

Q1 2020 Fund Commentary

It's difficult to know where to begin when looking back at how much the world has changed in the last three months, let alone what has happened in the markets. We're saddened by the scale of the humanitarian crisis, and hope that you and your family are safe and healthy as we all work through these unprecedented times. While we certainly have opinions on the politics and the medical aspects of this pandemic, we aren't virologists, and we aren't paid to give political views, so, we'll stay focused in this note on the things we think we do understand: what has happened to markets, where they might go from here, and how we are controlling risk and preserving your capital.

While hard to believe in retrospect, it was just over a month ago on February 19th when global equity markets hit an all-time high, before ending the month with the sharpest correction in history, falling more than 12% in just five days, as the reality set in that the Covid-19 virus was on its way to becoming a global pandemic. Despite the sharpness of the fall, February was just a warm-up for March, where after a reflexive 10% rebound to start the month, the market fell nearly 30% in a relentless "dash for cash" that spared virtually no asset class. From market-high peak to the late March trough, the S&P 500 fell 35.4%, the TSX Composite 37.8% and the MSCI EAFE 33.9%, marking an end to the second longest bull market in history. The speed of the decline was striking – this was the fastest decline into a bear market ever. The cause? A massive deleveraging event, with multiple sources of forced selling that drove a self-fulfilling cycle of "selling begetting more selling". While we suspect that books will eventually be written on the subject, we highlight here some of the more obvious (if somewhat technical) culprits:

- **Systematic or "volatility-targeting" strategies:** We would place ourselves in this category, as the process we use for our long/short funds reacts to changing market trends and increasing volatility by "gearing down" risk. We tend to act fairly early, and by the end of February our process had reduced directional risk across our funds by selling longs and adding weight to shorts, as well as rotating from riskier U.S. High Yield bonds and into the flight-to-safety 30-yr U.S. Treasuries. An estimated US\$850 billion is in strategies that reduce risk as volatility increases or as trends change (source: IMF), and by mid-March, there was billions of dollars in systematic selling from trend-following or "CTA" strategies, risk-parity strategies, variable annuities and other risk-managed tactical strategies responding to the declining trends and increased market volatility.
- **Leveraged "spread" strategies:** Low funding costs, coupled with low volatility and a credit tailwind have made popular strategies that aim to profit by owning a "spread" between two assets, including strategies such as buying corporate bonds while shorting Treasuries, or buying "off-the-run" Treasuries while shorting "on-the-run", or other strategies such as statistical arbitrage, index arbitrage, etc. The common feature tends to be copious amount of leverage, with many credit funds carrying 10-12x leverage or more. These strategies had massive dislocations as spreads blew-out, in many cases, to unseen levels, as managers scrambled to find liquidity. In our corner of the world, merger arbitrage was a visible, liquid version of a spread strategy that also saw its worst dislocation in history, with all deals suddenly trading as if they had broken (or worse), before recovering somewhat into month end.
- **Options and structured notes dealers:** Structured notes have become a popular product in the "search for yield", and essentially use derivatives to convert equity returns and volatility into a note with a yield, and which also typically have a limit on the downside for the buyer. This cap on the downside however, means that the dealer that sold the note (typically a bank) is at risk of loss if the market falls suddenly and they are unable to hedge their exposure. There are tens of billions of these products outstanding, and as the market fell off a cliff, these dealers were forced to sell into a declining market, with losses accelerating as the market dropped (known as having "negative gamma" for the technically inclined). In addition, options dealers who had sold billions of dollars of put options or were short volatility found themselves in a similar position. With markets gapping down instead of falling "smoothly", it was a mad dash to sell, and this behaviour was one of the key reasons why a market already down on the day tended to accelerate into the close.

