-shined everything for the last few years, their excessive valuations keep us underweight, and ironically we suspect they are the most at risk of future underperformance in the event we are actually in a new cyclical bull market.

As always, we will remain patient and disciplined in terms of applying our process, diligently following our models that rely on actual market improvements and not forecasts of such. We wish everyone a safe and happy summer and as always appreciate your trust in us as allocators of your hard-earned dollars.

Fund Specific Commentary

Summary of Returns (F-Class)

Fund	1M	3M	YTD	1YR	Inception
EHP Foundation Alternative Fund	0.7%	1.8%	-0.9%	-0.6%	2.5%
EHP Foundation International Alternative Fund	-0.1%	0.7%	-2.6%	-1.2%	3.0%
EHP Global Arbitrage Alternative Fund	0.3%	10.5%	-0.7%	3.6%	8.5%
EHP Advantage Alternative Fund	0.5%	4.4%	1.1%	2.6%	2.9%
EHP Advantage International Alternative Fund	1.5%	5.3%	-2.3%	-3.0%	1.6%
EHP Select Alternative Fund	2.1%	20.4%	9.7%	12.2%	6.7%

Defensive / Conservative Funds

<u>EHP Foundation Alternative Fund</u>

The Fund was up 1.8% over the quarter, with gains coming from a mix of Merger Arbitrage, Canadian equity long/short and Credit Momentum strategies. Gains on U.S. equity longs were nearly fully offset by losses on shorts as low quality, volatile stocks that had been in a downtrend reversed course aggressively during the quarter. We had entered the quarter at the low end of our risk ranges, a position we had maintained since markets rolled over in late February, and as markets recovered throughout April and May we added both gross risk and directional beta. High Yield credit was the first “green shoot”, recovering quickly off the March lows as the Fed moved to backstop the bond market including directly purchasing high yield and corporate debt for the first time ever. The Fund rotated from its profitable U.S. 30-yr Treasuries holding into High Yield credit by the end of April. Equity markets followed suit, rising through our key risk levels, and by early June the Fund was at the higher end of its risk range, carrying a beta of approximately 0.3. We enter Q3 in a similar position, although with persistently high market volatility and risk indicators not too far away from levels that would cause us to decrease risk again should this rally ultimately fail.

From a sector and style perspective, the Fund is skewed toward higher quality dividend-paying stocks in healthcare, financials and industrial sectors, while avoiding the most overpriced growth stocks. As such, the Fund is expected to outperform if a cyclical rotation takes hold as is typical of post-recessionary bull-markets, but has been elusive so far.

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

The Fund was up 0.7% over the quarter, with the bulk of gains coming from our Credit Momentum strategy, which rotated out of its profitable U.S. 30-yr treasury position and into High Yield and Emerging Sovereign debt in late April. Long/Short Equity strategies were challenged to provide much return given our defensive positioning and the nature of the sharp market rally which was led by higher beta, lower quality stocks. International markets generally trailed the U.S. recovery, with Japan rising through our key risk indicators first, followed by Europe in early June. Australia and the U.K. are generally lagging the recovery seen elsewhere, but are also approaching levels that would position the Fund at the higher end of its risk range. We enter Q3 with directional beta approaching 0.3, although with persistently high market volatility and risk indicators not too far away from levels that would cause us to decrease risk again should this rally ultimately fail.

From a sector and style perspective, the Fund is skewed toward higher quality stocks in healthcare, technology and industrial sectors, while avoiding the most overpriced growth stocks. Deep value sectors such as energy and materials remain underweight while we await signals that the recent rally is turning more cyclical in nature which would be typical of a post-recession reflation, but has been elusive so far.

EHP Global Arbitrage Alternative Fund

The Fund was up 10.5% over the quarter, as spreads quickly recovered from some of their widest levels in history. As noted in the previous quarterly letter, merger arb spreads saw huge deleveraging in March, but snapped back quickly alongside other spread or "carry" trades as the Fed stepped in to backstop corporate and high yield bonds. Our view at the time was that the wide spreads were not correctly discounting the likelihood that most deals, historically, still close on their original terms even in times of large market dislocation. So far, our thesis has been accurate, with 58 deals closing since March, and 8 deal breaks, or an 88% close rate. While lower than the long-term average of a 94% close rate, it is clear the market had over-discounted the possibility of wide-spread deal failure. In a number of deal breaks, notably Taubman Centers and ForeScout Technologies, the buyers are attempting to use the pandemic as a material adverse change. These cases are off to court, where the odds, in our opinion, favour a resolution for the sellers, and we see good optionality in holding these "broken" deals at current prices.

We were able to take advantage of the huge volatility during the quarter to enhance returns by rotating more actively among spreads as their spreads widened and tightened, often on funds flow alone and not the relative merits of the deal itself. The gold market was active for mergers, and we expect will continue to be so, and we were able to take full advantage of a 3-way bidding war for Guyana Gold, which ultimately had a final winning bid some 240% higher than the original proposed deal price. The SPAC market, which held in better than more liquid merger spreads in Q1, rebounded sharply in Q2, finishing with the average SPAC trading through their trust value, suggesting that investors were willing to pay up for the optionality of a "good" IPO deal being consummated. In fact, the SPAC market has become one of the destinations for speculative money flow, with SPAC IPOs like DraftKings, Virgin Galactic and Nikola becoming retail darlings with massive short-term gains. We ended Q2 with a slightly higher than normal allocation to SPACs given the relative attractiveness of little to zero downside and willing buyers to sell to on seemingly any deal announcement.

