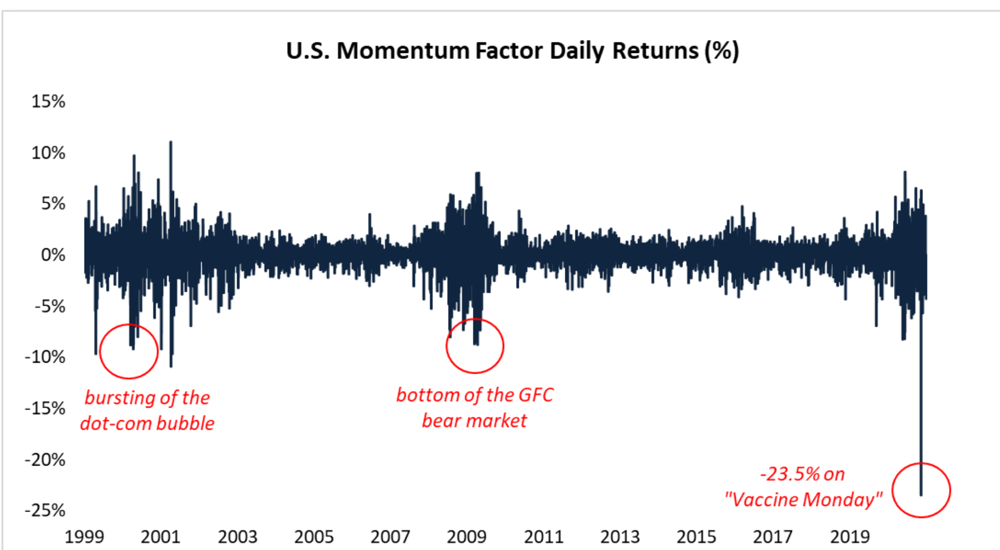
Q4 2020 Fund Commentary

Q4 has been a fitting end to a year that we suspect most will be happy to put in the rear-view mirror, with a host of extreme market moves and unprecedented events, which is certainly "on-brand" for 2020. Broad equity markets moved sharply higher, initially driven by the relief of getting through the U.S. election without a civil war, and then on the better-than-expected vaccine news, leading to optimism that there is light at the end of the pandemic tunnel. While equity indices advanced, the real action was under the surface with some very large sector and factor rotations. Discerning if those moves might imply a "changing of the guard" in terms of market leadership will be critical for managing risk in 2021. Finally, it would be irresponsible of us not the point out that this new bull market, in all its strangeness, has already taken us into uncharted territories in terms of valuation, with sentiment running *very* hot, and outright bubbles in several pockets of the market. Again, managing through these extremes in the medium term may yet again put to the test investor ability to manage risk.

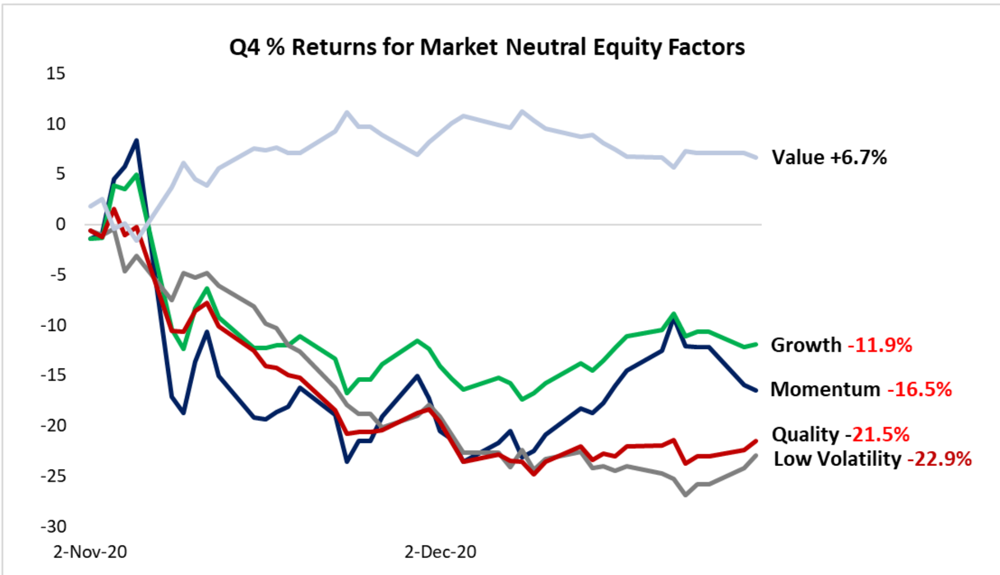
A market of extremes

We've seen our fair share of extremes and "unprecedented" events this year, from the fastest-ever drop from an all-time high into a new bear market, and then the quickest recovery into a new bull market ever (both in terms of shortest time and largest magnitude of the moves). We would not have had oil trading at negative $40 on our 2020 bingo card, nor the fact that the average employee would earn *more* during a pandemic (thanks to government stimulus) than they did prior. Market moves in November did not break the trend of extreme events, with the single largest one-day move in history for some of the main investment "factors" or styles that we use within our core long/short equity strategies. We had been suggesting for some time now that the regime that has dominated market for the past few years, namely that of "growth at any price" at the expense of value stocks, was at risk of reversal as we exited the pandemic. However, we did not expect that rotation to occur in a single day. On November 9th, with the announcement of the success of the Moderna vaccine, the market experienced the largest one-day trend reversal in history, with stocks that had been in a downtrend jumping on average 18%, while those that had been in an uptrend falling an average of 6%. This "net" decline of more than 23% for the momentum factor was the largest in the record, and more than double similar events in 2001 and 2009 (see chart).



Source: Morgan Stanley, Bloomberg, EHP Funds

We run a diversified portfolio of investment styles that over time are generally uncorrelated with each other, and are in aggregate additive to returns. In Q4 however, many of these factors were highly correlated, with the "Covid-19" factor dominating returns. Momentum, growth, quality and low volatility longs meaningfully lagged, while low quality, levered, volatile stocks that had been in a downtrend (which tend to be on the short side of a long/short portfolio) massively outperformed. Only "deep" value stocks (cheap on a price to book basis) outperformed, but even then, not by a large enough margin to make up for the declines in the other factors (see chart).



Source: Morgan Stanley, Bloomberg, EHP Funds

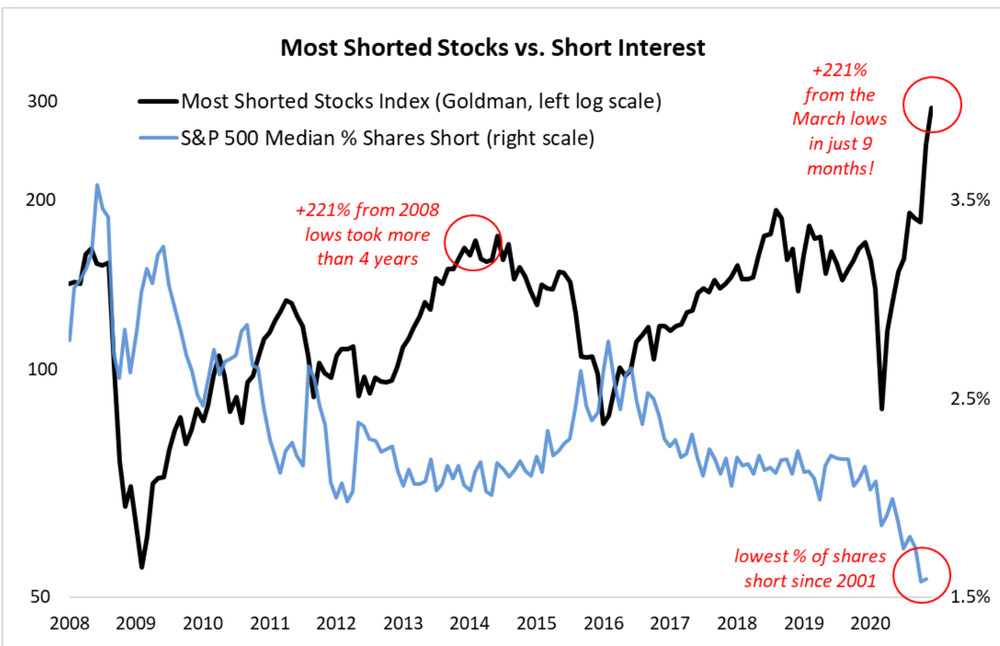
Across our Funds, those that were by design already tilted toward cyclical value stocks (EHP Foundation with its bias towards sustainable dividend stocks, and EHP Select with an overweight to cyclical stocks) performed well, while our Funds that were more balanced between high-quality value, momentum and low vol (EHP Advantage and EHP Advantage International) underperformed.

