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Q3 2019 Fund Commentary

Equity markets globally finished the quarter much where they began, but despite flattish markets, there was plenty of volatility and chop to frustrate investors. A largely unchanged July for equity markets was followed by a far more challenging August as stocks swooned, down substantially by mid-month as concerns of the inverted yield curve spooked investors once again, raising red flags around an impending recession. Treasury bonds had a massive move higher as yields crumbled, with the U.S. 10 year below 1.5% and its lowest levels since 2017, reflecting concerns over weak growth and a lack of inflation. September was almost the reverse of August, with markets rallying aggressively out of the gate, regaining the losses sustained in August by mid-month before moderating into quarter end as impeachment concerns for President Trump added to the list of worries. All this makes for a challenging environment for managing risk – with no real trends, and large swings up and down, often caused by a single tweet or headline, these markets have done their best to frustrate both bulls and bears.

It's perhaps no wonder markets seemed confused - we can make a reasonably compelling argument for both "bull" and "bear" market scenarios looking forward. On the bear side, global macro data continues to weaken, Germany is likely in recession, and global trade is suffering from the ongoing U.S./China trade war. The bond market continues to signal concerns, with the yield curve remaining inverted at the short end of the curve, and the more important 10s/2s also inverting briefly for the first time this cycle before backing up in September. On the bull side, markets globally are not far off their respective highs with most indices we track now in an uptrend. Leading indicators have not turned negative, and market breadth is improving as beaten down cyclical sectors are suddenly showing signs of life. While economic data is indeed weak, most metrics are holding the levels that marked the temporary slowdowns prior to recoveries in both 2011 and 2015. Perhaps most importantly, global banks globally are back to easing in response to the concerns – can they once again kick the can and extend this cycle further?

A Seismic Shift: Growth to Value

Perhaps one of the most interesting events of the quarter occurred in early September, as the "momentum massacre" drove some of the most extreme sector/factor moves we have witnessed in decades. While broad indices were generally flat over the few days in question, there were major shifts under the surface, with the sharpest sell-off in momentum stocks relative to deep value stocks since 1999. Stocks that had previously been in an uptrend – mostly defensive, low volatility, or growth stocks, reversed sharply lower en masse, while the most beaten up, lower quality, high beta, "deep value" stocks leapt higher in a wave of short-covering. While we have been calling for a rebound in value stocks for some time, it is hard to put a finger on the specific cause of this move, but we can certainly point to a confluence of contributing events; a sharp move upwards in bond yields as inflation and growth expectations picked up, the WeWork debacle where the company experienced a 75% cut in its private market valuation and the shelving of its IPO in the process, and finally, perhaps the sudden recognition that overpaying for growth stocks was an overcrowded trade and that ultimately valuations do matter.

Interestingly, these violent "regime shifts" tend to occur at major market turning points – both at the end of bull markets as in 1999 and 2007, as well as at the end of bear markets such as 2003, and 2009. The chart below puts the September 5-day move in context with other similar events of the last few decades:

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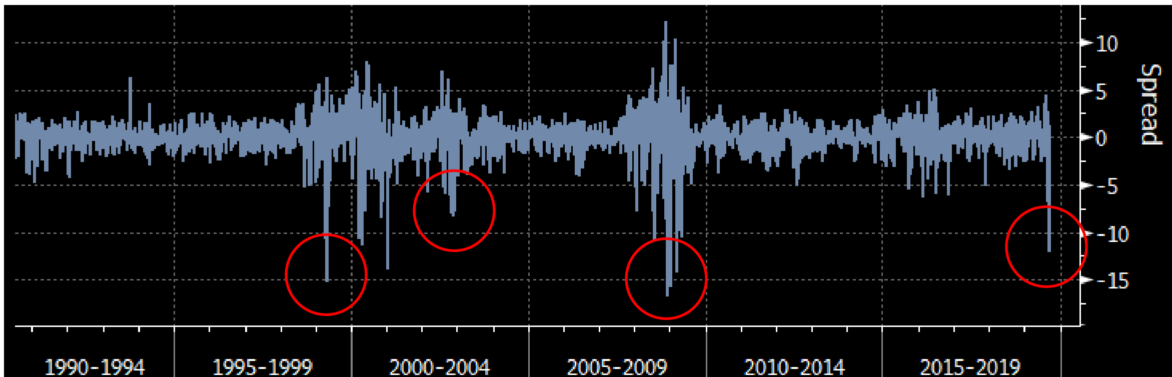
Momentum Index 5-day % change – Value Index 5-day % change



Source: Goldman Sachs, Bloomberg

While it's unclear whether this recent event is the start of a renewed up-leg for markets or the early warning for a coming bear market, (or "none of the above"), we would suggest that if nothing else we should consider that the extended cycle of growth-style outperformance has likely come to an end. Given the similarity of this cycle to the 1999 dotcom boom (as opposed to the 2007 boom that was led by traditional value sectors like energy and financials), it's a good chance to remind ourselves what happened in the bear market that followed from 2000-2003. The following chart shows long-only Value in blue, vs the index in white, and growth in red.

