FULCRA ASSET MANAGEMENT INC.

LYSANDER FUNDS®

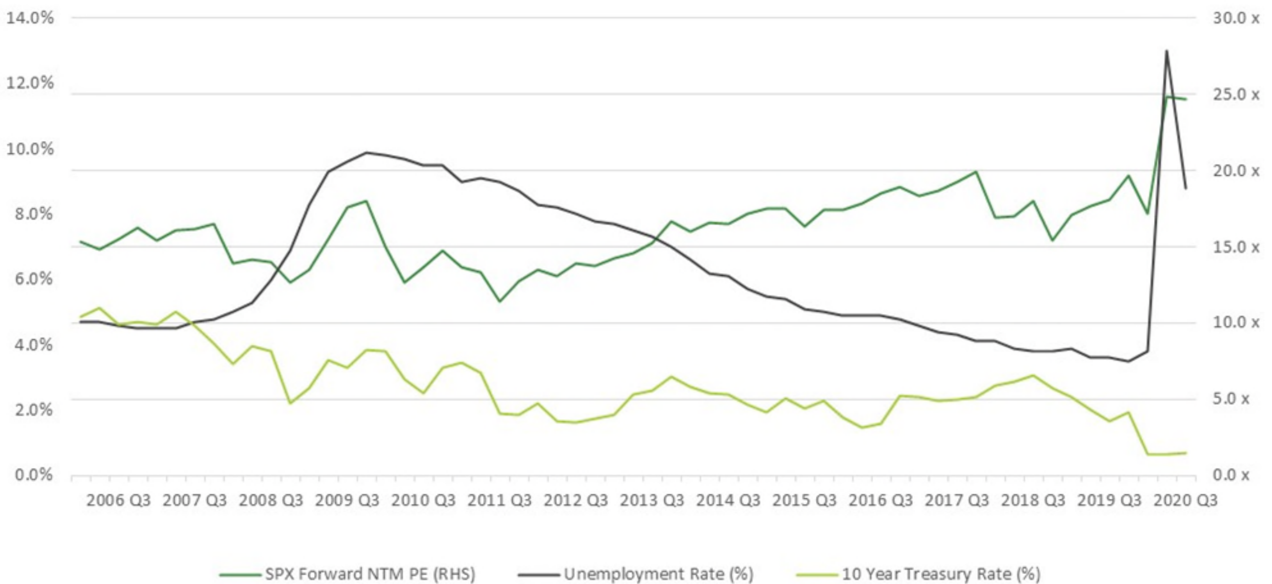
Mowed Down But Not Leveled

November 2020

When the US Federal Reserve dropped short term interest rates to zero in the first couple of weeks of March, it did little to stem capital markets concerns about the building worry of COVID-19 and the breakdown of OPEC discussions that led to a drop in the price of oil. Quickly following this, the Federal Reserve announced on March 23rd, 2020, the establishment of the Primary and Secondary Market Corporate Credit Facilities. These pools of capital were put in place to provide loans and purchase bonds of investment grade companies. Just two days later, on March 25th, 2020, the CARES Act was signed, a fiscal stimulus package significantly larger[1] than that administered during the 2008 – 2009 financial crisis. These historic monetary and fiscal policies unleashed a "follow the Fed" bid for investment grade corporate bonds that was without historic precedent. The goal was to stabilize markets that quickly became very concerned with the impossible calculus of the COVID-19 pandemic.

The US government's support for the corporate bond market also included some high yield companies (i.e. Ford Motor Credit) that had just recently been downgraded to non-investment grade. With the US government opening its wallet in historic precedent, investor confidence turned to the stock market. At the end of September 2020, the S&P 500 was sitting at 3,363 points – or 26 times earnings. At the end of 2019 when many market pundits believed the stock market was getting ahead of itself, the P/E on the S&P 500's 2020 expected earnings was 19.7 times.