While all of this is interesting (at least maybe to quants), the more important take-away is what a move like this might imply for the future. Historically, large momentum "crashes" like what we witnessed in Q4 tend to occur at major regime changes, where one dominant trend is ending, and a new one is beginning. In this case, we believe it is indicative of a mass repositioning away from the pandemic winners in high-priced, defensive, growth sectors, and into the laggards in more cyclical value stocks. If in fact this rotation is for real, and it coincides with increasing inflation expectations, rising longer-term rates, and a legitimate economic recovery, then there could be many quarters ahead of us where value outperforms growth.

One of the key elements for our process is that our Funds adapt to changing market conditions. While the sudden shift in November was too fast for this process, our Funds had already begun tilting towards cheaper cyclicals while avoiding expensive growth. Momentum style investing, by definition, picks up on emerging trends, and we are already seeing the leadership baton handed to stocks in financials, industrials, and materials sectors, while short covering and adding selective long positions in energy. Defensive stocks in consumer staples and in expensive tech have been a source of cash for this rotation, and we would expect that to continue in coming months.

Will the last remaining short seller please turn out the lights?

As mentioned, it was the short side of the portfolio that caused the bulk of the factor "crash" in November. One of the real challenges this year for long/short strategies has been managing this "junk rally" risk. While these same shorts are what offer protection in market selloffs like March, they can detract from returns in rallies, particularly if the market is being driven by lower quality, more speculative stocks. The chart below highlights just how aggressive market participants have been in bidding up these types of stocks. Goldman Sachs produces a "most shorted stocks" index, and the move off the lows in March has been record-setting. In just 9 months, that basket of stocks is up 221%. From the lows in March of 2009 during the Great Financial Crisis, it took almost 4 ½ years for the most-shorted index to increase that much. The speed of the moves this year has been striking and has made risk management a most difficult task. As the shorts have been run out of town, we now see the lowest percent of shares short in the S&P 500 in 30 years, leaving fewer and fewer participants to stand in front of rising share prices, and driving further rallies in the lowest quality stocks as these shorts are covered.



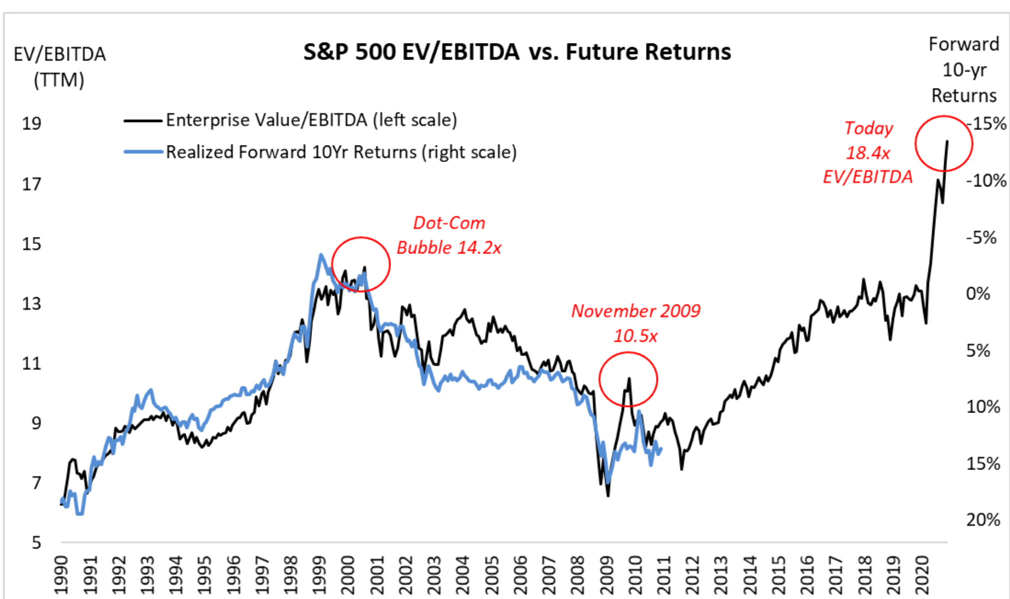
Source: Goldman Sachs, Bloomberg, EHP Funds

