How We Invest: Ewing Morris & Co. Flexible Fixed Income Fund LP

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3rd Edition

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INTRODUCTION

Since our first meeting to discuss the blueprint for Ewing Morris & Co., we agreed that our guiding principle would be "to build an investment firm of which we would want to be clients." For us, the firm that we would want to be clients of has the following characteristics:

- Employs an understandable approach to investing based on common sense principles and underpinned by fundamental business and security analysis.
- Makes operational excellence a priority and works with best-in-class service providers.
- Strives to build meaningful long-term relationships with its investors based on candid communication.
- Measures its success based on the absolute net returns delivered to its investors over time.

The investment management business is highly competitive; hard work and passion are mandatory. There is no guarantee or magic formula for success; however, we firmly believe that the odds increase in your favour if you have a solid mental framework to help make difficult decisions, as well as processes in place to guard against emotion. If you do these things, then the financial returns will take care of themselves.

We have prepared this book to help our Limited Partners understand our business, goals, philosophy and limitations.

In December 2015, we created the Ewing Morris Flexible Fixed Income Fund LP, a follow-on fund to the Ewing Morris Opportunities Fund LP launched in 2011. These thoughts are derived from a process of debating the critical issues we face daily and developing rational reasons for taking one particular approach over another. We will continue to add additional chapters as our firm evolves. Consider this book the Ewing Morris & Co. blueprint for action in fixed income.

These pages do not cover the businesses we invest in in detail, although there is a library of research reports that do. For more detail, you should look to our annual report card, our quarterly reports and our annual meeting. There is also further information on our website at www.ewingmorris.com.

THE GOAL OF OUR STRATEGY

Shared Yardsticks for Measurement

We believe it is important to communicate to you the standards of performance against which we evaluate our investment results. It is most effective to have a pre-determined and agreed upon standard of measurement, so that you can evaluate us on known criteria which minimizes our ability to make excuses or otherwise re-characterize our results.

An appropriate timeframe for measurement is at least three, and preferably five, years. More importantly, the time period should include a variety of market conditions. For instance, a three-year measurement period that includes 2018, which had a large decrease in high yield bond prices, is a more useful measurement period than periods of market tranquility.

The fundamental measure of our success will be the wealth we create for our Limited Partners over the long run, when also taking into account the stability of fund returns.

Returns

The goal of the partnership is to earn 5-8% annualized net returns, over a reasonable timeframe, while controlling volatility and minimizing the risk of permanent loss. We define a reasonable timeframe as five years, which translates into a cumulative return in the range of 30-40%. We think our goal of achieving stable, 5-8% net returns compares favourably to our two principal benchmarks – the iShares Canadian Investment Grade Corporate Bond Index ETF and the iShares US High Yield Bond Index (Canadian Dollar hedged) ETF[1]. These two benchmarks reflect well-known and accessible fixed income alternatives which can be regarded as our Limited Partners' fixed income opportunity cost.

Risk

Our goal is to minimize the risk of permanent loss (what we consider to be true investment risk) and control volatility. We would posit that "permanent loss" can also be considered "permanent loss of purchasing power," a concept that takes into account the impact of inflation on capital. At current rates of inflation, one dollar today needs to grow by about 2% on an after-tax basis to avoid loss of purchasing power. From this perspective, it can be understood that long term allocations to cash effectively

[1] We have listed the iShares U.S. High Yield Bond Index ETF and iShares Canada Corporate Bond Index ETF because they are representative of widely known and followed fixed income benchmarks. These benchmark indices are provided for information only and comparisons to benchmarks and indices have limitations. Investing in fixed income securities is the primary strategy for the Fund, however the Fund does not invest in all, or necessarily any, of the securities that compose the referenced benchmark indices, and the Fund's portfolio may contain, among other things, options, short positions and other securities, concentrated levels of securities and may employ leverage not found in these indices. As a result, no market indices are directly comparable to the results of the Fund.

ensures permanent loss. Even at today's low rates of inflation, a 5-year holding period would result in an approximate 10% impairment on cash relative to the future cost of living. Our view is that higher yielding fixed income investments are one of the few conservative means of minimizing loss of purchasing power while maintaining a liquid investment profile.

The Relationship Between Risk and Volatility

Although volatility on its own is not risk, it is easy for investors to conflate volatility with risk. In public markets, assets can be placed on a continuum reflecting varied ranges of investor opinion and possible future outcomes. For example, stocks generally have wider ranges of outcomes (i.e. Investor A: "Company X is a fraud"; Investor B: "company X is a wonderful compounder"). Therefore, stocks generally see wider ranges of market prices than bonds. The wider the range of price, the more observed volatility and the more potential there exists for an investor to lose, particularly if an investor is prone to emotional decision-making.

Investors who have limited capacity to bear loss of capital over shorter periods of time (i.e. less than one year) should certainly favour fixed income portfolios, which usually have tighter bounds of value, and thus have less exposure to loss.

Although many investment managers rightly make a distinction between risk and volatility, in practice, fund volatility and risk are not completely independent. When volatility interacts with emotional decision-making, it exposes an investor (or Limited Partner) to loss if the investor decides to sell because of short-term risk aversion. In this way, low volatility results can be a valued outcome and enable superior generation of Limited Partner wealth. This is why fund stability is part of our stated goal.

What to Expect

Since we invest in liquid securities that are traded daily in markets, temporary price fluctuations are out of our control. This can lead to temporary losses, particularly in periods within one year. In fact, there have been many times where different parts of fixed income markets declined more than 5% inside of one year. Our aim is to construct a portfolio that can withstand, at any point in time, a variety of adverse market conditions. We strive to control risk in the portfolio such that in bear markets:

1) We would expect to experience less than half of the declines of our high yield benchmark; and

2) We would be surprised to experience negative returns in the fund's value over a 12-month measurement period.

To date, we have controlled risk through conservative credit underwriting, and equity and credit hedges. This has produced a fund volatility profile that is meaningfully more stable than its high yield and investment grade bond benchmarks.

Guidance for the Loss-Averse

An investor we follow expressed it well when saying that *"investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. "Risk" is the possibility that this objective won't be attained."*

To us, this means that cash is riskier to hold than it would appear, particularly over longer periods. The conclusion we would draw for loss-averse investors is that prudent investment in fixed income securities with mid-to-high single digit return expectations is necessary even if an investor's goal is simply to preserve purchasing power over multiple-year time periods. The Flexible Fixed Income Fund is our answer to this need.

Part One

OUR FIRM

HOW EWING MORRIS CAN ENSURE FAILURE

"*Invert, always invert*." – Carl Jacobi, German Mathematician

When faced with a difficult problem, Carl Jacobi suggests turning the problem on its head. We often use this technique when considering investments; studying why companies in similar circumstances have failed.

Our challenge is to build an investment firm which we would want to be clients. Since success in our business is a moving target, it would be arrogant of us to offer advice about how to build a successful firm. However, we can suggest how to ensure an investment firm's failure:

Lose your clients' trust. If you do this, the remaining advice is unnecessary. Losing trust can be accomplished in many ways, including failing to protect client information, failing to report errors, tax mistakes, refusing to discuss portfolio holdings, name-dropping, and partnering with second-rate service providers.

Accept clients indiscriminately. You should seek as many clients as possible. In particular, seek impatient clients who do not know you or understand your investment approach. You do not need to be concerned with the risk of rapid redemptions and additional forced selling the first time your portfolio declines in market value.

Assume the world will beat a path to your door. You would not have started the investment firm unless you were "superstars". Your talent will be readily apparent to others so you should expect that attracting new clients will be easy and not take much time. Do not worry about overcapitalizing your business since you will become profitable quickly.

Change your investment style frequently. At the first sign of trouble, make sure you change your investment style. You should also make sure you *focus on short-term results*, preferably daily, so that you detect trouble as early as possible.

Use lots of leverage. Leverage always amplifies returns so you should use all available leverage. If possible, leverage illiquid securities.

Do not worry about operations. Operating a business is easy and does not take much time. Do not let details like bookkeeping, compliance, tax reporting or IT distract you from investing. Do not surround yourself with experienced advisors. Nor should you be concerned with attracting and retaining talented people to help run the firm.

We firmly believe that any investment firm that heeds the above advice will quickly fail.

ADVANTAGES OF STRUCTURE

"*You have to learn the rules of the game. And then you have to play better than anyone else.*" – Albert Einstein

At Ewing Morris we believe that, regardless of how smart, hard-working or charming we may (or may not) be, our firm has three structural advantages that should lead to our goal of superior investment returns for our partners:

Our first advantage is <u>size</u>. Asset size is the enemy of investment returns. If you manage $2 billion, want 40 investments and do not want to own more than 10% of any one bond, then the smallest bond in which you could invest would have to have an amount outstanding of at least $500 million. In a universe of more than 2,000 bond issues, following this size constraint would exclude more than 50% of the total. The odds of finding an outstanding investment opportunity correspondingly shrink when there are fewer investments to consider. Since all large funds face this problem, they wind up fishing together in overcrowded ponds. In contrast, we manage a relatively small amount of capital which allows us to fish in ponds overlooked by others.

Our second advantage is <u>flexibility</u>. Most investment firms offer many choices (Private Debt Fund, Floating Rate Loan Fund, Emerging Markets Bond Fund, etc.) so that they always have something to sell. This means their best ideas are always scattered across multiple funds. In contrast, Ewing Morris manages a handful of very focused funds. Each Fund has a flexible investment mandate and holds our best ideas with no filler.

Our third advantage is <u>focus</u>. Great investment ideas are scarce and require extensive research to identify. Making an investment with inadequate knowledge is usually more dangerous than having thoughtless diversification. Most funds have at least fifty distinct investments and many have hundreds, therefore, one cannot get to know any of them very well. In contrast, Ewing Morris has a limited number of carefully chosen investments because we have no interest in watering the wine with our one hundredth best idea.

While we believe that any investor possessing these three structural advantages should be positioned to deliver superior investment results, many investment firms' primary goal is to gather assets, which erodes the structural advantages underpinning exceptional investment results. These advantages are only available to firms that focus on investment returns, like Ewing Morris.

ADVANTAGES OF EXPERTISE

"Talent wins games, but teamwork and intelligence wins championships" – Michael Jordan

Equity and fixed income markets are often disconnected from each other, most notably within the context of the same company. The reason for this is because stocks and bonds are usually considered different areas of investment expertise. For example, fixed income and equity trading desks are normally separated at investment banks and most buy-side investment firms are either debt- or equity-focused.

At Ewing Morris, we have the unique advantage of having both equity and fixed income expertise. This allows us to be capital structure agnostic when it comes to analyzing businesses and investment opportunities. It also gives us the ability to identify and exploit the discrepancies in value that arise from the lack of communication between the equity and debt markets. This is an attractive opportunity set that is best identifiable by those who pay careful attention to how the debt and equity markets are overvalued in the same underlying company. Furthermore, our team is able to leverage company-specific insights from our equity Opportunities Fund in order to make decisions about the same company's fixed income (debt) security.

When it comes to executing our investment strategies, we like to use the analogy of a sports playbook. A team with only one play can often be stopped, but a championship team will have perfected a few plays to ensure success regardless of game conditions and the opposition's tactics. While our Equity Playbook can be considered the offensive strategy, our Flexible Fixed Income Playbook involves four defensively-oriented plays that are designed to generate returns but have downside protection as their primary goal.

In developing our equity strategy, we identified three dominant drivers of an investment's value: the **economics of the business**, the **people** in the business or the **price** of the security versus a relatively fixed underlying value. Our Flexible Fixed Income Playbook is a complementary strategy which mirrors these dimensions.

Business: The ideal business to own in our equity strategy, a Great Business, is highly profitable, has a sustainable competitive advantage and has one or more terrific growth opportunities ahead. The business that we think best serves fixed income investors is a Durable Business, which is a business that can withstand extraordinary pressures from the economy or its own specific business landscape.

People: The people who are best suited to produce exceptional equity returns are what we call Great Capital Allocators. A Credit Maker is what we call a key decision maker who should defend the financial strength of a company.

Price: Some investments might not involve an exceptional business or a helpful key decision maker. In these cases, the value of an investment may be identified through tangible or structural features of a company or security. These features can often make the intrinsic value of a security easier to measure and often with a higher level of confidence. We refer to these types of equity investments as Cheap Assets, situations where a stock is trading at a significant discount to its tangible assets or net working capital. Analogous types of investments in fixed income we refer to as Structural Value, where expected return is driven by contractual features relevant to a subject debt contract.

Equity Shorts: In our Equity Playbook, our equity shorts are what we refer to as Broken Business Models. These are businesses that are weakening and their ability to generate equity value is permanently impaired. By shorting Broken Business Models, we are able to target a potentially high return short opportunity, while also benefitting from reduced equity exposure as a by-product. On the defensive side, the equity shorts we have in our Fixed Income Playbook are what we refer to as Equity Hedges. Similar to shorting Broken Businesses, Equity Hedges are typically focused on low quality businesses where we believe the Equity Hedge significantly reduces risk while not meaningfully impacting the prospective return of the investment. Equity Hedges offset specific bond investments and have historically provided very effective downside protection against unforeseen negative business developments[2].

This Playbook is fundamental to our everyday idea generation, due diligence process and execution of our investment strategy. We also believe that these unique equity and fixed income investment strategies will aid us in developing meaningful relationships with like-minded Limited Partners.

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[2] See Precision Drilling case study on page 22.

Part Two

THE FLEXIBLE FIXED INCOME PLAYBOOK

THE FLEXIBLE FIXED INCOME PLAYBOOK

"*The highest form of warfare is to attack strategy itself*." – Sun Tzu

Similar to our equity strategy, when it comes to executing our investment strategies, we like to use the analogy of a sports playbook. We have four plays in our Flexible Fixed Income Playbook; which investment opportunities best represent the various layers of defense we seek.

1. The Durable Business

A Durable Business is a business whose franchise or assets seem to survive no matter what happens. This is because, among other things, its assets may be indispensable to its particular industry, the business has a compelling moat, or it has little exposure to technological change. The Durable Businesses, we find, usually have some combination of attributes that provide us with a strong level of certainty in a company's long-term asset value. Investing in businesses or companies with assets that have very little risk of value impairment are ideal targets through which debt investors can earn returns, while limiting downside risk.

2. The Credit Maker

Credit Makers are people or entities whose influence over a company's capital strategy leads to favourable outcomes for credit investors. Examples of Credit Makers can include highly influential insiders, competitors, regulators, or even governments, who can come to the aid of a company that is struggling. We think it is critical to determine who the relevant parties are in shaping a company's capital strategy and develop a superior understanding of their unique incentives. Quite often, these very logical and important dynamics are overlooked by investors taking a more conventional approach to credit analysis. As a result, after one takes into account the fortification the Credit Maker provides to a company's balance sheet, debt investments can offer disproportionately high returns relative to the company's actual credit risk.

3. Structural Value

Bond investors focus on traditional drivers of credit pricing such as a company's financial condition, cash flow characteristics, leverage, management's capital strategy and the term structure of a given debt security. Often, that is where the analysis ends. However, there are special circumstances where value in a debt investment is ultimately driven by dynamics that reside outside of these conventional models for credit pricing. Our investments in securities with Structural Value have different, often hidden, drivers of returns. The most common structural sources of value can be found in a bond's *covenant structure*, its *call (refinancing) structure* and its *capital* or *corporate structure* positioning. Looking carefully at the subtle aspects unique to the structure of each debt security can uncover exceptional, unrecognized value; value which typically becomes recognized by the market within foreseeable time horizons.

4. Equity Hedges

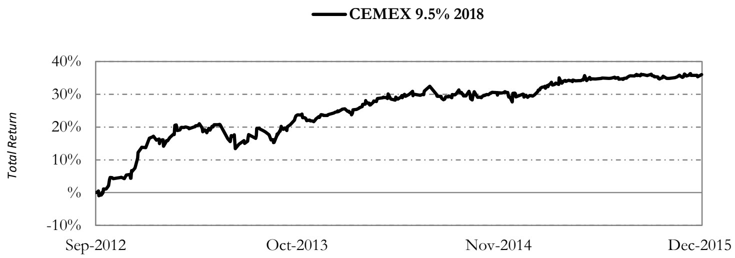
The business-related factors that cause a company's credit rating to be classified as 'high yield' typically undermine a company's ability to build shareholder value. This dynamic can make the equities of high yield companies particularly compelling short candidates. By shorting an appropriate amount of a company's stock, we are essentially acquiring insurance against unforeseen company developments, while, at the same time, we can continue harvesting a high income from the bond investment in the company. We take great satisfaction in how direct this form of risk management can be; if our debt investment is not paid back 100 cents on the dollar, the underlying equity generally becomes worthless, resulting in a profit on the hedge.

THE DURABLE BUSINESS

"We try to figure out why the castle's still standing and what's going to keep it standing or cause it not to be standing five, ten or twenty years from now. What are the key factors? How permanent are they? And how much do they depend on the genius of the lord in the castle?" – Warren Buffett

We believe that in credit investing, you win by not losing, and, when you lose, the severity of the loss is extremely consequential. Understanding that not all businesses will generate positive returns for their credit investors, we strive to be invested in situations where there is higher certainty of what the downside outcome can look like. When evaluating a business from a credit perspective, we look for companies that possess compelling drivers of long-term business value to support its debt. Long term value can be underpinned by business models that, for example, are resilient producers of cash flow or companies that have assets that are critical to an industry's value chain.

One example of a Durable Business is Cemex, a global producer of cement and ready mix. The cement business is one where local monopolies or oligopolies are commonly found. This is because transportation of cement over reasonably short distances becomes cost prohibitive. In addition, cement has been used for centuries and remains one of the most cost-effective building materials available. Low returns on capital, combined with significant environmental regulation on new plants or quarries create meaningful barriers to new entrants, making incumbent cement assets quite entrenched. Finally, long term population and infrastructure growth provide reliable long-term demand so these assets should remain in use over long periods. In other words, these assets have durability.



Source: Bloomberg

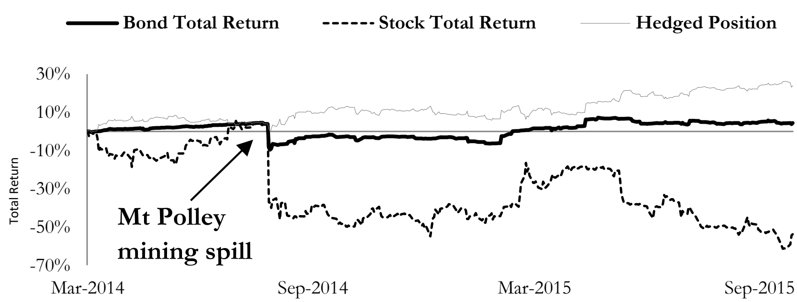
THE CREDIT MAKER

"The personalities of statesmen and soldiers are such important factors that in war above all it is vital not to underrate them." – Carl von Clausewitz

While a business' financial state is important to understand, we think the market tends to underappreciate the qualitative and behavioural aspects that can lead the pricing of a company's bonds. These important drivers of credit performance lie in the hands of Credit Makers, both internal and external, to a company. Credit Makers are motivated, not always for financial reasons, to support a company in times of need. Shareholders, insiders, customers, suppliers and governments all have the potential to be Credit Makers. A superior understanding of the incentive structures that shape the behaviour of these decision makers is critical to identifying whether they will take the role of either a Credit Maker, whose acts during financial adversity will defend the company's financial position, or, instead, be an unhelpful bystander.

One example is the recent history of Imperial Metals Corp. Imperial Metals experienced a catastrophic tailings pond spill shortly after issuing a large amount of debt. The Credit Maker was Murray Edwards, Imperial Metals' largest shareholder. Edwards is also Chairman of Canadian Natural Resources, one of the largest energy companies in Canada. Given the financial and political consequences of abandoning a company and its environmental liabilities, Edwards had a lot at stake. Guided by these incentives, Edwards injected new capital, which arrested declines in the price of Imperial Metals' high yield bonds. The market came to recognize the value of Edwards to Imperial Metals, which came to light in the outperformance of Imperial Metals' bonds over the ensuing year, amidst significant stress in the mining sector.

Imperial Metals Corp.



Source: Bloomberg

STRUCTURAL VALUE

"Education is when you read the fine print; experience is what you get when you don't." – Pete Seeger

A bond is a contractual agreement between a borrower and a lender. Contractual nuances can potentially create investment opportunities which we refer to as Structural Value. The most common sources are:

1) The fine print in a bond's covenant structure: High yield debt contracts often restrict corporate actions like dividends, spin-offs and acquisitions. Companies may need to pay a premium to its bondholders to break the contract in order to pursue their corporate strategy.

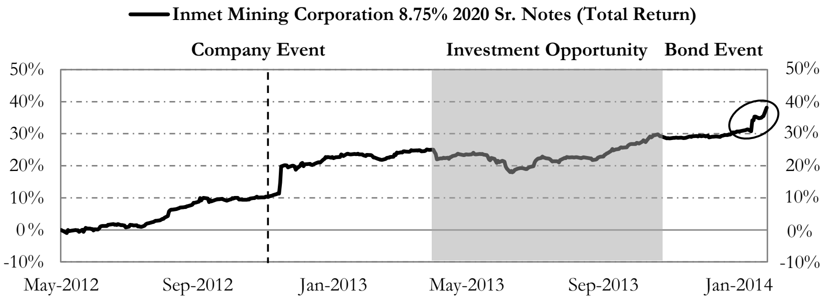
2) The "call" or refinancing structure: Bond agreements usually permit early refinancing in exchange for a fee. Sometimes the market misprices the likelihood of a borrower refinancing a bond, which can create compelling returns in advance of the refinancing.

3) The positioning of a bond in a company's capital or corporate structure: A company's most senior bonds often have significant asset or market value coverage and may even be secured by liens on the company's assets. For example, a $500 million senior bond in a company with a total market value of $4 billion is likely well covered.

The outcome of a Structural Value investment is primarily determined by the bond contract, not the credit performance of the borrower. This typically results in greater clarity of the investment's time horizon and reduces portfolio risk.

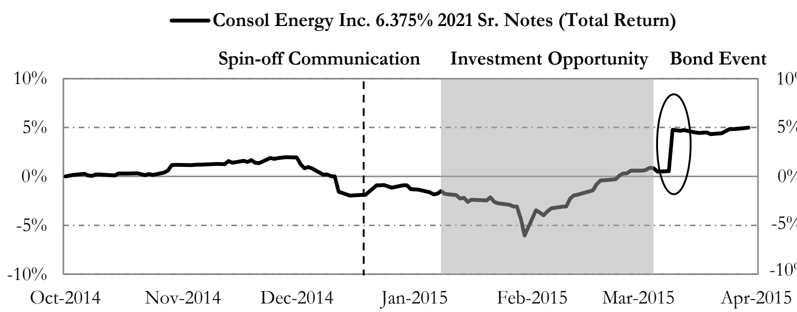
Here are two examples of Structural Value opportunities that were both identified and monetized. Both companies had covenant restrictions that resulted in large premiums for bondholders.

- **First Quantum's** acquisition of Inmet Mining Corporation was not permitted by Inmet's bonds, resulting in Inmet bondholders receiving a large premium in exchange for waiving the restriction.



Source: Bloomberg

- **Consol Energy** announced plans to spin-off a subsidiary to create value for shareholders. However, two Consol bonds restricted spin-offs and blocked this strategically important goal. The 8.25% bond was callable (i.e. could be refinanced at a modest premium). However, the smaller, 6.375%, bond was not yet callable which meant Consol would have to prepay interest in order to retire the bond (a "make whole payment"). The market correctly priced the refinancing of the 8.25% bond but overlooked the restrictions in the smaller 6.375% bond, which was ultimately redeemed at a healthy premium to its prior price.



Source: Bloomberg

EQUITY HEDGES

"Everyone has a plan until they get punched in the mouth." – Mike Tyson

It would be naïve to expect every investment to unfold as planned; we *expect* to encounter the unexpected. In situations where a company's debt is priced pessimistically while its stock is priced optimistically, the prices tend to converge towards "reality" over time. This means we can often control risk by hedging our debt investment with the stock of the *same* company.

Companies that are high yield borrowers, especially ones that have publicly-traded equity (as opposed to private equity-owned borrowers), often have fundamental issues like thin profit margins, elevated capital intensity and cyclical demand. These challenges can exert a stubborn gravity on their stock prices over time. The following example demonstrates how this works:

SuperValu Inc. operates a chain of supermarkets and pharmacies in the United States. Like many high yield companies, Supervalu has a few unattractive features. The industry is very competitive and Supervalu lacks scale compared to industry leaders, Wal-Mart and Costco, resulting in challenged margins. Competition has actually intensified as Whole Foods and dollar stores have grown. After reinvestment needs and interest expense, SuperValu struggles to generate free cash flow.

These negative factors were evident in the company's returns on assets. From 2005 to 2014, the average return on assets was just 2.4%[3]. Given the company's three bonds cost between 6.75% and 8%, it is no wonder Supervalu has struggled to generate value for its shareholders; when lenders have to be paid 7%, but assets are only generating 2.4%, equity value usually erodes.

So how has Supervalu's debt and equity performed? In May 2009, the company issued $1 billion of 8% senior notes due 2016, at 100 cents in a refinancing transaction. The day the bond transaction closed, Supervalu's stock closed at $16.55. At the end of 2015, Supervalu's stock was $6.78, having declined significantly over the six and a half-year period. The stock's holding period return, including reinvested dividends, was -53%, a remarkable result considering the S&P 500 Index produced a total return of 160% over this same time period. On the other hand, the company's bond collected 53% in income from its 8% annual coupon, and even gained 2% in price, ending at 102 cents in 2015. In six and a half years, bondholders were up 55% and shareholders were down more than 50%[4].

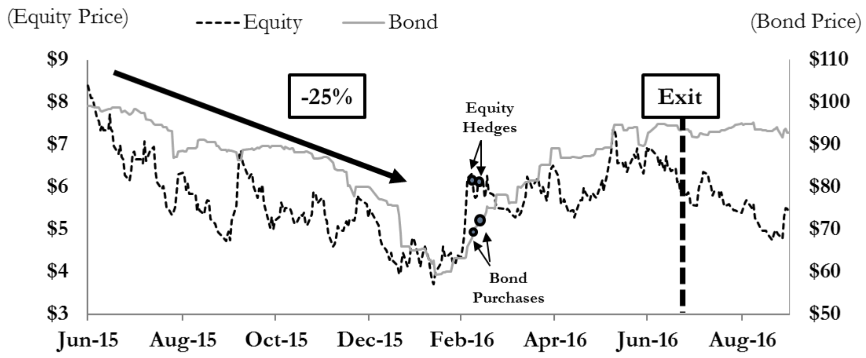
How can returns between two securities of the same company be so different? The explanation is that expectations between debt and equity investors can vary widely. If expectations for a company significantly differ between two of its securities, it is likely that, over time, expectations (i.e. prices) will become more consistent with each other,

[3] Source: Bloomberg.
[4] Source: Bloomberg, Capital IQ and company filings.

since they are ultimately linked to the same underlying company. In 2009, the expectations of Supervalu's debt investors were well-calibrated to the reality of the business, with the bond's price little changed from where it started. However, equity investors in Supervalu proved far too optimistic as the business underperformed their relatively higher expectations, resulting in a large decline in Supervalu's stock price. Opinions converged to reality and equity investors were the ones left disappointed.

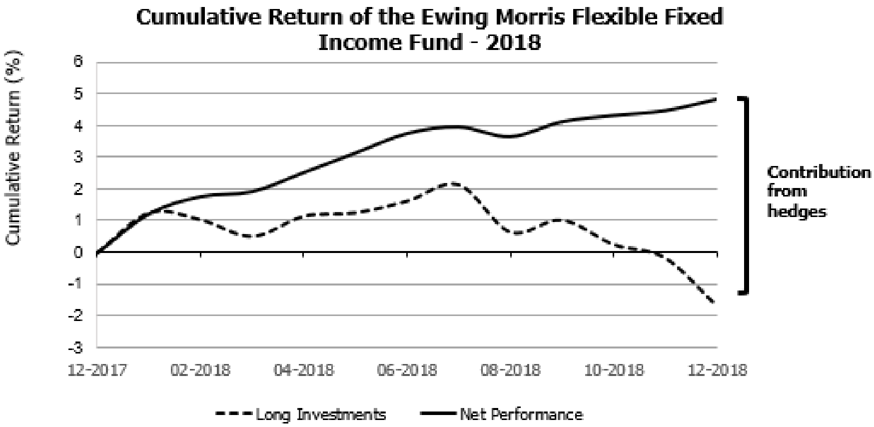
Large differences in debt and equity performance are reasonably common. However, the recognition of these differences as an opportunity for risk-controlled investing is uncommon. Using this approach, which is more flexible and unique, we are able to capitalize on a type of opportunity that is hiding in plain sight.

Precision Drilling, an energy services provider, is another good example of this type of opportunity. In March 2016, Precision's stock had fallen about 25% over the prior 9-month period, while its bonds were down 25% over the same time period. This was highly unusual, particularly given Precision's financial makeup, asset coverage and liquidity profile. This indicated to us that the chance of bankruptcy at Precision Drilling was quite low and, at these prices, debt investors were overly pessimistic and equity investors were perhaps too optimistic on the future of the company. We purchased the bonds and hedged the investment with its equity. In the ensuing 4 months oil rallied, and the bonds increased 30% in value, while the stock fell modestly over this time. This hedge allowed us to reduce risk and enhance returns at the same time.



Source: Bloomberg

From a risk management perspective, equity hedges are a fundamental part of the way we manage risk in the Fund. The big picture is that we may have many bond investments in the portfolio where we have an offsetting hedge, in the form of a short stock position, in the company whose bonds we own. The purpose is to save-guard against future potentially negative events. There is a reliable relationship between the bonds of high-yield companies and the stocks of those companies. It is this value that exists at the interface between these two pieces of capital in the capital structure, to which we pay the most attention. The chart below illustrates how the hedges benefited the portfolio in 2018.



Source: Ewing Morris and Bloomberg

The dotted line represents the performance of the Fund's long investments. As market volatility increased during the second half of 2018, the equity-hedged asset side of the Flexible Fixed Income portfolio performed. This highlights the role of the hedge: to protect against turbulent markets.

Part Three

OUR PROCESS

WHERE DO WE GET OUR IDEAS?

"If you want to have good ideas you must have many ideas." – Linus Pauling

Ted Williams, regarded as one of the greatest hitters in baseball history, describes the idea of the "Fat Pitch" in his book entitled *The Science of Hitting*. Williams divides his strike zone into sectors, determines his success rate in each sector and attempts to only swing at pitches where his odds of success are high. We apply the same approach to investments, focusing our efforts on debt investments that fall into the sectors of the strike zone that our Flexible Fixed Income Playbook occupies. The following is a description of our general approach to identifying ideas for each play.

1. *Durable Businesses*

Screens for, and experience with, companies that have stable financial performance in adverse economic environments are the most obvious sources for identifying Durable Businesses. The certainty of a business' long-term value may also be assessed through careful analysis of a company's industry positioning, its business model and its ability to pass through changes in its cost structure or otherwise adapt to protect its profitability and asset value.

2. Credit Makers

Credit Makers are revealed through understanding the incentive structures of a company's key stakeholders and how they might react to financial adversity. Insights gained in discussions with management, competitors and seasoned sell-side analysts are a good starting point. We will also review management compensation contracts and conduct a detailed analysis of the company's holders of equity and debt. Finally, superior insight into the incentive structures of players external to a company, including competitors and even government bodies, can generate great investment ideas. We routinely find that businesses contain valuable assets desirable to a larger competitor, and these businesses may turn into prey during an extended period of financial stress. In these circumstances, a well-capitalized predator may be likely to buy the weaker, high yield company, resulting in a very positive outcome for bond investors.

3. *Structural Value*

Structural Value opportunities are found in the fine print of a bond's contract, or from a bond's positioning within a company's capital or corporate structure. Therefore, it is not usually obvious to the naked eye that a bond may be a Structural Value opportunity. Prior experience with detailed examination of bond indentures, combined with intuition for potential places to look for Structural Value, is how we find new ideas. