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Q3 2020 Fund Commentary

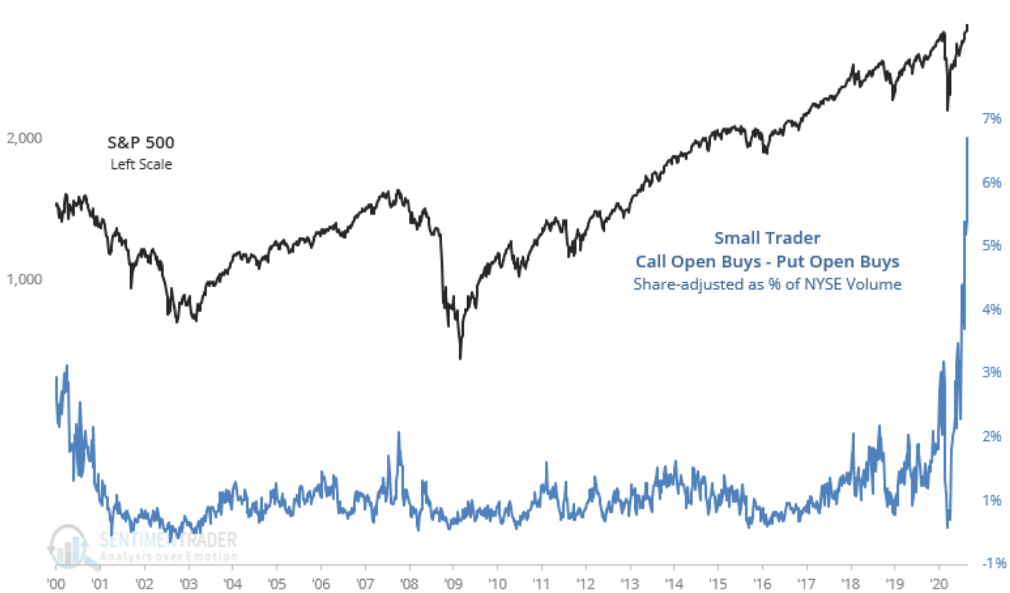
Q3 saw more gains for North American stocks, but with the first meaningful dose of downside volatility since the March sell-off. International markets had a tougher time hanging on to their gains, with more notable weakness in the U.K. and Europe as the dreaded second wave of COVID-19 materializes. The strangeness of this rally persists, with a preponderance of "unprecedented" events including more evidence of the power of the small retail trader driving short-term speculative flows, the U.S. Fed with a major policy shift that will see them deliberately allow inflation to "run hot", and the prospect of a contested election before ballots are even counted. The one thing that hasn't surprised is that volatility has remained elevated, and given both the gridlock in Washington over extending the stimulus, and the near-term uncertainty of the U.S. election, we would expect volatility to remain the one constant we can count on.

A bull like no other

Given that the S&P 500 hit a new all-time high in August before the pullback in September, we think the debate as to whether we are in a new bull market or just a bear market rally is probably settled in favour of the bulls, but it is also fair to say that this is a recovery like no other. A typical bull market tends to be led higher by beaten down cyclical stocks as the market starts to forecast improving economic growth and interest rates move higher off their lows. In contrast, this rally has been led by some of the most expensive growth stocks, while interest rates have been stubbornly pinned near trough levels. The logical explanation is that this rally has effectively been funded by central banks doing "whatever it takes" to bridge the gap between the pandemic and a return to normal, which has resulted in more of a recovery in the price of assets rather than a true economic recovery. While central banks have arguably done the right thing to prevent an outright depression, and in record speed, it is almost certain that more stimulus will be needed as the pandemic drags on. As Fed Chairman Powell has suggested, stimulus needs to come in the form of fiscal spend that puts money directly in the hands of individuals, or longer term via infrastructure programs that directly stimulates economic growth. Given the somewhat binary outcome of a "stimulus versus no stimulus" outlook, complicated further by the upcoming U.S. election, it's perhaps no wonder that we continue to see the market flip-flop from growth/defensive stocks (stay at home), and more value-oriented cyclicals (return to work). In our Funds, we find ourselves relatively balanced between these opposing outcomes, on one hand owning high-quality but less cheap consumer staples and technology companies, and on the other cheaper but more economically sensitive industrial and consumer discretionary stocks. We expect that this "barbell" approach, which is a by-product of our process that seeks to own reasonably priced stocks with positive price momentum, will remain in place until we see a more definitive break in the current trends, one way or another.

