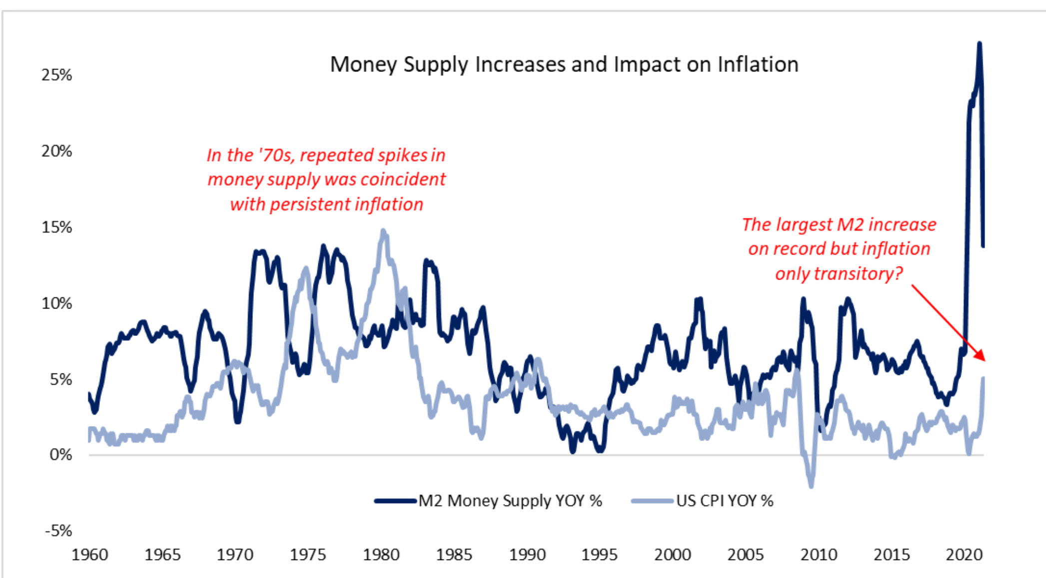
Q2 2021 Fund Commentary

Equity markets continued their march to fresh record highs in Q2, with strength in virtually all global indices we follow. Bonds found their footing after a challenging period, with the Barclays Aggregate bond index finishing up strongly in June as inflation fears moderated and the yield curve flattened. While broad equity markets advanced, once again the moves under the surface were the more important ones to watch, as stocks tied to the reflation narrative checked back sharply in response to the U.S. Fed admitting it was now "talking about talking" about future rate increases. Investors responded by lurching from one side of the inflation boat to the other, dumping recently acquired cyclical stocks and rushing back to their true love: mega cap tech stocks that had only just finished a multi-month period of negative fund flows. Was the Fed already giving up on its new mandate for "average inflation targeting" and soon be putting an end to the reflation party?

Transitory for longer

From a factor and style perspective, understanding which economic regime is dominant (or equally important, which regime investors believe will become dominant) is key to determining appropriate asset class and sector exposures. In an environment of widespread economic growth and rising inflation, cyclical stocks lead returns, while growth stocks tend to see multiple contraction. This type of environment began last August as growth and defensive stocks began to underperform, and then accelerated in November when the vaccine news put a potential timeline on the end of the pandemic. We suggested last quarter that while the lowest quality, most levered cyclical stocks had been market leaders, that it was time to hand the baton off to higher quality stocks as measured by cash flow, return on equity and with better balance sheets, and indeed these stocks held up much better in the recent pullback. However, for the most expensive growth stocks to become leaders again, we believe we would need to see inflation and growth reverse course, something we would suggest is not currently the most likely outcome.

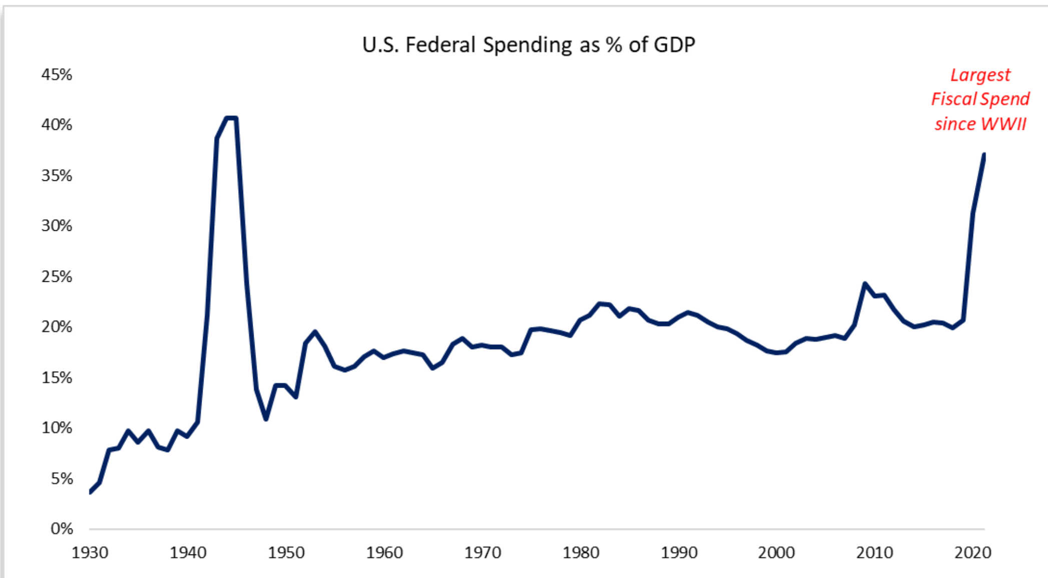
Central banks globally have taken extraordinary steps to support and stimulate economies in the face of the global pandemic. It would be reasonable to assume that the knock-on effect of these moves is also likely to be commensurate, and at the very least we had better be prepared for the unexpected. One of the more amazing charts from last year was the extent of M2 money supply increase as the Fed flooded the market with liquidity. We take another look at M2 below as its rate of change comes back down to earth, but also take a look at its historical impact on inflation:



Source: Bloomberg

What is notable from the chart is how in the 1970's, each successive spike in money supply was followed some quarters later by successively higher spikes in inflation, ultimately leading to an environment of "stagflation" where growth was choked off, leading to a multi-year period of equity market weakness. In contrast, after the great financial crisis in 2008, increases in money supply did little to spike inflation. It is certainly possible that with rates stuck near zero, money supply increases alone aren't enough to move growth and inflation higher, and lends credence to the argument that QE doesn't actually work.

However, the Fed isn't acting alone this time. In fact, the Fed may not even be in as control of inflation as they'd like to think they are. The narrative has been that the post-covid world be a re-run of the "roaring '20s", and from a consumer spending perspective that is likely true. But from a macro-economic perspective, we'd suggest that the WWII period is a better analogy, as fighting the pandemic has been more similar to fighting a global war, with governments around the world opening the pandora's box of fiscal spending not seen since that period:



Source: Federal Reserve

The chart above, which doesn't yet include the impact of the most recently agreed to $1.2 Trillion infrastructure spending plan, shows just how aggressive the U.S. has been with fiscal spending relative to the great financial crisis (and relative to the distinct lack of spending that prolonged the great depression and deflation in the thirties). Fiscal stimulus has been exceedingly effective at jump-starting the economy and backstopping unemployment, and it's reasonable to guess that politicians may be reticent to stop spending given its popularity with voters (after all, who doesn't like free money deposited into their bank account). Sustained fiscal stimulus, when coupled with easy money, may well have the effect of inflation being "transitory for longer" as it did during the WWII period.

In our view, the sharpness of the recent yield curve flattening, and roll-over of cyclicals, is more a result of overconfident investors with levered bets finding themselves suddenly offside, leading to quick losses for these latecomers to the inflation trade and causing hedge funds to de-risk and reduce exposure as a result. While our investment process doesn't make predictions on macro-trends, but rather responds to them as they begin to change, we are not (yet) seeing the evidence that these recent moves are the start of another major regime change, but are rather a check-back in an upward trend of inflation and interest rates. For now, we stay the course of favouring higher quality stocks and bonds in sectors that benefit most from this reflation: financials, industrials, materials and discretionary.

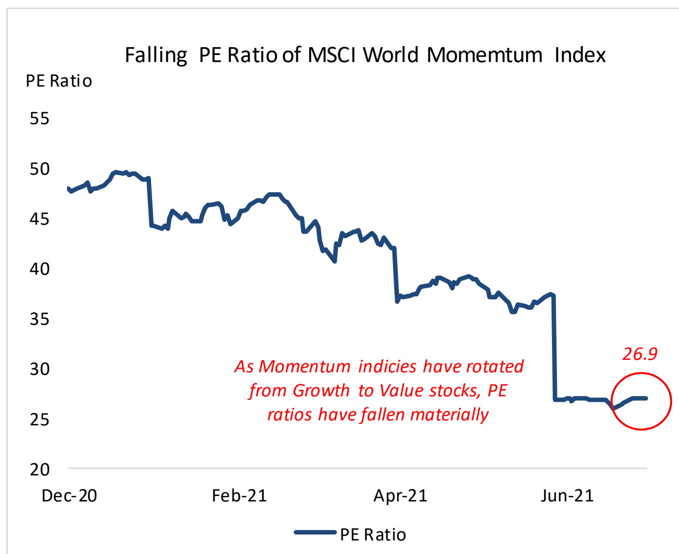
The changing face of momentum

We’ve discussed in recent notes how investment factors tend to act over cycles, and how we were monitoring the rising correlations between “momentum” and “value” as an indicator of where dollars are flowing. Momentum investing buys assets that have been strong recently, with the belief that they are likely to continue to be strong for some time into the future. Investors tend to like to buy things that are going up already (i.e., currently making them money), and tend to avoid things that are declining (i.e., causing them pain). Historically, these money flows are persistent for some time, as evidenced by the huge and near constant money flows into tech stocks over the last number of years, before ending abruptly this year. Momentum is one of our core investment tenets, as we too prefer to own stocks that are going up and prefer to short stocks that are going down. We also prefer to own stocks that are cheap and short stocks that are expensive, however these two investment styles are often in conflict.

More recently however, the face of momentum stocks has changed materially. The chart below shows how the U.S. MTUM ETF, a $15 Billion fund that invests solely in stocks with the highest momentum scores, has changed over the last year, with much of those shifts occurring during their recent rebalance:

Sector Composition of MSCI U.S. Momentum ETF

Sector	Now	1yr ago	Change
Financials	31.1%	0.6%	30.6%
Industrials	11.6%	0.8%	10.8%
Communications	14.0%	4.2%	9.8%
Consumer Discretionary	9.7%	2.8%	6.9%
Energy	2.5%	0.0%	2.5%
Materials	3.1%	2.4%	0.7%
Real Estate	0.4%	2.2%	-1.8%
Utilities	0.2%	2.6%	-2.4%
Consumer Staples	2.8%	5.6%	-2.9%
Technology	18.9%	32.8%	-14.0%
Health Care	5.6%	26.9%	-21.3%