[1] McKinsey & Company: The $10 trillion rescue: How governments can deliver impact

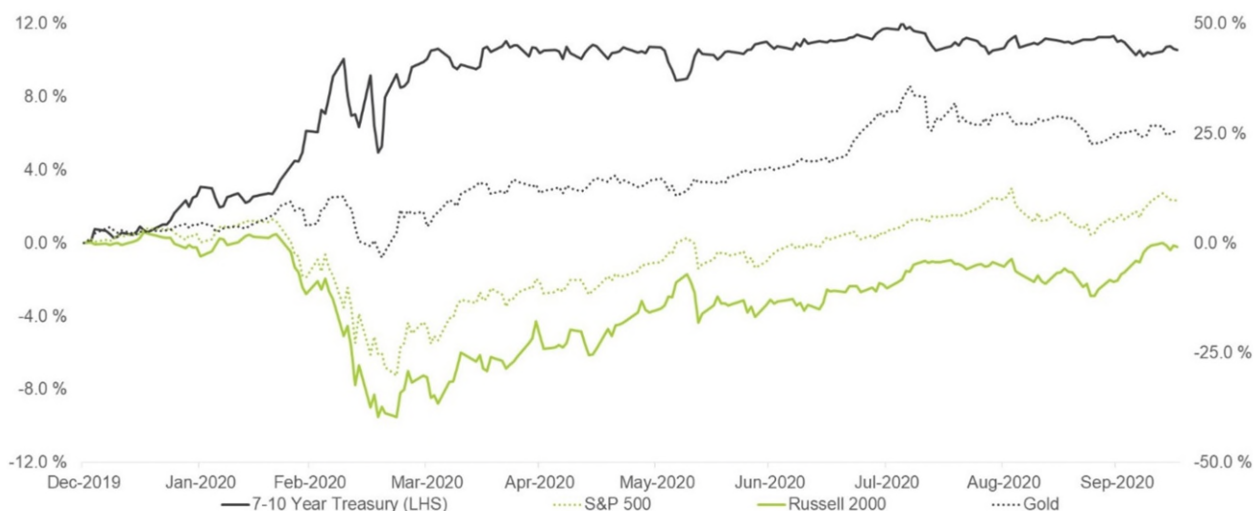


Source: Bloomberg Finance L.P.

With the "higher powers" taking care of liquidity, can you blame investors for buying stocks at historically high valuations when "safe" government and IG bonds AGAIN hit all time low yields?

The theory that low interest rates make the relative "earnings yield" from stocks more attractive misses the fundamental fact that the future is difficult to predict. Maybe in the short term this low interest rate and high P/E relationship can be rationalized … or maybe the US unemployment rate going from 14.7% in April 2020 to a more subdued 7.9% in September 2020 justifies the S&P 500 returning 15.48% over the summer.

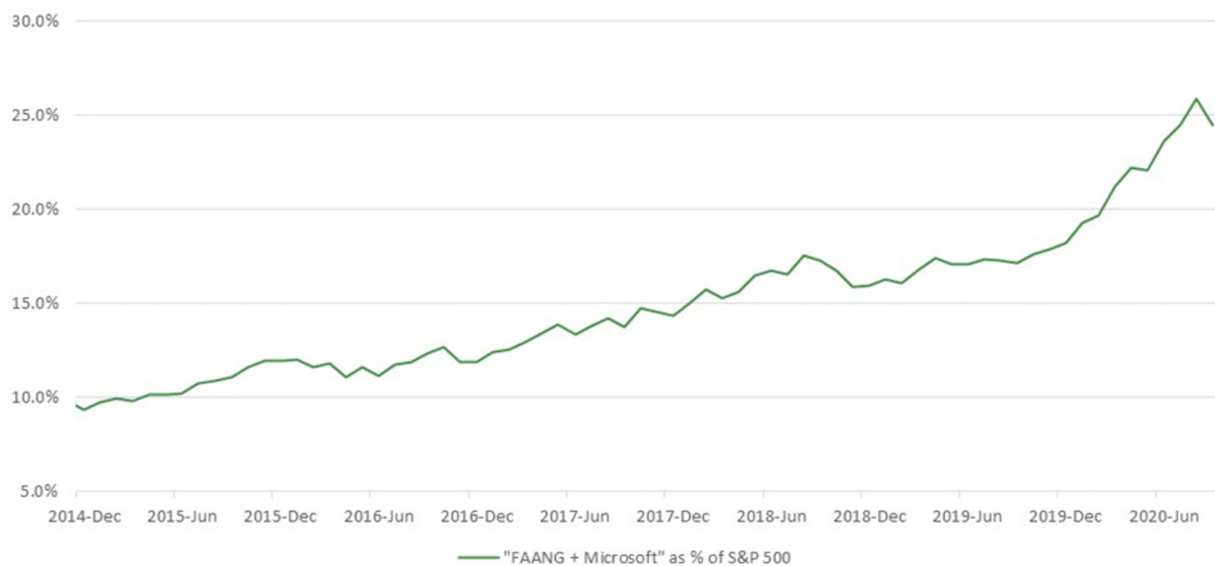
So, unemployment at the onset of COVID went from an all-time bad level to a level only last seen in the Great Recession of 2008-2009. Perhaps it was the velocity at which unemployment dropped that meant everything would be back to normal by the end of the year.