Volatility as the constant

Markets have a tendency to evolve over time, and one of the more interesting elements of market structure that has become increasingly topical over recent years is how options and related products that systematically sell volatility have become the tail that wags the market dog. We discussed in our Q1 letter how we viewed the March crash as driven in part by the forced unwinding of levered "carry trades", as well as dealers caught in a "gamma trap" where the sudden market drops caused them to be offside on their hedges and thus forced to sell exposure into a declining market. Gamma works both ways of course, and the market melt-up in August, which was concentrated in the Nasdaq, is another example of this phenomena. The headline news suggested it was a "Nasdaq whale" (believed to be Softbank) who caused the dislocation, but the more likely cause was an army of small retail traders buying short-term call options on single name stocks. The call options in question typically had less than two weeks to expiry and were concentrated in mega-cap tech stocks. These contracts carry a lot of leverage, in some cases 100:1 or more, and require the dealers who sold them to buy the underlying stocks aggressively as they rise in order to remain hedged. This is yet another self-fulfilling "gamma" trade, but unlike March the accelerant was to the upside in August, and then an accelerant to the downside in September in a near mirror image move. For those who find it hard to believe that these small trades can have a meaningful impact, the evidence from the data is remarkable. Since mid-July, trades for 10 contracts or fewer have consistently accounted for more than 60% of all opening call purchase premiums, dwarfing larger trade sizes, and in August alone, these small traders spent ~$40 billion on option premiums (source: Sentiment Trader, OCC). Options trading is apparently the latest expression of the speculative euphoria that has shown in up in parts of the market, and is yet another “off the charts” example when viewed against the historical precedent:



Source: Sentiment Trader, OCC, NYSE

While this particular type of options activity is possibly just a passing fad as these younger investors start to lose money (as they surely did in the September pullback), or as the current speculative wave on tech stocks fades, it is yet another example of how from a risk-management perspective it is becoming increasingly important to understand volatility-based products and their impact on the market, particularly as short-term accelerants of market trends.

The next looming event for the markets that is nearly certain to cause short-term volatility is the U.S. election, and we’ve been asked by a number of clients how we pre-position for events like this in terms of the risk profile of the Funds. Our risk management process doesn’t try to predict what the market might do in the future, but rather responds to changing credit spreads, volatility and market trends. In other words, we don’t attempt to make a “call” on the market direction, but rather we reduce risk as markets actually become less stable, and add risk back as trends reassert themselves. We find that following a process like this avoids making emotional decisions that can turn out to be quite wrong in hindsight. For both the Brexit vote and the 2016 U.S. election, had you told us the outcomes in advance, the inclination would have been to cut risk. But in both cases, the market trend was strong enough that our risk management process kept the Funds engaged, which ultimately proved to be beneficial. Today, we find our risk indicators more mixed heading into the U.S. election. High Yield bonds have weakened enough to cause us to sell the profitable position we entered in late April of this year. Interestingly, U.S. long bonds are not yet acting as the typical flight-to-safety asset, and are not in an uptrend by our measure, and so we end the quarter with no allocation to our Credit strategy, and with cash as the preferred asset for now. In equity markets, International markets are considerably weaker than the U.S., and we’ve reduced risk in Europe, the U.K. and Australia, with Japan still in an uptrend. For now, U.S. and Canadian markets remain risk on, but are now close to levels that would cause us to reduce risk.

What is clear is that investors are very nervous about the outcome of the election, and the odds for it to be contested in the event Trump loses. Based on the insanity of the first presidential debate, its easy to see how this could devolve quickly if there is no decisive result. The VIX futures curve has priced in a lot of volatility for the November *and* December periods, far more than is typical based on prior elections, suggesting that it is not just a Trump loss that is concerning investors, but a messy, drawn out fight in the courts that might ensue. That said, given the amount of pre-positioning and fear ahead of the event, we wonder if anything short of a civil war might actually be viewed as a relief, and form the basis for the next leg up in this new bull market. As always, we'll rely on our process to guide our risk allocation, and not our speculation or emotions.

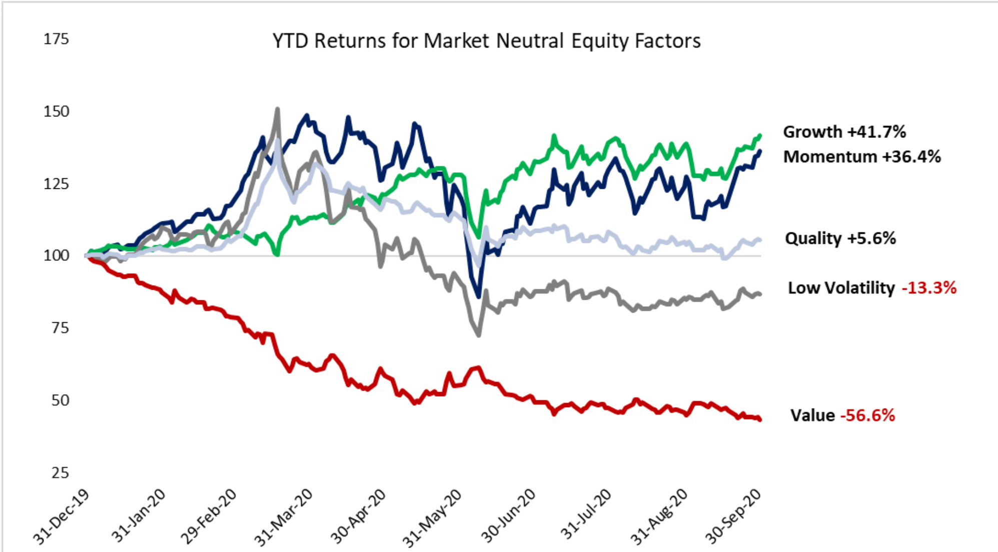
The trouble with bonds

One of the other big events of the quarter was the policy change as it relates to inflation targeting announced by the U.S. Fed. On the surface, it's a subtle change, with the Fed now saying that in the future they will let inflation run "hot" in order to target an *average* inflation rate of 2%. This has some meaningful implications however, especially for holders of long-duration bonds. While central banks have been largely ineffective at creating inflation, it has always been viewed that as inflation increases, they would raise rates to contain it at around 2% in any given period. By targeting average inflation, that implies that they would need to offset multiple years of sub-2% inflation with a similar number of above-2% inflation to achieve their goal. At the same time, the U.S. Fed has stated that zero rates are in fact the lower bound for them, as they likely understand that negative rates destroy the banking system as it has in Europe, and the U.S. money market fund infrastructure is not set up to handle negative rates. Bonds, which are the foundation of the typical 60/40 portfolio approach that has worked so well for decades, are suddenly in the worst of positions. In the short run (next 5 years), yields will likely remain very low, earning investors next to nothing. If rates truly are bounded by zero, there is also virtually no possibility for capital gains from today's starting point. In the longer-term (10+ years), investors now have to factor in the chance of a period where inflation runs well above 2% for years, hurting their real yield and eroding their savings. It has been the wrong call to be negative on bonds as an asset class, but it's clear that bondholders today are between a rock and a hard place. While we expect that bonds will still be useful when used tactically as a flight-to-safety asset, a "buy and hold" strategy for bonds will almost certainly disappoint.

This "repricing" of longer-term bond risk is causing investors to search for alternatives. While we'd be highly biased on the matter, we think it further strengthens the argument for alternative strategies like equity long/short, merger arbitrage, or long/short bond funds. These strategies can offer returns that are similar to the historical expectations for bonds (5-7% annualized), can do so without a great deal of correlation to equity markets, and have the ability to cut the left-tail risk of market crashes due to their ability to profit off of short positions or other tactical positions. We also expect that dividend-paying stocks, which have been squarely lumped into the "value" bucket for the last few years and are often in more "old economy" parts of the market, will once again be in favour as we exit the pandemic, as most of these equities have the ability to not just maintain, but rather grow their dividends over time. Our EHP Foundation Alternative Fund for example, targets sustainable yield as a core factor when selecting long positions for just this reason. Merger arbitrage is another good example of a strategy that can outperform bonds in a low interest rate environment, due to the harvesting of the "deal risk" premium which tends to be fairly constant over time irrespective of rates.

Factor Performance Update

As we enter the last quarter of this very strange year, we wanted to take a look at how the various "factors" that form the basis of our core long/short equity strategies have performed this year. We mentioned that this has been a strange bull market in that it looks nothing like a "typical" bull market recovery after a recession. The key difference is the lack of performance of the cyclical part of the market which has borne the brunt of COVID-19 shutdowns, and that has yet to recover. The pandemic has created distinct winners and losers, and the flow of funds has been so bifurcated into the "haves" and out of the "have nots", that the extremes that existed before the pandemic have been pushed to even greater extremes this year. Below are the main investment styles we track, presented as "pure" factors in that they are market neutral (i.e. equal weight to longs and shorts and without any directional market risk).



