



The Ugly, The Bad, And The Good | March 2020

“All we need is just a little patience.”
Guns N' Roses

First and foremost, we hope that you and your family are safe, healthy, and coping well during these difficult times.

One of the most frequently used words of this period is ‘unprecedented’. Accordingly, we are going to break precedent from our usual commentary format. Rather than the usual drivel that fills these pages, this month we opted for a summary of the carnage in the corporate bond market, and a review of our portfolio and strategy going forward.

The Ugly.

Corporate Bond Market Summary.

While COVID-19 has taken equity markets on a rollercoaster ride, corporate bonds experienced an unabated sell-off through most of March.

The two major drivers:

- Credit risk. With businesses shutting down across the globe, the creditworthiness of corporations has declined, and the risk of delinquencies has increased
- Liquidity premium. A scarcity of cash in the financial system has banks, institutions, and asset managers selling high-quality corporate bonds to raise the cash for their immediate needs (regulatory requirements, margin, collateral, fund redemptions etc.)

The net effect was a sharp widening of credit spreads, with short-dated corporate bonds being the hardest hit.

Credit Spreads.

The credit spread is the premium on a corporate bond over government bond yields. This spread is comprised of default risk and a liquidity premium.

- The default risk reflects the probability that the corporation will be delinquent on its debt obligations and will vary from company to company
- The liquidity premium represents the ease and costs of selling an asset and converting it into cash. For example, disposing of a property can be a lengthy and costly process, as opposed to the relative ease and low transaction costs of selling a stock

The COVID-19 Effect.

The table and graph below offer some illumination into the magnitude and speed of the virus' impact on credit markets.

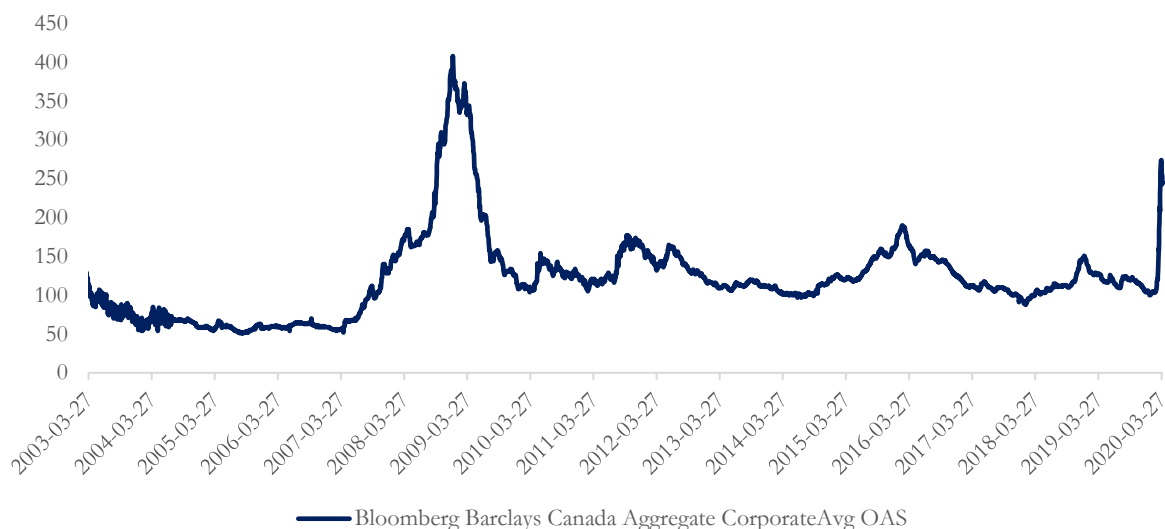
Indicative Canadian 5y Credit Spreads.

	March 31, 2020	February 19, 2020	Change
Government of Canada 5y Yield	0.60%	1.36%	-0.76%
Bank Sr	+2.50%	+0.85%	1.65%
Bank NVCC	+3.65%	+1.10%	2.55%
Bell Canada	+2.70%	+0.95%	1.75%
Volkswagen Canada Finance	+3.92%	+1.00%	2.92%
RioCan	+3.35%	+1.15%	2.20%
Enbridge	+4.01%	+1.05%	2.96%

We have fielded several questions about how the current experience compares to 2008. The major differences are the underlying causes and the speed of the sell-off.

- In 2008, the concern was that the banks would fail and take down the financial system with them. Today, the shock to spreads is due to the global economy unexpectedly and suddenly being put on pause
- The credit spread widening of the Great Financial Crisis occurred over several months. During the current crisis, we experienced approximately $\frac{3}{4}$ of the 2008 move within four weeks

Canadian Investment Grade Corporate Bond Spreads.



While increased default risk has contributed to higher credit spreads, the majority of the move has been driven by the need for liquidity i.e. selling of corporate bonds to raise cash.

The Liquidity Problem.

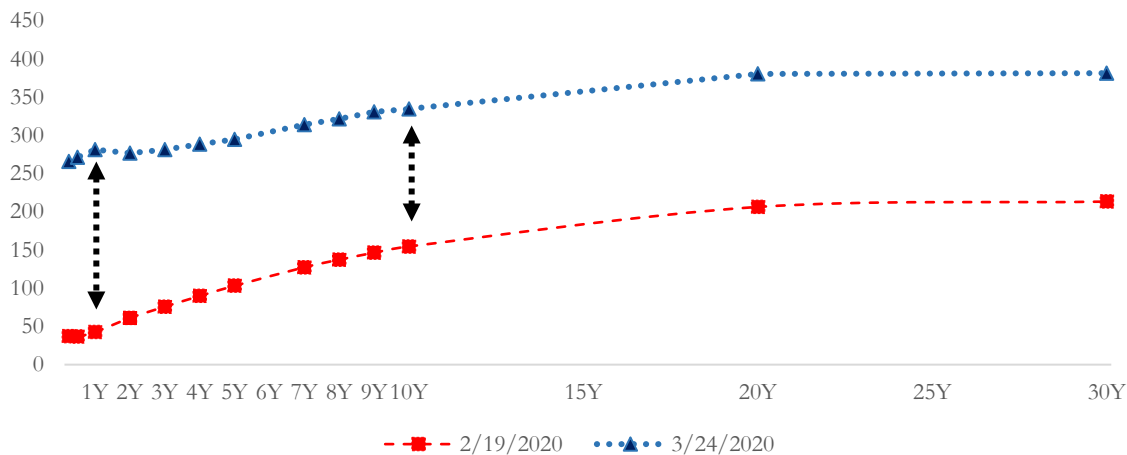
Everybody either wants or needs cash at a time when it is a scarce commodity.

- Businesses and individuals are drawing down on their credit lines
- Banks are experiencing funding pressure
- Financial institutions and pensions are required to post more margin and collateral against their positions
- Asset managers need cash to fund redemptions

To raise the cash to meet their immediate obligations, market participants sell 'cash proxies'. The most popular assets to sell have been high-quality, shorter-dated investment-grade bonds and commercial paper.

As per the graph and table below, this created a more pronounced spread widening in less than 2-year maturities.

Canadian BBB Spread Curves.



Indicative 3-month Credit Spreads.

	March 31, 2020	February 19, 2020	Change
Loblaws	+2.10%	+0.40%	1.70%
Hydro-One	+1.45%	+0.35%	1.10%
National Bank	+3.50%	+0.60%	2.90%

The Bad.

The Fund Performance.

With the Fund concentrated in higher-quality, short-dated bonds, the sell-off in this space led to mark-to-market losses.

- These losses are due to marking down the prices of our corporate holdings and are not the result of permanent capital loss due to default
- Hedges through short positions in credit derivatives partially offset the rise in default risks within corporate bonds but were ineffective against the increase in liquidity premiums
- While we were net sellers of credit exposure through February, we did not anticipate moves of this magnitude and velocity
- Despite running much lower than normal exposure, the magnitude and speed of the widening in credit spreads led to a net return of -16.3% for March

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	-16.30%	-15.61%	-13.62%	-15.61%	-10.38%	-0.96%	6.47%	7.23%
F Class	-16.31%	-15.72%	-13.96%	-15.72%	-11.14%	-1.71%	NA	NA

The Good

The silver lining with credit strategies is that while spread widening leads to losses, it does also result in increased portfolio yields and opportunities for recovery and outsized returns in the medium term.

- The losses are mark-to-market and as long as the issuers don't default these losses can be recovered
- Given the Fund is concentrated in higher-quality issuers, the risk of portfolio defaults remains low
- The dramatic widening of credit spreads has resulted in a substantial increase to the yield on the portfolio
- The sharp sell-off has created dislocations and opportunities that we, as active managers of a small fund, can capitalize on
- Central Bank and government stimulus are supportive of investment-grade bond markets

Our Portfolio.

Below is a high-level summary of our portfolio as of March 31, 2020. For a more detailed breakdown of exposures and metrics, please refer to the appendix of this document.

- Portfolio Yield: 13.5%
- 99% Investment-grade
- Average Term to Maturity: 1.87 years
 - 44% matures within 12 months
 - 92% matures within 3 years
- Net 5y Credit Leverage 1.5x
- Total Long Credit Exposure 5.6x (not including hedges)
- Largest issuer exposures: BMO, TD, and Bell Canada
- Largest sector exposure: Banks
- Energy exposure
 - Only exploration and production exposure are two positions in Canadian Natural Resources which mature in 2-months and 4-months, respectively. The remainder is in pipelines and midstream issuers
 - 43% of the energy exposure matures within 4-months
- In good standing with prime brokers with a significant excess margin
- Liquidity through bonds maturing every month for both deployment and portfolio de-levering

The Opportunity.

Although volatile markets present several enticing opportunities, we feel few offer the attractive risk/reward profile of investment-grade credit.

- Wide credit spreads mean high-quality assets offer extremely attractive yields and potential for price appreciation
- Central Banks have rolled out programs that already exceed those employed in 2008 in both scope and scale. Many of these measures are aimed at improving liquidity in the markets
- The Federal Reserve and European Central Bank have extended Quantitative Easing to include investment-grade corporate bonds, and the Bank of Canada has enacted similar measures for provincial bonds and commercial paper
- Large-cap companies that are integral to the economy should benefit from fiscal stimulus and government support
- A significant recovery in equities is not a prerequisite for high-quality credit to perform

The Timing.

To paraphrase legendary credit investor Howard Marks' recent memo:

'The bottom' is the day before the recovery. Thus, it's absolutely impossible to know when the bottom has been reached...ever. Even though there's no way to say the bottom is at hand, the conditions that make bargains available are materializing.

In the medium-term credit markets typically recover faster than equities. But we anticipate the short-term moves will be slower and more gradual in credit. This gives us a greater opportunity to adjust exposure and participate in more of the upside.

Our Strategy.

Keep It Simple Stupid.

- With bonds maturing every month, we look to capitalize on the dislocations in high-quality credit while maintaining financial flexibility should even greater bargains emerge
- As markets stabilize, use new issues to enter positions at deep concessions
- Focus on high-quality issuers and sectors that will survive and thrive in the long-term. Given the current opportunity set, there is no need to be heroes and venture into lower-quality debt

Final Thought.

In times like these, often the greatest commodity is patience. Patience with self-isolation, your family, long line-ups at stores, and the slow internet.

Thankfully, given the nature of our strategy, the patience we require is not of the Warren Buffet 5-10 year nature, but more like that of a millennial with a one to two-year investment horizon.

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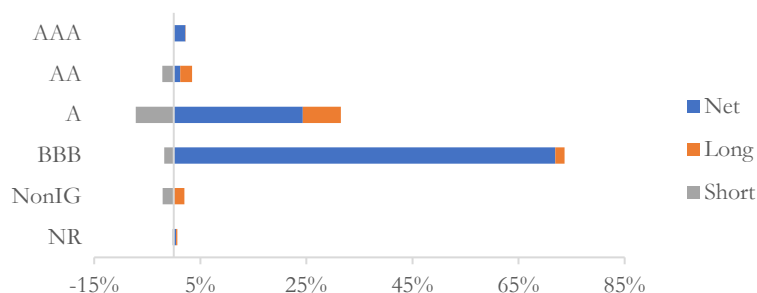
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Appendix.