Source: Bloomberg Finance L.P.

Certainly, the dramatic shift to a work / play from home culture has resulted in a pickup of demand for the products / services of hardware and software companies that make this a reality. Whether this new reality is here to stay or we go back to a pre-COVID lifestyle, the FAANG's (Facebook, Amazon, Apple, Netflix and Google (Alphabet)), Microsoft, and other technology related companies have seen their stocks in hot demand. At the beginning of 2020, the market capitalization of the FAANG stocks, including Microsoft, represented 18.2% of the S&P 500; by the end of September 24.5%. Over the first 3 quarters of the year these six stocks were up 40.21% versus the index being up 4.09.%.

To get a better read / confirmation of the overall US economy through the lens of the S&P500, and the other 494 companies, we looked at the performance of the equal weighted version of the S&P 500. This version of the index weights each company equally versus their individual market capitalization in the main index. Over the first 3 quarters of the year this version of the S&P 500 index was down 4.8%.



Source: Bloomberg Finance L.P.

At Fulcra, some of our most compelling US bond investments, if they are public companies, have come from companies on the outer bounds of the S&P500 or, more likely, those in the small cap equivalent Russell 2,000 index. Through the first 3 quarters of 2020, the Russell 2,000 was down 9.6%.

While some Russell 2,000 companies were able to receive payroll and other monthly business expense relief, these temporary aids didn't necessarily translate to the reinstatement of pre-COVID company valuations and / or access to capital markets at reasonable terms. Small to medium sized businesses,

including those rated non-investment grade have had, to the end of September, a much tougher go this year than their larger cap compatriots.

An example of this type of company came from Lysander-Fulcra Corporate Securities Funds' (the "Fund") investment in the bonds of Briggs & Stratton, one of the largest small engine manufacturers in the world. Our investment thesis was based on the value of certain engine plants and strong working capital position - resiliency of engine inventory and counter party strength from the likes of Home Depot and Lowe's. However, with bonds coming due in December 2020, management, in hindsight, waited too long to initiate a strategic review which left the company, and us as bondholders, exposed to the unpredictable behaviour of senior creditors, management, competitors and other stakeholders at the onset of a global pandemic.

As the summer progressed and the pandemic took on a level of permanency, the first and second earnings reports from many companies we follow became incredibly insightful beyond the usual unpredictability of trying to operate during a global pandemic. It was not so much what they said but what was happening to their top line.

Certain companies / sectors are seeing an uptick in revenues because of consumers being home bound and changing their buying patterns. Some of these positive changes, in our opinion, will become more permanent in nature for businesses where their product / service offering is non-discretionary and possess a product quality and deliverability advantage.

An example are the bonds of a privately owned grocer that the Fund purchased at a mid teens yield. As the company is a private issuer, we are limited in what we can say. However, leading metrics like basket

size / composition and margins have become exceptionally robust. In our opinion, this is a trend that may not continue at its current record level, post vaccine, but will settle at a level significantly higher than pre-COVID operations.

The world has been permanently scarred by the COVID pandemic; all that needs to be determined is the length of it. As difficult a time as this is for everyone, there are businesses that will thrive through this period and create longer term resiliency as a result. We embrace this opportunity to apply common sense business judgement and execution through the Fund's flexible and opportunistic mandate.

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Fulcra is the portfolio manager of the Fund.

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