Source: Bloomberg, Morgan Stanley

What is striking is just how bad "value" has done, down more than 56% this year, as expensive stocks have gone up, and "cheap" stocks as measured by price to book and price to earnings have gone down. This would actually be normal in the early stages of a recession, but is completely counter to what occurred coming out of the 2000-2003 and 2008 bear markets. On the other hand, the best style this year has once again been "growth", followed closely by "momentum" which tends to adapt to invest in whatever has been working for a period, and has become quite correlated to the growth factor. One of the more surprising results has been "low volatility" investing, which had become the flavour of the day a few years back, but has now suffered as some of the historically "safe" sectors like REITS and utilities have struggled this year, while the most volatile high-flyers have soared.

We highlight these ever-widening divergences because it can serve to underscore the potential risks facing investors who choose to allocate to a single style. U.S. benchmark indices, and by extension average investors, are currently skewed to the growth style, as have the flow of funds into actively managed funds or ETFs that favour growth stocks. However, the pandemic will not last forever, and at this stage any one of a number of catalysts, from a successful vaccine, to deployment of cheap rapid testing, to fiscal stimulus, or just the natural cycle of the virus infection rates fading, could have investors suddenly poorly positioned for a mean reversion into cheaper stocks that outperform as inflation expectations increase. Our approach in the face of these divergences is simple. Rather than attempt to time individually volatile investment styles or chasing only what has worked recently, we allocate to a balance of cheap, rising and stable stocks, while shorting the opposite, which over time delivers the best of what each of these factors have to offer while also avoiding the worst of their difficult periods.

Where to from here?

In contrast to the first half of the year, where just about every historical precedent for risk was tested or exceeded, Q3 showed some signs of a more "normal" market, despite volatility remaining quite elevated, and the persistence of some unusual market action as noted above. The market tends to become focused in the short run on specific events, and clearly the election and the various outcomes are the current focus. It would be typical for the market to remain volatile and driven by technical factors between now and then. As mentioned earlier, we think that the event itself will likely be viewed as a relief, setting up the market for another leg higher into what is a typically strong seasonal period in the latter part of the year. Whether our Funds will enter the election with a lower risk level than we entered October will depend entirely on the risk levels we use to define exposures, and not any emotional reaction we may have to the events in front of us. Looking past the election, and into the next year or so, we think the bigger opportunity in front of us, irrespective of the next U.S. president, is the ultimate waning of the COVID-19 crisis, one way or another. While the second wave appears to be here (although to get the true context of the current wave we would need to backward adjust the more limited testing that was done during the first, which of course would have shown that many more people were infected at the time), but at some point, the pandemic will end. It’s unlikely that the pandemic will end suddenly, even with an effective vaccine, but markets will at some point start to discount its resolution. Given that the stocks that would benefit from a reopening have clearly not recovered, and those that have benefited from the pandemic are at or near all time highs, this sets up for a major risk / opportunity for investors. The risk, of course, is that investors are all on one side of the boat, and rush suddenly to the other causing a rather violent mean-reversion. The opportunity is that once a rotation does start to occur, it will likely last for quarters or even years, providing new investment opportunities in the survivors in industrial, discretionary, financial and even energy sectors.

We do expect that additional fiscal stimulus will be provided to continue to bridge the pandemic economic gap, and it is very clear that central banks around the world have no intention of turning off the liquidity taps anytime soon. Fed Chairman Powell said it best, “we’re not even thinking about thinking about raising rates”. If we want to be optimistic, we could envision an environment where the pandemic is moving into the rear-view mirror, financial conditions remain highly accommodative, and fiscal stimulus, perhaps in the form on longer-term infrastructure spending, is still working its way through the economy. We can debate what this monetary experiment ultimately means for the market, or what the long term consequences might be, but it will almost certainly have a positive impact on the market, particularly for “real world” businesses that benefit from a steepening yield curve or rising inflation expectations.

Given that we don’t make a discretionary call on the timing of the potential scenario described above, but rather respond in real time as trends shift, for now we remain balanced between the haves and have-not sectors. The “haves” show great price momentum but tougher valuations, and the “have nots” have cheap valuation and weaker price trend. We remain of the view that the most expensive growth stocks, as well as the more speculative parts of the market carry the highest risk, as is typical with “glamour” stocks that capture the bulk of investor attention but become valued well beyond any reasonable future outcome.

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 fall and 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	-0.8%	2.4%	1.5%	1.8%	3.3%
EHP Foundation International Alternative Fund	-0.2%	1.0%	-1.6%	-0.2%	3.2%
EHP Global Arbitrage Alternative Fund	0.6%	3.4%	2.6%	4.9%	9.1%
EHP Advantage Alternative Fund	-0.3%	4.6%	5.8%	6.9%	4.8%
EHP Advantage International Alternative Fund	1.7%	6.6%	4.1%	3.9%	4.5%
EHP Select Alternative Fund	-0.9%	5.9%	16.1%	19.6%	8.8%

Defensive / Conservative Funds

EHP Foundation Alternative Fund

The Fund was up 2.4% over the quarter, with gains coming from all sub-strategies, including U.S. long/short equity, Canadian long/short equity, Credit Momentum and Merger Arbitrage. From a factor perspective, the higher quality, sustainable yield stocks that the Fund favours did lag the market leaders in growth sectors, but our approach of also avoiding stocks in a downtrend had us sidestepping the many value traps in the most cyclical stocks. We had entered the quarter at the higher end of our risk ranges, after adding back exposure beginning in late April, and that directional market beta helped drive returns as the markets continued to move higher in Q3. As we move into the historically bumpy month of October, with the U.S. election front and center, the Fund is responding to the increased volatility and weakening broad market trend with a rotation out of our profitable U.S. High Yield position. The Fund currently has no allocation to Credit as U.S. long bonds are not yet in an uptrend. With the sharp correction in September, North American equity markets sit just above levels that will have us reducing risk if weakness persists.

From a sector perspective, the Fund is skewed toward higher quality dividend-paying stocks in healthcare, industrial and consumer discretionary sector, with underweights to financial and utilities, and also continues to avoid the most overpriced growth stocks. As such, the Fund is well positioned to outperform markets if a cyclical rotation takes hold as is typical of post-recessionary bull-markets, while continuing to provide downside protection if market trends reverse.

EHP Foundation International Alternative Fund

The Fund was up 1.0% over the quarter, inline with the 1.2% gain for the MSCI EAFE index, which has struggled to keep up with much stronger U.S. markets. Gains came from a blend of Credit Momentum and Equity long/short strategies, with Japan the strongest contributor followed by Europe. The U.K. market detracted from returns as their economy continues to struggle with the double whammy of the pandemic and a perpetually stalled Brexit negotiation. We had entered the quarter at the higher end of our risk ranges, after adding back exposure beginning in late April, and that directional market beta helped drive returns as the markets continued to move higher in Q3. As we move into the historically bumpy month of October, with the U.S. election front and center, the Fund is responding to the increased volatility and weakening broad market trend. The Fund rotated out of its profitable U.S. High Yield position and currently has no allocation to Credit as U.S. long bonds are not yet in an uptrend. U.K. markets are weak and are in a “risk off” position, and Europe and Australia are approaching levels that will have us reducing risk if recent weakness persists.

From a sector perspective, the Fund is skewed toward higher quality dividend-paying stocks in healthcare, technology and industrial sectors, with underweights in energy and materials.

EHP Global Arbitrage Alternative Fund

The Fund was up 3.4% over the quarter, as merger arbitrage spreads returned to more normal levels and a number of "pre-COVID" deals successfully closed. While there continues to be some notable deal breaks, or at least an attempt by the buyer to get out the transaction, the bulk of deals continue to close, albeit with longer timelines than initially expected. In some of these contested deals, which we avoided prior to the deal break, we liked the risk/reward post break for a renegotiation in the courts, and we benefited from just such a re-cut deal with ForeScout/Advent, and anticipate something similar for the Tiffany/LVMH deal. Traditional deal volume was lighter than usual over the quarter, although it is picking up as companies recover from the depths of the panic and look at what assets and firms remain mispriced. Canadian small and mid-cap deals provided some outsized returns, with spreads trading quite wide relative to larger, more well followed deals in the U.S., and with some unexpected upside in a few situations like Seven Aces, which saw a healthy bump from the buyer to get shareholders onside.

SPACs were once again the topic of the quarter, and our policy of avoiding too much exposure due to the generally illiquid nature of asset class hurt our relative returns as virtually the entire SPAC market moved higher, trading with negative spreads to trust value, implying investors are paying up for the prospect of the next "hot" deal. While we like true SPAC arbitrage where there is a guaranteed positive rate of return and upside optionality, we aren't willing to chase what has become an overheated asset class or pay for "lottery tickets". With a huge amount of SPAC issuance filed, which will nearly double the existing pool of SPACs over the next few months, there is a real risk of the supply overwhelming demand, and if the retail crowd sours on the space, we could see overall spreads come back to attractive levels. In the interim, we remain focused on SPACs that still trade below trust value guaranteeing a positive rate of return, and we expect a number of catalysts in the coming months as our current roster of SPAC holdings approach their deal deadlines.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was up 4.6% over the quarter, with gains from all strategies, led by U.S. Equity Long/Short and with equal contributions from Canadian Equity Long/Short, Credit Momentum and Merger Arbitrage. A weak USD detracted from gains despite having an allocation at the low end of our tactical range. Momentum was the strongest investment style over the period and drove the bulk of gains, while value struggled as a new stimulus bill in the U.S. continues to be delayed and the pandemic drags on.

We had entered the quarter at the higher end of our risk ranges, after adding back exposure beginning in late April, and that directional market beta helped drive returns as the markets continued to move higher in Q3. As we move into the historically bumpy October, with the U.S. election front and center, the Fund is responding to the increased volatility and weakening broad market trend with a rotation out of our profitable U.S. High Yield position. The Fund currently has no allocation to Credit as U.S. long bonds are not yet in an uptrend. Despite a sharp correction in September, North American equity markets are just above levels that will have us reducing risk if weakness persists.

From a sector 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, discretionary and financial sectors. The deep value energy sector, as well as the relatively weak REIT and utility sectors remain underweight as we await more evidence and improving momentum before our process would shift allocations towards them. While the timing of an eventual rotation into more cyclical stocks that would be typical as economic growth picks up remains uncertain, the Fund remains well positioned to take advantage if this reversion does occur.

EHP Advantage International Alternative Fund

The Fund was up 6.6% over the quarter, outperforming the relative weak MSCI EAFE Index which gained 1.1%. All equity long/short regions contributed to gains, with Europe the strongest, and with gains from Credit and Merger Arbitrage. Momentum and quality styles were the strongest over the period, while more traditional deep value continued to struggle as the second wave of the pandemic picks up steam across Europe and the U.K., further delaying a more robust cyclical recovery.

We had entered the quarter at the higher end of our risk ranges, after adding back exposure beginning in late April, and that directional market beta helped drive returns as the markets continued to move higher in Q3. As we move into the historically bumpy October, with the U.S. election front and center, the Fund is responding to the increased volatility and weakening broad market trend with a rotation out of our profitable U.S. High Yield position. The Fund currently has no allocation to Credit as defensive long bonds are not yet in an uptrend. U.K. markets are weak and are in a "risk-off" position, and Europe and Australia approaching levels that will have us reducing risk if recent weakness persists.

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, telecom services and technology sectors, and the "return to work" cyclicals in industrials and discretionary sectors. Deep value sectors like energy remain underweights as we await more evidence and improving momentum before our process would shift allocations towards them. REITs and Utility sectors are also underweight given their relative underperformance and expensive valuations. While the timing of an eventual rotation into more cyclical stocks that would be typical as economic growth picks up remains uncertain, the Fund remains well positioned to take advantage if this reversion does occur.

EHP Select Alternative Fund

The Fund was up 5.9% over the quarter, with gains led by a cross-section of stocks in industrial, consumer discretionary and materials sectors. Given that the Fund has a bias to higher quality value stocks, it tends to look quite different than the TSX Composite, and our gains have come from outside the traditional heavyweight banks and gold sectors, with companies such as Trisura Group, Badger Daylighting, Sleep Country Canada, and Northland Power driving returns during the quarter. The common thread is a higher quality business with good cash flow, return on equity and a reasonable balance sheet, proving that even in a market that favours growth stocks, there are healthy returns in other parts of the market.

We had entered the quarter at the higher end of our risk ranges, after adding back exposure beginning in late April, and that directional market beta helped drive returns as the markets continued to move higher in Q3. As we move into the historically bumpy October, with the U.S. election front and center, the Fund remains "risk on", but market trends have weakened enough that we are close to the levels that would cause us to reduce risk if the volatility continues.

From a sector and style perspective, the Fund is weighted toward "return to work" sectors in industrial, financial and materials sectors. Energy stocks, which were a source of returns on the rebound off the bottom in Q2, have fallen out of the portfolio as their nascent uptrend has failed to hold, despite quite reasonable valuations. 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 rotation toward much cheaper cyclicals that is typical of post-recession recoveries.

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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