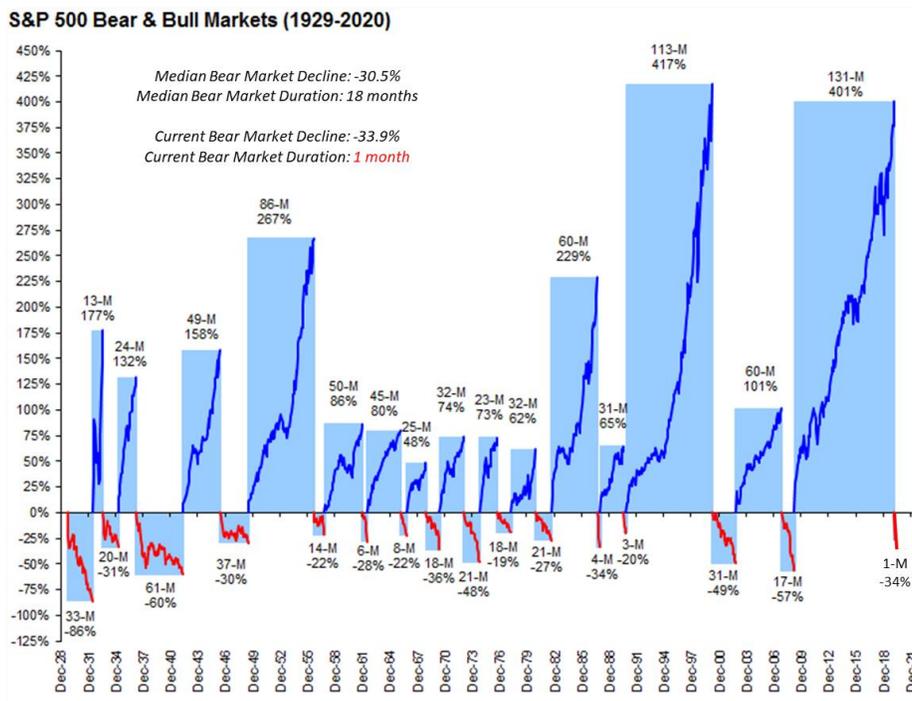
These certainly weren't the only sellers in March, but the above highlights the amount of automatic or forced selling that can create a downward spiral like we witnessed. There are clear parallels to the "portfolio insurance" blamed in part for the 1987 crash, as well as the 1998 mini-crash that resulted in the demise of the highly levered Long-Term Capital Management, which also bet on usually reliable "spreads" across multiple asset classes. This level of forced selling and extreme sustained volatility tends to create unexpected market behaviours, which is why we saw "normal" asset correlations become unglued, with gold selling off on big market down days, or defensive U.S long bonds actually down on the month at one point before recovering. It was also clear that ETF market makers couldn't (or wouldn't) keep up with the selling pressure in bond funds. While the benefit of an ETF is that you can always get a price (as opposed to a mutual fund that might gate redemptions), we suspect that the sellers of typically liquid, multi-billion dollar bond ETFs did not expect to see discounts to NAV as large as 10-15%.

For our part, while our risk-gearing process had us reduce risk prior to the March events, we responded to the very high sustained volatility by further reducing our "gross" risk across our long/short funds, meaning we made the decision to decrease the size of all positions, both long and short. When volatility is this high, the safest approach is to have less overall risk, a lesson we learned during the 2008 financial crisis. While we use only moderate leverage even at the higher end of our risk ranges, we felt it prudent to shore up additional flexibility to ride out the market storm, and we'll look to add gross exposure back only when overall market volatility calms down, and once "normal" correlations reassert themselves.

There was some good news by the end of the month. Equity markets staged their largest 3-day recovery since the 1930's once the forced selling abated, and as the U.S. government passed the largest stimulus program since the 2008 financial crisis. Pension fund rebalancing and the return of the dip-buyers kept markets reasonably well-bid into quarter end. Importantly, the Fed managed to stabilize the corporate bond market after becoming the buyer of last resort, and in the final week of the month a record US\$107 Billion of investment grade debt had been issued.

Too early to buy?