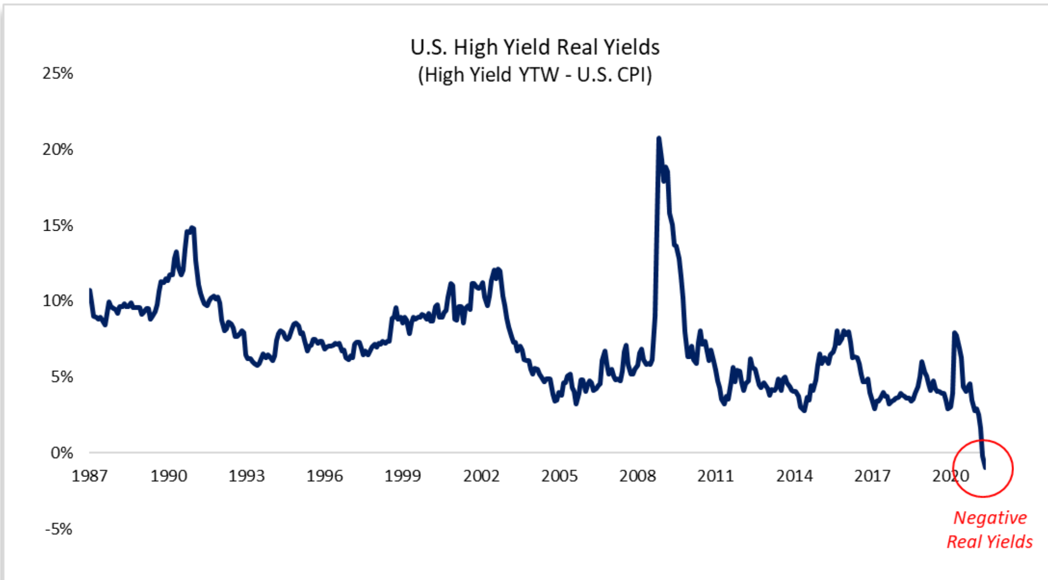


Source: MSCI, Bloomberg

Compared to last year, technology exposure has been cut in half and dropped from the top weight, replaced by financials and industrials that had almost no exposure a year ago. More interesting is that the overall price to earnings ratio of the global momentum basket has dropped massively as a result (2^{nd} panel), falling from the 50’s to much more reasonable PEs in the mid-20’s today. All things equal, most longer-term investors prefer cheaper stocks. We certainly do - buying cheap, rising, stable stocks and bonds and shorting the opposite is at the core of our investment process. What’s not shown in the charts above is the expected growth in earnings from these more cyclical sectors. Companies in the Russell 1000 Growth Index are expected to grow earnings at a rate of 44% over the next 12 months, while companies in the Russell 1000 Value Index are expected to grow at a nearly identical rate of 43%. Given the large disparity in starting multiples, with value stocks trading at just over half the PE multiples of growth stocks, there appears to be a much higher margin of safety in cheaper, trending, value stocks, as opposed to expensive growth stocks. We fully recognize that cyclical stocks are in fact *cyclical* and their earnings growth is likely fleeting, but in the near term, the evidence continues to favour more reasonably priced stocks against the backdrop of an overall pricey market.

“High” yield no longer

We wanted to highlight just how difficult it has become for bond investors, and for those looking for reasonably safe source of income. For the first time in history, the high yield bond market now yields negative real rates, the combination of low absolute yields (just under 4% yield-to-worst) and high current inflation (running at 5% annualized last check). Despite seeing the highest new issuance of bonds on record, the additional supply has been easily absorbed by yield hungry investors, and credit risk hasn't been priced this tight since 2007. The environment has been a boon to M&A and private equity firms, who are taking full advantage of the easy money and endless demand for riskier debt, and are on pace to smash records for the number and size of deals announced this year.



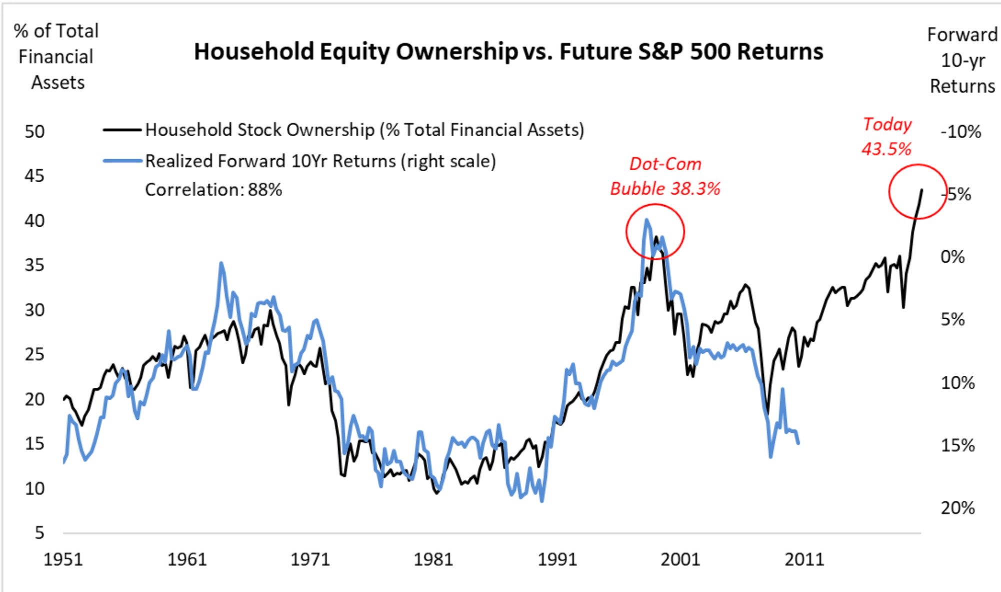
Source: Bloomberg

The challenge for the bond investor is that this leaves little room for error on the credit risk side, and no real income for taking on this risk. Owning bonds outright is truly a case of "all risk, no reward". While we offer solutions to these problems in the form of lower-risk equity long/short and merger arbitrage funds, we recognize that for many advisors these equity-based strategies simply don't "fit" into a client's investment policy statement since they aren't categorized as bond offerings. It is in this environment that we have launched a first for Canadian investors – a true, quantitatively-based, long/short bond offering, the EHP Strategic Income Alternative Fund. Led by Ovidiu Sandu, our new Head of Credit, the fund follows a strikingly similar approach as our equity funds to generating returns and avoiding drawdowns. We follow a disciplined quantitative approach to building a true long/short portfolio of high yield bonds, with an approach that can profit from the *relative* returns among them as well as generate yield. Given how tight credit spreads are today, we also think it's imperative to have a process that can reduce credit risk quickly when (not if) this current cycle ends. Our approach does exactly this, with a layer of liquid ETFs that allows us to quickly cut risk and rotate to defensive treasury duration as market conditions change, something we've been doing successfully for 8 years within our existing funds. We believe the fund is an excellent complement to both existing bond alternatives and long-only bond holdings given the expected lack of correlation with these strategies during market pullbacks. We look forward to speaking to you more about this unique offering!

Storms on the horizon

While we remain optimistic for the medium term on markets in general, and believe the weight of evidence is on the side of the inflationists for the time being, we wouldn't be doing our job if we didn't look at the longer-term risks on the horizon. Fund flows have been absolutely incredible, with ETFs alone taking in $467 Billion in the first half of the year, more than 50% higher than the previous record for a six-month period. Equity ETFs have already set an annual record, with value, small cap and emerging market funds leading the pack. Even Europe, seemingly perpetually hated by allocators, has seen its highest pace of ETF inflows since 2015.

These fund flows have predictably done nothing good in terms of lowering the absolute valuations of stocks, and in the past, we have shown charts showing that the starting point on valuation matters a lot in terms of defining the long-term rate of return (higher starting valuation = lower forward returns). We'll add to that body of evidence with another way of looking at what drives stock returns: the level of household ownership as a percent of total financial assets:



Source: FRED, Bloomberg, June 30,2021 data point estimated

This looks at stock more from a "supply and demand" perspective, and its clear that investors have well and truly fallen in love with stocks. Today, we see the largest allocation to equities as a percent of financial assets in history (or at least back to 1951 when the data starts). The logic follows that if everyone has bought already, where are the next dollars coming from? This chart doesn't look specifically at valuations, yet is a fairly accurate predictor of the longer-term rate of equity returns, and which shows that investors are likely to realize negative returns over the next 10 years. These longer-term predictors tend to be pretty terrible at short-term timing, but unless the concept of supply and demand is permanently changed, its difficult to escape the reality that people can only own so much of something before the buying dries up. To their credit, companies are "hitting the bid", and meeting the demand for stocks with a record $457 Billion of equity issuance over the last 12 months. At the same time, insiders have been selling at a pace that hit a 14-yr high in Q1 of this year. While insiders tend to be early, they are often directionally correct about their company's prospects. Partially offsetting all of this selling is the return of corporate buybacks, which had largely been on hold during the pandemic, as well as dividend increases from companies like the Banks, now free of stress-test restrictions and with overly conservative loan loss provisions being unwound back into free cash. All in all, the tug of war between buyers and sellers has never played out with such scale before, and we monitor it closely for clues as to when the demand for stocks will finally be satiated.

Where to from here?

Despite the month-to-month swings, and the potential for changing regime narratives, not much has changed the overall issues investors face with low rates and inflationary pressures limiting the prospects for the traditional 60/40 model, especially as it relates to protecting the downside from elevated valuations. We continue to believe that a balanced approach of allocating to a diverse set of alternative sources of return, manage tactically to increase or decrease risk as necessary, is a strong complement to traditional long-only investments. We enter Q3 with all of our funds at or near the higher end of the risk ranges, supported by strong markets globally, ample financial liquidity, and improving growth prospects coming out of the global pandemic. As always however, we remain cognizant of potential risks, with a process that can quickly change gears to adapt to ever changing markets. We thank you for trusting us with your dollars, and hope you enjoy a well-deserved summer free of many of the restrictions of the past year!

Fund Specific Commentary

Summary of Returns (F-Class):

Fund	1M	3M	YTD	1YR	Inception
Defensive/Conservative Funds:					
EHP Foundation Alternative Fund	0.6%	3.1%	7.6%	12.3%	5.8%
EHP Foundation International Alternative Fund	0.7%	2.8%	5.2%	4.9%	3.7%
EHP Global Arbitrage Alternative Fund	-0.3%	3.5%	5.4%	13.0%	10.1%
EHP Strategic Income Alternative Fund*					
Core/Moderate Funds:					
EHP Advantage Alternative Fund	0.9%	4.4%	9.6%	14.2%	6.7%
EHP Advantage International Alternative Fund	0.4%	4.0%	745%	8.8%	4.0%
EHP Select Alternative Fund	-1.0%	6.5%	19.7%	44.2%	18.5%
Speciality Fund:					
EHP Global Multi-Strategy Fund	0.1%	4.7%	9.6%		

*Returns for the EHP Strategic Income Alternative Fund are available after 1 year of track record as per National Instrument 81-102

Defensive / Conservative Funds

<u>EHP Foundation Alternative Fund</u>

The Fund was up 3.1% over the quarter, with the strongest gains from Canadian long/short equity, followed by U.S. long/short equity, and Merger Arbitrage. Returns from our Credit Momentum strategy, which held U.S. high yield debt throughout the quarter, were muted as spreads remain very tight, and the index appears challenged to move much higher from current levels.

From an equity factor perspective, value sold off as another round of speculative buying pushed lower quality, expensive stocks higher, while concerns that the inflation narrative had run to far, too fast, led investors to rotate out of more cyclical sectors and back into mega cap tech stocks. Despite the Fund's bias toward dividend-paying stocks that are well represented by cyclical sectors, our more balanced approach of sticking to higher quality, trending stocks helped us avoid any meaningful damage from the rather sharp pullback in the most value-oriented names. There is a great debate over whether the inflation impulse we are seeing in the economy is transitory or not, and the market is having a difficult time digesting the changing Fed views on the matter. While we can't be sure, it appears that the sharpness of the market rotations is more a result of funds being poorly positioned for the slightly hawkish shift in the Fed narrative, rather than a durable regime change back to "growth at any price" that dominated during the stay-at-home world. We stick with higher quality, more reasonably priced, dividend paying stocks in industrial, health care, discretionary and energy sectors, while remaining underweight interest-sensitive REITs and utilities. We enter Q3 with the Fund near 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 up 2.8% over the quarter, with gains led by Europe and U.K. and Australian long/short equity, while Japan, suffering from a challenging vaccine rollout, had negative returns for the quarter, resulting in flat returns for our long/short allocation in that country. Returns from our Credit Momentum strategy, which held high yield corporate and sovereign debt throughout the quarter, had positive but muted returns as spreads remain very tight, and the high yield index appears challenged to move much higher from current levels.

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<u>EHP Global Arbitrage Alternative Fund</u>

The Fund was up 3.5% over the quarter, with the bulk of returns coming from traditional merger arbitrage with SPACs adding small gains. The Fund participated in approximately 77 traditional merger arb deals, and holds 45 positions as of the end of June. SPACs now account for just over 20% of the Fund (after accounting for SPACs that have been tendered for redemption), represented by 77 positions. The SPAC market appears to be healing, with investors working their way through the massive oversupply from earlier in the year. We continue to see some excellent opportunities in guaranteed rates of return for announced deals, and attractive "yield to worst" returns with upside optionality in SPACs searching for a deal. As always, we are mindful of liquidity (or the lack thereof) in SPACs, and they are sized appropriately in the Fund as a result.

The traditional merger market continues to be robust as the economy reopens and credit markets remain highly supportive. Mergers tend to occur when company boards are confident, and that is certainly true today with easy access to cash, low borrowing rates, and improving economic growth. We continue to see a relatively low deal break rate, while the rate of topping or competing bids is running above average levels. Spreads remain quite wide, a result of an ample supply of new traditional mergers, and a well supplied SPAC market. Spreads are particularly compelling when measured against very tight high yield and corporate bond spreads. The Fund enters Q3 with an approximate 4.4% gross spread over the average deal life of 113 days. These calculations assume no deal breaks, but also no higher competing bids, and assume deals close on the timelines we anticipate.

<u>EHP Strategic Income Alternative Fund</u>

The Fund launched June 1, 2021, and finished the month with a NAV per Class F unit of 10.078. As per National Instrument 81-102 regulations, return calculations can only be shown after one year of track record. Upon launch, the Fund was fully invested with our core long/short bond portfolio representing 50% of NAV on a net basis (95% long and 45% short), and our Credit Momentum strategy (which rotates between U.S. High Yield debt and U.S. 30-Yr Treasuries) in a "risk-on" position, with a long a 30% weight in U.S. High Yield ETFs. These ETFs serve both as a "liquidity buffer", as well as an effective way to quickly reduce credit risk in the event our risk indicators roll over. Merger Arbitrage opportunities round out the portfolio at 11% of NAV. We enter Q3 with credit risk at the higher end of its range, with duration at 2.1, and with a net yield of 4.1%.

In June, the fixed income market was strong across the entire quality spectrum. The higher quality end was helped by treasuries tightening, while the lower quality segments benefitted from the general hunt for yield. The Bloomberg

Barclays US Aggregate Bond Index returned 0.7% during the month of June (but it is still down 1.6% for the year) while the Bloomberg Barclays US Corporate High Yield Bond Index was up 1.3% in June (advancing the year's return to 3.6%).

During the month, the new issue activity in the high yield market has been robust with nearly $38 Billion priced, further padding the record first-half's sales tally to $282.3 Billion.

Spreads on investment-grade bonds narrowed to an average of 80 basis points over Treasuries as of June 30th, the lowest since 2005, while the risk premium on high-yield debt fell to 2.68 percentage points, the lowest since 2007. Historic low spreads coupled with near historic low treasuries yields creates an historic negative skew and we are comforted by having the ability to short bonds and to gear the risk down when (not if) the market regime changes. From a sector perspective, the Fund is weighted toward more cyclical sectors with improving fundamentals, with the largest weights in energy and materials, while more interest sensitive real estate and utilities bonds are underweight or net short.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was up 4.4% over the quarter, with gains led by U.S. long/short equity, followed by Canadian long/short equity and Merger Arbitrage. Returns from our Credit Momentum strategy, which held U.S. high yield debt throughout the quarter, were muted as spreads remain very tight, and the index appears challenged to move much higher from current levels. The strength of the Canadian dollar, up 1.3% for the quarter, held back returns slightly, despite maintaining our tactical exposure at the low end of the range throughout the quarter. That said, as we enter Q3 the U.S. dollar has firmed, and is potentially poised to outperform again as the Fed shifts to a slightly more hawkish stance.

From an equity factor perspective, value sold off as another round of speculative buying pushed lower quality, expensive stocks higher, while concerns that the inflation narrative had run to far, too fast, led investors to rotate out of more cyclical sectors and back into mega cap tech stocks. We had suggested recently that we believed the rally in the cheapest "deep" value stocks has likely run its course for the time being, and expected higher quality value stocks as measured by return-on-equity, price-to-free-cash flow, and balance sheet quality to pick up the baton. Quality, lower volatility stocks did indeed find their footing in Q2 showing positive returns on a market neutral basis for the first time in a year, but have plenty of room to play catch-up vs. the more speculative, junkier parts of the market that have seen stunning gains.

There is a great debate over whether the inflation impulse we are seeing in the economy is transitory or not, and the market is having a difficult time digesting the changing Fed views on the matter. While we can't be sure, it appears that the sharpness of the recent market rotation away from value is more a result of funds being poorly positioned for the slightly hawkish shift in the Fed narrative, rather than a durable regime change back to "growth at any price" that dominated during the stay-at-home world. We stick with higher quality, more reasonably priced, stocks in financial, materials, industrial and discretionary sectors, while remaining net short in interest-sensitive REITs and utilities. We enter Q3 with the Fund near the higher end of its risk range, carrying an estimated market beta of ~0.7.

EHP Advantage International Alternative Fund

The Fund was up 4.0% over the quarter, with gains led by Europe, U.K. and Australian long/short equity, while Japan, suffering from a challenging vaccine rollout, had negative returns for the quarter. Returns from our Credit Momentum strategy, which held high yield corporate and sovereign debt throughout the quarter, were muted as spreads remain very tight, and the high yield index appears challenged to move much higher from current levels.

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EHP Select Alternative Fund

The Fund was up 6.5% over the quarter, extending the gains for the YTD to 19.7%. Returns for long positions were strong for the period, and slightly ahead of the strong S&P TSX returns. Shorts held back returns, with another round of speculative buying pushing some lower quality, unprofitable stocks higher in June. The Fund is titled toward more cyclical value stocks, which pulled back sharply in June after a very strong run of returns, but our bias towards higher quality stocks across a range of sectors helped mitigate any pullback from recent highs. Gains in the quarter were again led by a cross-section of stocks in industrial, materials and consumer discretionary sectors. Larger winners in the quarter included TFI International, Canaccord Financial, Champion Iron Ore and Arc Energy. While not necessarily the "household" stocks typically present in Canadian portfolio, these mid and smaller cap stocks tend to outperform meaningfully at this part of the cycle.

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Specialty Funds

EHP Global Multi-Strategy Fund

The Fund was up 4.7% over the quarter, and is up 9.6% from January 1, 2021. As a "fund of funds", the Fund holds interests in a number of our EHP alternative mutual funds, with a tactical approach to rotating assets to more defensive strategies as markets become more volatile, and our risk triggers are hit. The Fund has been positioned for a "risk on" environment, with a baseline exposure to our Global Merger Arb strategy which aims to provide consistent returns in all market environments, and with a tactical exposure to our Advantage and Select long/short strategies.

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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. Unless otherwise noted, all values are in U.S. dollars. Source for all index data: Bloomberg.

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