Blowing bubbles

One of the side effects of the unprecedented (but arguably necessary) amount of central bank and fiscal stimulus has been that a portion of the population who have been able to work through the pandemic, or are in industries that directly benefit from the shift in spending, have actually had a windfall in terms of having more money than they would have prior to the pandemic. Exceptionally low rates have had the desired effect of allowing companies to refinance or borrow new debt (with 2020 hitting an all-time high for corporate debt issuance), but has also encouraged another wave of homebuying and real estate price inflation as cheap mortgages can service higher home values. As we've noted in prior letters, short-term call option buying has leapt off the charts, the consequence of free money, zero brokerage commissions, and day-trading becoming the new national pastime in the absence of anything else to do. With all this money flowing into markets, it's somewhat inevitable that bubbles will form, and perhaps this is an acceptable side-effect of avoiding a deep recession, but it does raise the risk of profile of the markets.

There is an increasing supply of "nonsense" stocks, where value is so disconnected from any likely future reality that a buyer today is solely reliant on finding someone to sell it to at a higher price. New valuation methods are being referenced, such as "Enterprise Value to Total Addressable Market (EV/TAM)". If, as a new electric vehicle entrant, your TAM is the entire potential global fleet of cars, then you might look pretty cheap on this metric, never mind how realistic it is for you to capture any part of that market. SPAC sponsors in particular seem to have become very adept at finding target companies in the hottest parts of the market, which certainly has paid off handsomely for the promoter and SPAC arbitrageurs, but leaves the average retail client as the bag-holder, and we suspect completely unaware of the multiples they are paying. Some of our favourite examples include Quantumscape (ticker QS), a battery maker with a who's-who of VC backing, and a market cap of US$38 Billion, but no *revenue* until 2024. Switchback Energy (SBE), a SPAC that will become ChargePoint, a developer of an EV charging network, sports a value of US$12 Billion, or 34x their optimistic 2022 sales estimate. Nikola Corp (NKLA), infamous for getting caught rolling their demo hydrogen truck down a hill rather than building a working prototype, still has a market cap of US$6 Billion (down from a high of US$34 Billion), despite never producing any revenue and arguably being proven to be a fraud. Of course, these valuations have been in part validated by the granddaddy of them all, and the exception that has made fools of all who care to worry about fundamentals: Tesla. With a market cap of US$680 Billion, Tesla's value is now larger than the *combined* market caps of Toyota, Volkswagen, Mercedes, GM, BMW, Honda, Ford, and Fiat-Chrysler, despite having sales of only 2% of the combined revenue of those competitors. With full credit to Elon Musk for his accomplishment, Tesla is now blessed with S&P 500 index inclusion, ensuring that every new passive dollar owns a piece of them at a forward PE ratio of 325x.

While these one-offs are interesting, and are just a few of a host of overvalued, overhyped stocks, investors have no obligation to invest in any of them, so why worry? The problem is that the speculative fever in the hottest parts of the market is a microcosm of widespread overheated valuations. Fund flows have been exceptionally strong of late, with equity inflows since the election of ~US$135 Billion, 30% above any prior five-week period. Mutual fund cash holdings are at cycle lows, and options trading is heavily skewed to call buying with limited hedging activity. As a result, valuations have reached record levels by many measures, surpassing prior high watermarks set during the dotcom bubble. Below is an update to a chart we've shown in past letters showing S&P 500 EV/EBITDA vs. subsequent 10-yr realized returns.



Source: Bloomberg, EHP Funds

Like many charts since the pandemic, this one has redefined the boundaries of historical precedent, with the highest level of valuation in 30 years. As earnings recover, this high multiple will likely contract as the denominator grows, similar to 2010 after the Great Financial Crisis, but even so, whether we use this valuation methodology or others like forward EV/EBTDA, Price/Sales, Price to Earnings, Market-Cap-to-GDP, Schillers CAPE or a host of others, the result is similar. Even after discounting for the low interest rate environment, the market overall is at historically high valuations. The unfortunate implication is that expected forward returns over the next 10-yrs are now negative for U.S., and in the mid-single digits for non-U.S. equities. This long-term prediction says little of what can happen in the near term or from year to year – there is every reason to believe that an overbought market can remain that way, or go further, but eventually, valuation has always mattered in the longer run, and the risks of being passively allocated to this market are very high.

Where to from here?

We don't want to be mistaken for being outright bearish on the market. In reality, while we are concerned that the market has run too far, too fast, and has favoured more speculative stocks, this isn't all that unusual for the start of new bull markets. Typically, after the initial wave of short covering and buying of the most levered "survivors" is done, longer-term investors allocate new dollars to the higher quality stocks in the leading sectors. While we are concerned that the broad index returns may be muted as they wait for earnings to catch-up to their very high multiples, we are optimistic that the pandemic is much closer to ending, with demand returning to some of the hardest hit sectors of the market. The average consumer has a high cash savings balance as spending has been curtailed during the pandemic, and it's logical to assume that demand for everything we haven't been able to consume will be robust. The broad breadth of the rally is healthy, with the average stock catching up with the mega-cap stocks that had dominated the bull market over the last few years, and capital markets coming alive again with demand for stock issuance and IPOs. We do believe this move into broader cyclicals makes sense, and expect to see an environment of accommodative policy, continued fiscal stimulus, and inflation in parts of the market where companies have pricing power.

The case for alternative funds remains strong with bonds offering little to no nominal yield, and arguably negative real yields if we account for expected inflation. With a robust M&A market, and an apparently endless supply of SPACs that will likely offer periods of good rate-of-return opportunities, merger arbitrage strategies continue to stand out as good bond replacements. The environment may well suit active long/short managers who can take advantage of fairly wide dispersion of valuations among stocks and sectors, as well as those that are nimble enough to adjust in what may continue to be a market of extremes. As always, we will remain patient and disciplined in terms of applying our process, following an approach that relies on actual market changes and not forecasts of such.

Introducing the EHP Global Multi-Strategy Fund

When we launched our family of liquid alt funds under the new prospectus rules back in August of 2018, we were fortunate that we had been running identical strategies as private Offering Memorandum funds since 2013, and that we could replicate these strategies as mutual funds without diluting down the process. Our plan was to gradually wind-down the legacy OM funds, with the exception of a single multi-strategy fund that would become our own "fund of funds" product where we would tactically allocate across our liquid alt mandates. We've now completed the wind-down of all our original OM funds and are pleased to formally launch our "EHP Global Multi-Strategy Fund". We've had a number of client requests for an "all-in-one" fund that would represent the best of what we have to offer in a single product, and this new Fund delivers on that promise. The Fund holds an allocation to our family of funds, with a tactical gearing approach to shift allocations based on market conditions and the opportunity set. The OM structure allows us more flexibility than what is allowed under the prospectus rules, and the Fund is designed as an equity alternative with better risk adjusted returns than passive long allocations. We remain meaningful personal investors in the new Fund, and we'd be pleased to provide you with more detail.

As always, we appreciate your trust in us managing your hard-earned dollars. We wish everyone a safe and happy new year and look forward to a better 2021 for everyone!

Fund Specific Commentary

Summary of Returns (F-Class):

Fund	1M	3M	YTD	1YR	Inception
EHP Foundation Alternative Fund	1.1%	1.8%	3.4%	3.4%	3.8%
EHP Foundation International Alternative Fund	1.2%	-1.3%	-2.9%	-2.9%	2.3%
EHP Global Arbitrage Alternative Fund	1.1%	3.9%	6.6%	6.6%	9.9%
EHP Advantage Alternative Fund	1.6%	-0.4%	5.4%	5.4%	4.1%
EHP Advantage International Alternative Fund	3.0%	-4.9%	-1.0%	-1.0%	1.8%
EHP Select Alternative Fund	5.2%	13.7%	32.0%	32.0%	13.8%

Defensive / Conservative Funds

<u>EHP Foundation Alternative Fund</u>

The Fund was up 1.8% over the quarter, with gains from Canadian long/short equity, Credit Momentum and Merger Arbitrage, while U.S. long/short equity detracted from returns as volatile, low quality shorts outperformed reasonably priced, sustainable yield stocks. We had entered the quarter partially risk-off as we entered the U.S. election, but quickly added back exposure as markets reverted higher and began the latest leg of their uptrend. Shorts were a challenge in November given the strong junk rally that followed the positive vaccine news, but we expect this to moderate in coming months as short interest is now at cycle lows and valuations are elevated. While the market has for a number of years favoured expensive growth stocks over all others, that tide appears to be turning in favour of more cyclical stocks that can perform well in an economic recovery. The Fund favours reasonably priced stocks with sustainable yield, and as such should be well positioned if this trend towards value stocks continues. Dividend-paying stocks have been out of favour for some time now as they have been lumped into the "value" bucket, but we expect with exceptionally low bond yields in place for the foreseeable future, that investors will once again turn to quality yield as an alternative to credit with negative real yields.