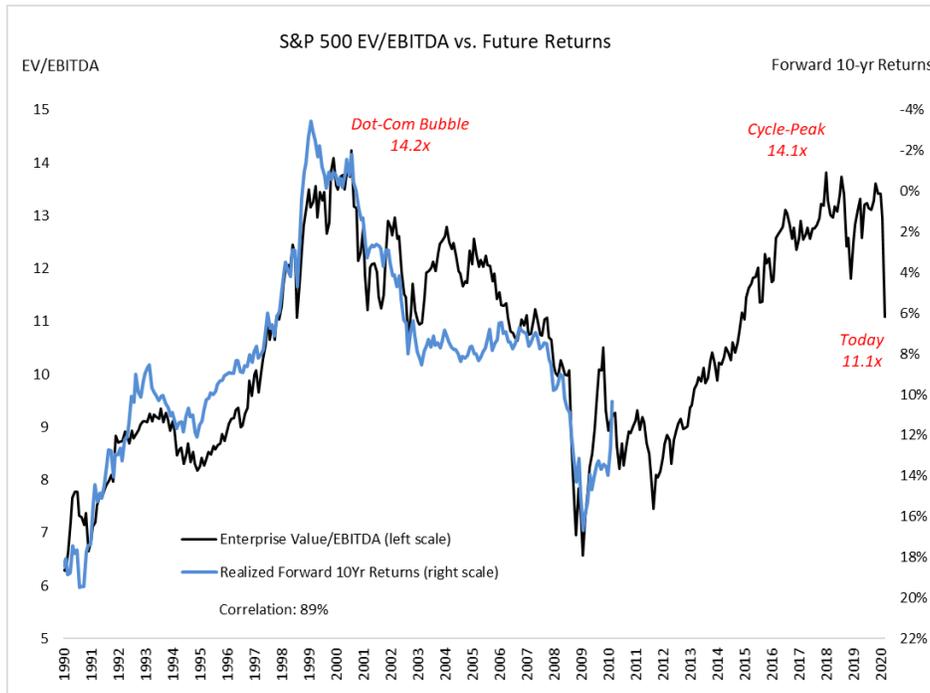
Our risk-management process responds to changing market trends, both for reducing risk, but also for adding it back. We look for the same risk signals in reverse, namely, the High Yield bond market stabilizing and trending higher, and individual broad equities indices (S&P 500, S&P TSX, Euro STOXX, etc) moving back up through key market averages. Despite the substantial rally off the lows, we are not yet close to any of these signals. Anecdotally, we have heard that Canadian discount brokers have seen a surge of retail buyers on the recent dip, with volumes many times in excess of the prior period high (which happened to coincide with the top of the cannabis bubble in early 2018). Real bear markets (which we are now most certainly in), don't tend to end on this kind of optimism, but on frustration for both bulls and bears. There is no doubt that global central banks as well as governments have moved swiftly to backstop the most vulnerable parts of the market through repos, swap lines, and outright corporate bond purchases (all likely necessary to avoid an outright freeze of the market "plumbing"), as well as via meaningful stimulus to bridge the gap for the suddenly unemployed and shuttered small businesses. These actions are certainly necessary to avoid an outright collapse, but it is difficult to see them as offsetting the inevitable slowdown. Absent a miracle treatment or vaccine, restarting the economy will take *time*. Will employers immediately hire back every furloughed employee? Will every small business operating with thin margins really be able to turn the lights back on? We suspect that a V-shaped recovery is not the most likely scenario (although of course not impossible given the unusual nature of this bear market). If we look to history, the median bear market sees declines of -30.5% but takes 18 months to complete (see chart below). This is month *one*.



Source: ScotiaBank GBM Portfolio Strategy, Bloomberg

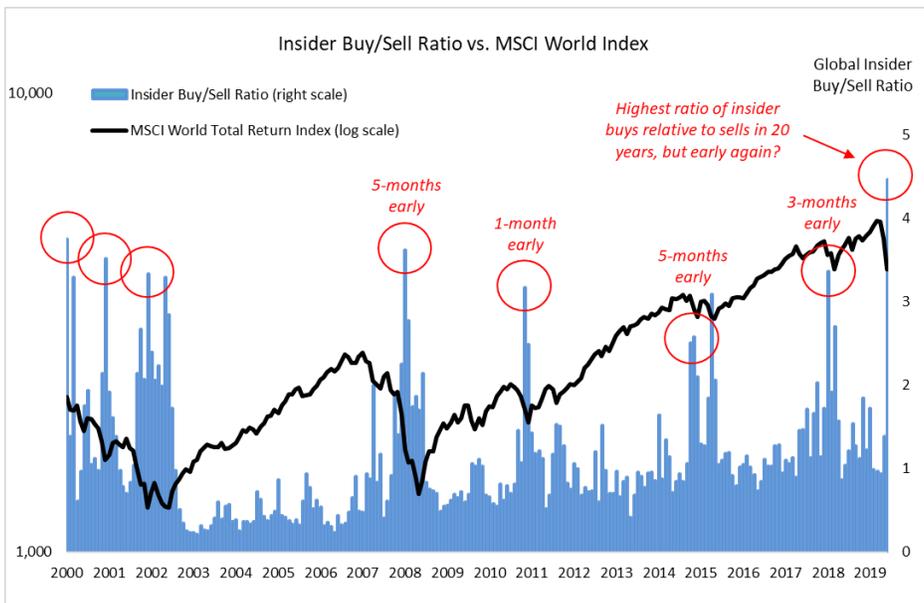
Recessionary bear markets tend to have worse declines on average, so even if we have hit “the” bottom, its more likely that we may see it again over the coming months, or that we see an extended period of time before a new bull run takes hold. Even with government support, there will almost certainly be bankruptcies and recapitalizations to come, and many companies will need to issue equity at a discount to shore up balance sheets. The largest net buyer of stocks in recent years – companies themselves through aggressive buybacks – is gone, and not likely to return anytime soon. HSBC estimates the amount of “missing” demand from buybacks over the next two quarters will top US\$300mm. As is typical, companies prefer to buy back shares in bull markets when cash (or cheap debt) is plentiful, rather than accrue that cash for deployment in pullbacks (Warren Buffett’s Berkshire Hathaway the exception to this rule).