One potential challenge for the Fund in the near term is the lack of new merger activity to replace deals rolling off. This is typical during periods of recession/recovery, and activity usually picks up with about a 4-6 month lag from market bottom. In the interim, we are utilizing our Credit Momentum strategy, and holding high yield debt as a proxy for merger spreads until traditional merger deals become available.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was up 4.4% over the quarter, with gains from both Canadian and U.S. equity long/short strategies, as well as from Credit and Merger Arb. Gains in long equity holdings were tempered by losses in shorts, where low quality, high leverage, high beta stocks performed best as the market rebounded from the panic lows of March. Our process of removing "dangerous shorts" where a stock has fallen too far, too fast, and now trades as a "call option" on survival served us well in the rebound, helping the Fund avoid being short the most severe part of the junk rally. With the most shorted stocks up some 56% during the quarter, the approach of systematically avoiding the hardest hit clearly has merit. The USD currency was a detractor from returns, giving back some of the gains accrued during the March panic, and moving us to the lower end of our tactical range for exposure to the flight-to-safety currency.

We had entered the quarter at the low end of our risk ranges, a position we had maintained since markets rolled over in late February, and as markets recovered throughout April and May we added both gross risk and directional beta. High Yield credit was the first "green shoot", recovering quickly off the March lows as the Fed moved to backstop the bond market including directly purchasing high yield and corporate debt for the first time ever. The Fund rotated from a profitable U.S. 30-yr Treasuries holding into High Yield credit by the end of April. Equity markets followed suit, rising through our key risk levels, and by early June the Fund was at the higher end of its risk range, carrying a beta of approximately 0.7. We enter Q3 in a similar position, although with persistently high market volatility and risk indicators not too far away from levels that would cause us to decrease risk again should this rally ultimately fail.

From a sector and style perspective, the Fund is currently balanced between the competing "stay at home" defensive, high quality, lower volatility stocks in consumer staple and technology sectors, and the "return to work" cyclicals in industrials and discretionary sectors. Deep value sectors like energy materials remain underweights as we await more evidence and improving momentum before our process would shift allocations towards them. REITs and Utility sectors are net short given their relative underperformance and expensive valuations. The Fund is well positioned for the near-term uncertainty of a market that is having trouble deciding if this is a new bull market, or a bear-market rally that ultimately fails. We would expect continued rotation away from defensives and towards cheaper cyclicals if a value rotation takes hold as is typical of post-recessionary bull-markets, but which has been elusive so far.

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

The Fund was up 5.3% over the quarter, with gains in equity long/short strategies in all regions, led by Japan. Credit Momentum and Merger Arb strategies were also contributors. Gains in long equity holdings were tempered by losses in shorts, where low quality, high leverage, high beta stocks performed best as the market rebounded from the panic lows of March. Our process of removing "dangerous shorts" where a stock has fallen too far, too fast, and now trades as a "call option" on survival served us well in the rebound, helping the Fund avoid being short the most severe part of the junk rally.

We had entered the quarter at the low end of our risk ranges, a position we had maintained since markets rolled over in late February, and as markets recovered throughout April and May we added both gross risk and directional beta. High Yield credit was the first "green shoot", recovering quickly off the March lows as the Fed moved to backstop the bond market including directly purchasing high yield and corporate debt for the first time ever. The Fund rotated from a profitable U.S. 30-yr Treasuries holding into High Yield and emerging sovereign credit by the end of April. International equity markets generally trailed the U.S. recovery, with Japan rising through our key risk indicators first, followed by Europe in early June. Australia and the U.K. are generally lagging the recovery seen elsewhere, but are also approaching levels that would position the Fund at the higher end of its risk range. We enter Q3 in a similar position, although with persistently high market volatility and risk indicators not too far away from levels that would cause us to decrease risk again should this rally ultimately fail.

From a sector and style perspective, the Fund is currently balanced between the competing "stay at home" defensive, high quality, lower volatility stocks in consumer staple and technology sectors, and the "return to work" cyclicals in industrials and discretionary sectors. Deep value sectors like energy materials remain underweights as we await more evidence and improving momentum before our process would shift allocations towards them. REITs and Utility sectors are underweights given their relative underperformance and expensive valuations. The Fund is well positioned for the near-term uncertainty of a market that is having trouble deciding if this is a new bull market, or a bear-market rally that ultimately fails. We would expect continued rotation away from defensives and towards cheaper cyclicals if a value rotation takes hold as is typical of post-recessionary bull-markets, but which has been elusive so far.

<u>EHP Select Alternative Fund</u>

The Fund was up 20.4% over the quarter, with the Fund taking full advantage of the recovery in higher quality consumer discretionary, industrial and even energy sectors, while balanced out by more defensive communications services holdings. The Fund is generally biased towards "value" stocks, and as such was able to participate in a larger part of the strong bounce off the March lows. Our process of removing "dangerous shorts" where a stock has fallen too far, too fast, and now trades as a "call option" on survival served us well in the rebound, helping the Fund avoid being short the most severe part of the junk rally, particularly in energy stocks where, as a result of the systematic approach, we covered all such shorts in late March.

We had entered the quarter at the low end of our risk ranges, a position we had maintained since markets rolled over in late February, and as markets recovered throughout April and May we added both gross risk and directional beta. Canadian equity markets moved to a “risk-on” position in early June, and we enter Q3 at the higher end of the Fund’s risk range and a beta of approximately 1.0, although with risk indicators not too far away from levels that would cause us to decrease risk again should this rally ultimately fail.

From a sector and style perspective, the Fund is weighted toward “return to work” sectors in discretionary, industrial and energy sectors, with exposure to the few remaining reasonably priced technology stocks. REITs and Utility sectors are underweights given their relative underperformance and expensive valuations. The Fund is well positioned for a continued bull market and relative value rotation toward much cheaper cyclicals that is typical of post-recession recoveries, although stands ready to reduce risk quickly should this rally prove to be a lower high in an ongoing bear market.

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