From a sector perspective, the Fund is skewed toward higher quality dividend-paying stocks in industrial, healthcare, industrial and energy infrastructure, with underweights in utilities and communication services, and also continues to avoid the most overpriced growth stocks. We enter the new year with the Fund at the higher end of its risk range, carrying an estimated market beta of ~0.3.

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

The Fund was down 1.3% over the quarter, with losses accruing entirely from the short side of the portfolio as investors chased the lowest quality, highest leverage, most volatile stocks that had been in a downtrend, and sold off higher quality stocks that had been in an uptrend. Credit Momentum and Merger Arbitrage strategies had gains. We had entered the quarter with Europe partially risk off, and the U.K. and Credit fully risk-off, while Japan and Australia remained risk-on. Stocks began to rally into the U.S. Election, but it was only after the vaccine news in November that markets overall moved into an uptrend, causing an element of whipsaw in the Fund. Shorts were a challenge in November given the strong junk rally that followed the positive vaccine news, but we expect this to moderate in coming months as short interest is now at cycle lows and valuations are elevated. While the market has for a number of years favoured expensive growth stocks over all others, that tide appears to be turning in favour of more cyclical stocks that can perform well in an economic recovery.

From a sector perspective, the Fund is skewed toward higher quality dividend-paying stocks in industrials, financials, and consumer discretionary sectors, with underweights in energy and utilities.

EHP Global Arbitrage Alternative Fund

The Fund was up 3.9% over the quarter, with a relative robust traditional merger arb market and a truly euphoric SPAC market. The last few "pre-COVID" deals rolled off, and in the final analysis approximately 88% of those deals closed on their original terms, with another 4% repriced lower, representing a deal close rate of approximately 92%. Over the last 25 years, the close rate averages 94%, so as we suggested back in March, once a deal is consummated it is difficult to walk away, even in a pandemic. In general, we liked the risk-reward of some the "broken" deals that were headed to court, and we were able to profit from the reprice of Tiffany's and Taubman Centers in Q4. There were also a number of deal price increases that we were able to capitalize on, including Rocky Mountain Dealership (RME), and more recently Apollo's bump for Great Canadian Gaming (GC). Perhaps the most remarkable deal this quarter was Front Yard Residential (RESI) where the original buyer successfully walked from the deal in May causing the stock to plummet, only to see a new buyer emerge in October at a *higher* price than the failed bid, which was then raised further as a third competing buyer forced a price bump. All told, a wild ride for shareholders of RESI with a good outcome, and perhaps a fitting analogy for the entire arbitrage market this year.

The Fund participated in 96 arbitrage positions over the quarter and ended the year holding 45 traditional arbitrage positions. The Fund also has an approximate 20% position in SPACs. While merger activity looks to be picking up again after a Q3 lull, traditional spreads have tightened overall, and we are taking care not to overpay while we wait for more supply of deals in the new year. We are finding a number of attractive opportunities in Canadian deals that continue to trade with wider spreads, and mid-cap U.S. deals that are less well owned by the larger funds. SPAC issuance accelerated further in Q4, with 118 new SPACs priced during the quarter, and a combined market cap surpassing US$115 billion. The SPAC market has become one of mass speculation with new SPACs immediately trading to a premium to trust value, and with the average SPAC now 20% above trust value (including SPACs with an announced but not yet closed 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", and so outside of participating in new issues, we have been a net seller of SPACs above trust value. The SPAC "pop" that has been occurring in the last six months relies heavily on the continued demand of retail speculators, and with the expectation of new issuance continuing unabated, the entire asset class is at greater risk of suddenly hitting an air pocket, along with other speculative parts of the market. We expect over the next few years there will be a number of excellent opportunities to pick up SPACs at attractive rates of return relative to their upside optionality, and we'll wait patiently in the meantime.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was down 0.4% over the quarter, with losses accruing entirely from the short side of the portfolio as investors chased the lowest quality, highest leverage, most volatile stocks that had been in a downtrend, and sold off higher quality stocks that had been in an uptrend. Credit Momentum and Merger Arbitrage strategies had gains. We saw the single largest one-day "momentum crash" in at least 30 years as the vaccine news forced investors to rush to reposition out of pandemic winners and cover shorts in pandemic losers. We had entered the quarter partially risk-off as we entered the U.S. election, but quickly added back exposure as markets reverted higher and began the latest leg of their uptrend. Shorts were a challenge in November given the strong junk rally that followed the positive vaccine news, but we expect this to moderate in coming months as short interest is now at cycle lows and valuations are elevated. While the market has for a number of years favoured expensive growth stocks over all others, that tide appears to be turning in favour of more cyclical stocks that can perform well in an economic recovery.