Equity markets started the year with the dubious distinction of being some of the most expensive on record when measured by metrics like Price-to-Sales, Market Cap-to-GDP and EV/EBITDA. Despite the pullback, we’d argue that while much less expensive, markets are not exactly *cheap* at these levels, as an update to the chart we used in our Q4/19 note shows (see chart below). While at its highs the valuation of the market suggested a 10-yr forward return of essentially zero. The sell-off has pushed that estimate to around 6% annualized, but nowhere near as cheap as the 8x EV/EBITDA bottoms and the 15%+ forward annualized returns offered at the end of 1991 and 2008. Markets outside of the U.S fair better on this measure, with Europe trading at 8.4x EV/EBITDA – as cheap as it was in both 2008 and the 2011 European debt crisis.



Source: Bloomberg, EHP Funds

Company insiders globally have been active buyers in March, which is encouraging, as they can be assumed to be “informed” investors with the best knowledge about the health of their businesses. Insider buyers outpaced sellers by the largest margin on record, at more than 4:1. That said, when examining the historical record, insiders tend to buy dips, but also tend to be early buyers (see chart below), suggesting again that being patient is the prudent course.



Source: ZIQ Research, Bloomberg

From a factor perspective, markets actually acted fairly rationally during the month. As is typical in market sell-offs, stocks with high volatility, poor prior price momentum, stressed balance sheets and poor quality of earnings fell dramatically more than equities with the opposite attributes, benefitting our long/short approach. Value, having already lagged massively over the last number of years, continued to sell off, in part due to heavy concentration in energy and financial sectors. Value, and in particular “deep” value as measured by price-to-tangible book, will at some point revert higher and will more than likely lead out of this recession, but again given how early we are into this economic downturn, as well as a lack of visibility as to its longevity, there is no rush to pick a bottom for the style with the most cyclical exposure. Growth continues to amaze, with high-priced tech stocks remaining high-priced throughout the sell-off. There is no question that in some cases the virtual nature of their businesses have true advantages over traditional bricks and mortar, and that has never been more true, but we suspect that before this bear market is over, even the favourite growth leaders will have their still very high multiples meaningfully repriced.

Year-to-Date Performance of Market-Neutral



Source: Morgan Stanley, Bloomberg

We enter Q2 of 2020 with the Funds at the bottom end of their risk ranges, and with all regional markets “risk off”. Our Credit Momentum strategy is allocated to 30-yr U.S. Treasuries as it remains the preeminent flight-to-safety asset class. We’ve been adding selectively to arbitrage positions where we have seen some of the largest dislocations, and have increased our weight to SPACs which widened out to very attractive, guaranteed rates of return as forced sellers sought bids at rates of return north of 10% annualized. Our sector exposures remain biased to quality companies with strong balance sheets, and we are finding value in industrial sectors on a relative basis, although more defensive communication services and staples have climbed in our ranks, while consumer cyclicals have fallen, as have technology and financials. We remain net short materials, but have covered the bulk of our energy shorts, as the sector has been decimated by the new Saudi oil price war, and the stocks have fallen so far, and so fast, as to become too dangerous to remain short at these levels. As always, we’ll remain patient and disciplined in terms of adding risk back, diligently following our process that relies on actual market improvements and not forecasts of such. We wish everyone a safe, if rather unusual Spring, and as always appreciate your trust in us as allocators of your hard-earned dollars.

Fund Specific Commentary

Summary of Returns (F-Class)

Fund	1M	3M	YTD	1YR	Inception
EHP Foundation Alternative Fund	0.0%	-2.6%	-2.6%	-1.9%	1.8%
EHP Foundation International Alternative Fund	0.4%	-3.3%	-3.3%	-1.2%	3.1%
EHP Global Arbitrage Alternative Fund	-10.0%	-10.1%	-10.1%	-5.3%	3.3%
EHP Advantage Alternative Fund	-0.3%	-3.2%	-3.2%	-1.5%	0.7%
EHP Advantage International Alternative Fund	-2.2%	-7.3%	-7.3%	-6.3%	-1.4%
EHP Select Alternative Fund	0.7%	-8.9%	-8.9%	-9.2%	-3.9%

Defensive / Conservative Funds

EHP Foundation Alternative Fund

The Fund was down -2.6% over the quarter, with the bulk of the losses sustained during the initial February roll-over as the Fund moved from a “risk on” position, carrying a beta of approximately 0.3, to a “risk-off” position by the beginning of March and beta at zero. Returns in March were slightly positive. Credit Momentum provided returns as we rotated in February from a profitable U.S. High Yield position and into the defensive 30-yr U.S. Treasuries, which provided protection during the March sell-off. Equity strategies had small losses over the quarter, with gains from shorts not quite offsetting losses from long positions. Dividend-paying stocks, even where there is a high-quality of earnings, struggled during the quarter as they have in many cases been bucketed as “value” stocks which were relentlessly sold throughout the quarter. Merger Arbitrage was a drag on returns as spreads on even the highest quality deals blew-out to the widest levels in history as liquid arb spreads were used as a source of cash in the global deleveraging. We used the opportunity to add to quality deals, some of which closed before quarter end, and into selected SPACs where guaranteed profits of 10% annualized or more were available. We enter Q2 with the Fund at the lower end of its risk range, and with little to no “beta” risk.

EHP Foundation International Alternative Fund

The Fund was down -3.3% over the quarter, with the bulk of the losses sustained during the initial February roll-over as the Fund moved from a “risk on” position, carrying a beta of approximately 0.3, to a “risk-off” position by the beginning of March and beta at zero. Returns in March were positive. Credit Momentum provided returns as we rotated in February from a profitable U.S. High Yield position and into the defensive 30-yr U.S. Treasuries, which provided protection during the March sell-off. Equity strategies in each region had small losses over the quarter, with gains from shorts not quite offsetting losses from long positions. Dividend-paying stocks, even where there is a high-quality of earnings, struggled during the quarter as they have in many cases been bucketed as “value” stocks which were relentlessly sold throughout the quarter. Merger Arbitrage was a drag on returns as spreads on even the highest quality deals blew-out to the widest levels in history as liquid arb spreads were used as a source of cash in the global deleveraging. We used the opportunity to add to quality deals, some of which closed before quarter end, and into selected SPACs where guaranteed profits of 10% annualized or more were available. We enter Q2 with the Fund at the lower end of its risk range, and with little to no “beta” risk.

EHP Global Arbitrage Alternative Fund

The Fund was down -10.1% over the quarter, with virtually all of the losses occurring in March as risk arb spreads blew-out to the widest levels in history, and with even the highest quality deals trading at very large rates of return to deal

terms. Merger arb spreads, which tend to be liquid, were used as a source of cash for multi-strategy managers deleveraging across their books, and presumably by long-only managers who had been using merger arbs as a cash-proxy and who liquidated to redeploy funds into beaten up equities. Dedicated merger arb funds were overwhelmed by the sudden flow of funds, and it was only after the initial rush to sell everything that spreads tightened back up, and as a number of deals closed on schedule and without issues. In each of the last few meaningful arbitrage dislocations (1987, 1998, and 2008), more than 90% of active deals ultimately closed, and we suspect this time will be no different. If all the deals owned by the Fund closed on their agreed terms, the Fund would have gains of approximately 18% absolute. In a “normal” market, this figure would be below 2%. Our approach for the Fund has been to be fully invested in these very wide spreads, as well as redeploying capital from completed deals into remaining deals. We also took advantage of price dislocations to add selectively to SPACs, where we were able to add at guaranteed “spread to liquidation” returns of 10%+ annualized.