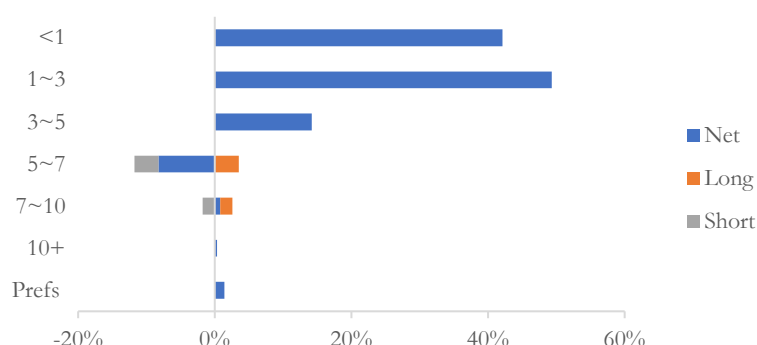
Rating Breakdown



Portfolio Metrics

CR01	7.32 bps
Average Weighted Maturity	1.87 years
Interest Rate Duration	2.23 years
Net Credit Leverage (5y)	1.46x
Total Long Exposure	5.58x

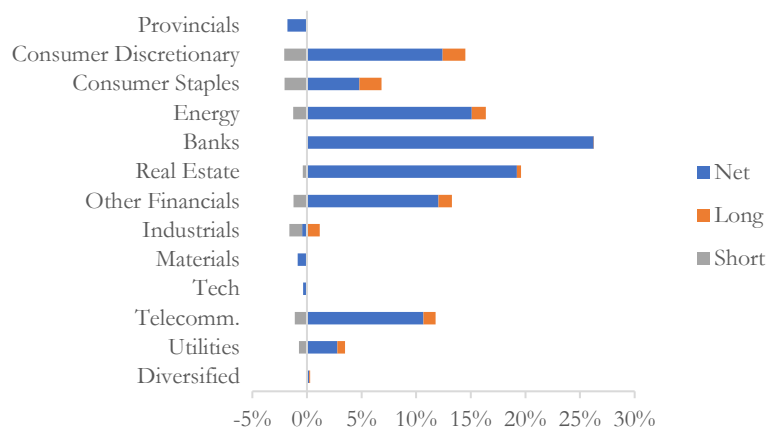
Term Breakdown



Performance Summary

Volatility	8.40%
Sharpe Ratio	0.75
Sortino Ratio	1.02
Maximum Drawdown	-16.30%
Months Positive	82.26%

Sector Breakdown



Trailing Performance (%)

	Class X	Class F
1M	-16.30	-16.31
3M	-15.61	-15.72
6M	-13.62	-13.96
YTD	-15.61	-15.72
1Y	-10.38	-11.14
3Y	-0.96	-1.71
5Y	6.47	N/A
SI	7.23	N/A

	S&P	TSX	XBB
Correlation	18%	18%	-19%
Upside Capture	23%	30%	30%
Downside Capture	-14%	-28%	-146%

Monthly returns shown are based on 'Series 1 X Founder's Class' NAV and are shown in Canadian dollars, net of all fees and expenses. Class X is closed to new investors. Past performance is not indicative of future results. There can be no assurance that the results achieved for past investments will be achieved by the fund in the future. The Sharpe and Sortino ratios are calculated using the Bank of Canada Target Overnight Rate and 0% respectively. Please note the Fund does not have performance benchmarks and statistics are for correlations and comparative purposes only. All indices are total return and S&P data is reported in United States dollars. CR01 represents the estimated impact on the Net Asset Value expressed in basis points for a one basis point change in credit spreads across all credit positions. Total Exposure/Leverage is calculated as the total market value of all positions that are not hedges divided by the Net Asset Value. Net Credit Leverage is calculated by converting the credit exposure into a 5y duration equivalent notional which is then divided by the Net Asset Value. Detailed explanations of calculation methodologies are available for download at <https://www.algonquincap.com/funds/fund-performance-and-metrics/>