



Playing with the House's Money | May 2016

"The house doesn't beat the player. It just gives him the opportunity to beat himself."
Nick the Greek

For this month's commentary we are following our colleague Brian on a field trip to the casino. Being the responsible gambler that he is, Brian has predetermined that he is willing to play with \$500 (high rollers, please hold the snickers). After a series of well-played hands and bit of luck, his stack sits at \$1,000. He takes a moment to slip the original \$500 stake into his pocket and continues to play only with his winnings.

At this point our friend is relaxed, loose and fancy free. He orders a round of drinks for the table and starts making more aggressive bets and takes on bigger risks. After all, he's now playing with the house's dough. While Brian may have suddenly made some new friends, he is breaking one of the fundamental principles of money - it is fungible. The house's money is still money, and the \$500 on the table has the same purchasing power as the \$500 in his pocket.

A similar phenomena occurs in the investment landscape. Suppose Brian bought a stock at \$50 and it's now trading at \$100. It might not bother him if it dipped down to \$80, as he would still be in the black. But if he bought that stock today at \$100 and it dropped down to \$80, he would not be too pleased. The same applies to portfolio managers, who can become more aggressive and take larger risks following a period of strong performance. This is because optically and psychologically it is much more palatable suffering a 1% loss on a year when you are up 10% than in a year when you are up 2%. But once again, the net effect is a loss of 1% and the impact on long run returns will be the same.

To avoid this trap, one must disregard the past and maintain discipline irrespective of the starting point. As investment managers we must apply the same rigour in our process regardless of our performance to date. At the casino, Brian needs to play based on having \$1,000 not on having started with \$500. When evaluating an investment we own, we must consider the current price and conditions, not where we got in. After all, profits are profits and losses are losses regardless of whether one is already up or down.

The Fund

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2016	0.19%	1.49%	5.32%	3.51%	0.60%	-	-	-	-	-	-	-	11.52%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

The market dealt us some great cards in March and April, but as May rolled around it felt as if the deck was stacked against us. Credit spreads started leaking wider so we decided to pocket our chips and head to the side lines. Our strategy during this period was to shift the portfolio into shorter dated securities and earn



some defensive yield while watching things develop. With the weak tone and a few deals not performing, our defensive approach kept us out of trouble. By avoiding losses and focusing on conservative carry and active trading, we were able to generate a decent return in a difficult credit environment.

June should be busy in terms of issuance, the FOMC meeting and 'Brexit.' We should be dealt a few promising hands, but we'll be quick to fold if we sense that the odds are unfavourable.

Credit

After a two month rally that saw credit spreads reach levels last seen in November, the market started to tire. By mid-May credit spreads were back to flat-on-the-year.

Dealers tried to bring a few deals to market, but oddly enough, a couple of companies felt they could raise money without a new issue concession. We opted to pass on those deals, which was a good thing as they ended up under water within a day or two. Corporate bonds might have continued to lose their lustre had it not been for the GE tender which put a great deal of cash into investor hands (approximately \$3.5B). Flush with a new bank roll, portfolio managers were back at the table placing their bets.

At the beginning of the month we exited our position in Canadian bank paper as spreads were near their tightest levels over the past year and with the expectation of significant supply post earnings. With the banks opting to source funding abroad and through short dated floating rate notes domestically, we re-entered our position in deposit notes and NVCC bonds toward the end of the month. However, being wary of 'Brexit' related volatility our position remains quite manageable.

Rates

Janet Yellen and company became decidedly more hawkish as they made noises about a possible rate hike in June. It appears that equities have finally come to terms with the idea of higher rates, as stocks barely flinched. Governor Yellen has demonstrated a great sensitivity to market tone so the odds of a hike are very difficult to say, especially as stocks may become unglued should 'Brexit' fears resurface.

Canada continues to struggle with a problematic blend of an overheated housing market in Vancouver/Toronto and serious economic slowdowns in oil producing provinces. The Bank of Canada is in a tough spot as monetary policy is a blunt instrument that can't be specifically targeted to a particular region. As such, Mr. Poloz and company ought to remain on hold in hopes that the weaker currency and modest recovery in oil prices leads to better economic prospects.

Regards,

The Algonquin Team

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