Core / Moderate Funds

EHP Advantage Alternative Fund

The Fund was down -3.2% over the quarter, with the bulk of the of the losses sustained during the initial February roll-over as the Fund moved from a “risk on” position, carrying a beta of approximately 0.7, to a “risk-off” position by the beginning of March. Returns in March were down -0.3%. USD exposure, which uses trend to tactically increase exposure to a maximum of 50% of NAV, was meaningfully additive to returns given the very sharp move higher in USD during March. Credit Momentum also had positive returns as we rotated in February from a profitable U.S. High Yield position and into the defensive 30-yr U.S. Treasuries, which provided protection during the March sell-off. Equity strategies in both the U.S and Canada had moderate losses over the quarter, with strong gains from shorts not fully offsetting losses from long positions. Price Momentum, Low Volatility and Quality styles all acted well during the pullback as is typical, whereas Value stocks continued to underperform massively, led lower by energy and financial sectors. Merger Arbitrage was a drag on returns as spreads on even the highest quality deals blew-out to the widest levels in history as liquid arb spreads were used as a source of cash in the global deleveraging. We used the opportunity to add to quality deals, some of which closed before quarter end, and into selected SPACs where guaranteed profits of 10% annualized or more were available. We enter Q2 with the Fund at the lower end of its risk range, and with a “beta” of ~0.2.

EHP Advantage International Alternative Fund

The Fund was down -7.3% over the quarter, with the bulk of the losses sustained during the initial February roll-over as the Fund moved from a “risk on” position, carrying a beta of approximately 0.7, to a “risk-off” position by the beginning of March. Returns in March were down -2.2%. Our Credit Momentum strategy had positive returns as we rotated in February from a profitable U.S. High Yield position and into the defensive 30-yr U.S. Treasuries, which provided protection during the March sell-off. Equity strategies in all regions had moderate losses over the quarter, with strong gains from shorts not fully offsetting losses from long positions. Price Momentum, Low Volatility and Quality styles all acted well during the pullback as is typical, whereas Value stocks continued to underperform massively, led lower by energy and financials. Merger Arbitrage was a drag on returns as spreads on even the highest quality deals blew-out to the widest levels in history as liquid arb spreads were used as a source of cash in the global deleveraging. We used the opportunity to add to quality deals, some of which closed before quarter end, and into selected SPACs where guaranteed profits of 10% annualized or more were available. We enter Q2 with the Fund at the lower end of its risk range, and with a “beta” of ~0.2.

EHP Select Alternative Fund

The Fund was down -8.9% over the quarter, with the bulk of the losses sustained during the initial February roll-over as the Fund moved from a “risk on” position, carrying a beta of approximately 1.0, to a “risk-off” position by the beginning

of March, and a beta of 0.5. Returns in March showed a gain of 0.7%. Strong gains in short positions offset a large portion of losses from long positions. Price Momentum, Low Volatility and Quality styles all acted well during the pullback as is typical, whereas Value stocks continued to underperform massively, led lower by energy and financial sectors. The Fund is finding value in high quality discretionary, industrial and energy sectors, while short expensive, over-levered balance sheets in REIT, utility and materials sectors.

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. Source for all index data: Bloomberg.

This material has been published by EHP Funds. It is provided as a general source of information, is subject to change without notification and should not be construed as investment advice. This material should not be relied upon for any investment decision and is not a recommendation, solicitation or offering of any security in any jurisdiction. The information contained in this material has been obtained from sources believed reliable.

This material may contain “forward-looking information” that is not purely historical in nature. These forward-looking statements are based upon the reasonable beliefs of EHP Funds as of the date they are made. EHP Funds assumes no duty, and does not undertake, to update any forward-looking statement. Forward-looking statements are not guarantees of future performance, are subject to numerous assumptions, and involve inherent risks and uncertainties about general economic factors which change over time. There is no guarantee that any forward-looking statements will come to pass. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made.

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 Inc. 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.

Contact Us Toll Free: 1.833.360.3100 Email: info@ehpartners.com www.ehpfunds.com