From a sector perspective, the Fund has its largest weights in financials, industrials, and consumer discretionary, and has been decreasing weight to more expensive consumer staple and technology sectors. REITs and utilities are underweights, and we continue to cover energy shorts as their relative value and price trends improve. As the market continues to rotate toward value and away from growth, the Fund will continue to adapt its exposures to benefit from a relative move to higher quality, reasonably priced stocks that tend to perform well during periods of economic reflation.

EHP Advantage International Alternative Fund

The Fund was down 4.9% over the quarter, with losses accruing entirely from the short side of the portfolio as investors chased the lowest quality, highest leverage, most volatile stocks that had been in a downtrend, and sold off higher quality stocks that had been in an uptrend. Credit Momentum and Merger Arbitrage strategies had gains. We saw the single largest one-day “momentum crash” in at least 30 years as the vaccine news forced investors to rush to reposition out of pandemic winners and cover shorts in pandemic losers. We had entered the quarter with Europe partially risk off, and the U.K. and Credit fully risk-off, while Japan and Australia remained risk-on. Stocks began to rally into the U.S. Election, but it was only after the vaccine news in November that markets overall moved into an uptrend, causing an element of whipsaw in the Fund. Shorts were a challenge in November in particular given the strong junk rally that followed the positive vaccine news, but we expect this to moderate in coming months as short interest is now at cycle lows and valuations are elevated. While the market has for a number of years favoured expensive growth stocks over all others, that tide appears to be turning in favour of more cyclical stocks that can perform well in an economic recovery, and the Fund has continued rotating into this group of stocks and away from more defensive sectors.

From a sector perspective, the Fund has its largest sector weights in materials and industrials, balanced with weights in staples and technology. REITs and utilities are underweights, with energy no longer net short as their relative value and price trends improve. While Q4 was a challenge given the very rapid regime shifts we witnessed, the overall performance of the Fund is inline with the MSCI EAFE Index since inception, but with better drawdown and volatility characteristics. As the market continues to rotate toward value and away from growth, the Fund will continue to adapt its exposures to benefit from a relative move to higher quality, reasonably priced stocks that tend to perform well during periods of economic reflation.

EHP Select Alternative Fund

The Fund was up 13.7% over the quarter and finished the year up 32.0%, with gains again led by a cross-section of stocks in industrial, consumer discretionary and materials sectors. The rotation towards more cyclical “recovery” stocks benefited the Fund, with its natural bias towards owning cash-flowing, more reasonably priced companies. Larger winners in the quarter included Canaccord Financial, Linamar, Champion Iron Ore, and forestry stocks. Energy and Cannabis shorts were a detractor from returns despite their relatively small weight in the Fund. The more cyclical Canadian market lagged the U.S. market for the 4th year in a row, coinciding with the overall period where growth stocks have dominated value. However, as dollars appear primed to continue the recent rotation to stocks that benefit from an economic recovery, the Fund is well positioned to capitalize and continues to find quite reasonably priced securities in what is an otherwise expensive 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 Q4. As we move into the 2021, the Fund remains “risk on”. From a sector and style perspective, the Fund is weighted toward “return to work” sectors in industrial, financial and materials sectors. Energy stocks continue to frustrate with attempts at uptrends tending to be sharp but fleeting. We are encouraged to see more mergers occurring in the energy patch, and a continuation of balance sheet repair and improving cash flows. REITs and Utility sectors remain underweights given their relative underperformance and expensive valuations.

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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