Growth vs. Value during the 2000-2003 Bear Market

Source: Morgan Stanley, Bloomberg

What is interesting to note is that value stocks actually rose on average through most of the '00-03 bear market, while it was largely over-priced growth stocks that led the market lower. Given that active management underperformance has become synonymous with value underperformance of late, we think this rotation, if it sticks, could move the needle back in favour of active management, and particularly long/short relative value

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strategies. Here is the same chart, but now overlaid with a fourth line (purple), which is a simple long value/short growth strategy, and which more than doubled during the bear market that took indices down 40%. While few managers would have executed this exact approach, given the general bias of long/short managers (ourselves included) towards higher quality, trending, reasonably priced stocks and against over-priced glamour stocks in a downtrend, it's easy to see why the period was historically one of the best for strategies like ours.

Growth vs. Value during the 2000-2003 Bear Market, with Long Value/Short Growth strategy

Source: Morgan Stanley, Bloomberg

Where to from here?

We enter Q4 with all our funds near the high end of their risk allocations. Credit Markets have remained remarkably resilient through the various periods of equity volatility, with high yield debt, which is the current allocation for our Credit Momentum strategy, touched all time highs in September. The portfolios are already responding to the regime shift signals, and are rotating toward more cyclical value stocks which are emerging from their long downtrends. As an example, we are once again net long energy stocks after being short for the better part of four years, and we are seeing more growth stocks move to the short side of the portfolio as they fall out of their leadership status and become more volatile. As to whether the regime shift signals a coming bear market like 1999, an extension of the rally like 2015, or neither of these outcomes – we honestly don't know, and thankfully our risk management process doesn't rely on us making a prediction, but rather on responding to current market signals. With that said, if we had to speculate, we'd suggest that with central banks once again stimulating globally, rates priced for a deflation crisis, hedge fund "beta" exposures near the low end of their ranges for the cycle, and a U.S. president who desperately seeks re-election while holding the single greatest card in the form of a headline "deal" with China, that the "pain trade" is likely a rising market for most, and those pressing their recession bets may be surprised by a market that breaks higher not lower out of its nearly two year malaise.

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Fund Specific Commentary

Summary of Returns (F-Class)

Fund	1M	3M	YTD	1YR	Inception
EHP Foundation Alternative Fund	0.6%	0.0%	2.7%	3.8%	4.5%
EHP Foundation International Alternative Fund	-0.1%	0.0%	3.2%	4.9%	6.1%
EHP Global Arbitrage Alternative Fund	1.4%	2.1%	5.3%	11.4%	12.5%
EHP Advantage Alternative Fund	-1.7%	0.5%	5.0%	3.5%	2.8%
EHP Advantage International Alternative Fund	-1.4%	-0.5%	7.4%	3.9%	4.8%
EHP Select Alternative Fund	0.3%	-0.7%	2.2%	1.3%	-0.1%

Defensive / Conservative Funds

EHP Foundation Alternative Fund

The Fund was flat over the quarter, with positive returns from the long side of the equity strategies offset by losses on shorts. Credit added small returns despite a volatile quarter that saw some risk-on/risk-off behaviour in bonds, and the fund enters Q4 with a long position in high yield. The Fund was stable through the September factor rotation as our overweight to stocks with sustainable dividends maintained a balanced weight to the "value" factor, offsetting losses from momentum and low volatility factors.

EHP Foundation International Alternative Fund

The Fund was flat over the quarter, with returns coming from the long side of the portfolio, predominantly in Europe, but which were more than offset by losses from our shorts across all markets. Credit provided small returns despite a volatile quarter that saw choppy risk-on/risk-off behaviour in bonds. The Fund enters Q4 with a partial long position in high yield. The Fund was relatively stable through the September factor rotation as our overweight to stocks with sustainable dividends maintained a balanced weight to the "value" factor, and offset losses from momentum and low volatility factors.

EHP Global Arbitrage Alternative Fund

The Fund was up 2.1% over the quarter, as a number of existing deals closed, and spreads tightened on some of the more volatile spreads we hold. We held just over 100 positions in aggregate over the quarter and enter Q4 with 56 active positions in the fund. SPACs represent approximately 7.8% of NAV exposure. Notables during the quarter included a large tightening in cannabis deal spreads (Origin House/Cresco and Acreage/Canopy), both moving to levels that had us taking profits on these volatile but profitable deals, as well as a bidding war in German lighting manufacture Osram Licht, and a top-up in Presidio as a result of a competing bid during their go-shop period. With a number of deals closing in recent days, we enter Q4 with some dry powder, waiting patiently for new deals with favourable metrics.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was up 0.5% during the quarter, with returns coming entirely from U.S. equities on both the long and short side. Canadian equity strategies were flat during the quarter. Credit provided small returns despite a volatile quarter that saw choppy risk-on/risk-off behaviour in bonds. The Fund enters Q4 with a long position in high yield. The Fund's strong outperformance vs indices in August was given back in September during the "momentum

massacre" which pulled down not only trending stocks but also high quality, low volatility equities on the long side, while spiking higher beta "junk" stocks causing losses on shorts. Our exposure to higher-quality value stocks with strong cash flow was not enough to offset the losses from the other factors in September. We enter Q4 with the Fund risk on in both Canada and the U.S., with the Fund beginning to rotate further away from low volatility and growth stocks, and towards more cyclical value stocks.

EHP Advantage International Alternative Fund

The Fund was down 0.5% during the quarter, with returns coming from long positions in Europe, which were more than offset by both long and short positions in other regions. Credit provided small returns despite a volatile quarter that saw choppy risk-on/risk-off behaviour in bonds. The Fund enters Q4 with a partial long position in high yield. The Fund's strong outperformance vs indices in August was given back in September during the "momentum massacre" which pulled down not only trending stocks but also high quality, low volatility ones on the long side. Our exposure to higher-quality value stocks with strong cash flow was not enough to offset the losses from the other factors in September. We enter Q4 with the Fund risk on in all markets, and with the Fund beginning to rotate further away from low volatility and growth stocks, and towards more cyclical value stocks.

EHP Select Alternative Fund

The Fund was down 0.7% during the quarter, with returns from longs essentially neutralized by losses from shorts. The Fund's overweight to higher quality value stocks has made for a tough few quarters as defensive, low volatility and growth stocks have dominated returns, but should the rotation toward more cyclical value stocks that started in September continue, the Fund is well positioned to outperform in a market rally. We enter Q4 with the Fund "risk-on", favouring higher-quality technology stocks along with more cyclical industrials and energy equities.

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.

Risk/Reward statistics are calculated using monthly returns. "Index" is a 50/50 blend of the S&P TSX Total Return Index and the S&P 500 Total Return Index in local currencies. "Agg Bond" is the Bloomberg Barclays US Aggregate Bond Index total return index. “MSCI EAFE” is the MSCI EAFE Net Total Return in local currencies. "Max. Drawdown" measures the largest single drop in a class’s Net Asset Value Per Unit from peak to trough before establishing a higher peak (the smaller, the better). "Sharpe Ratio" is calculated as the annualized return divided by the annualized standard deviation, and uses a 0% risk-free rate (a higher Sharpe Ratio implies less risk per unit of return). "Fund Correlation" measures the Fund's correlation to the comparative indices, where a value of 100% implies the Fund's movements are identical to the index. "Fund Beta" measures the Fund’s volatility relative to the comparative indices, where a value of 1 implies the fund’s movements are identical to the index.

"Upside/Downside Capture" is a measure of an investment manager’s performance during only the up or down movements of an index (ideally you want to capture as much of index up months and as little of index down months as possible). The numbers shown here are the average returns of the Fund during average up and down months of the index. The index used is a 50/50 blend of the S&P TSX Total Return Index and the S&P 500 Total Return Index in local currencies, rebalanced monthly.

The compounded rate of return showing the growth of $100,000 in “Returns vs Index” chart is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of the investment fund or returns on investment in the investment fund. Commissions, trailing commissions, management fees, performance fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated. EHP Funds is the investment manager to the EHP Funds offered under prospectus. EdgeHill Partners is the investment manager to the EHP Funds offered under offering memorandum, and is an affiliate of EHP Funds Inc. The Funds are available only in those jurisdictions where it may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or investment advice.

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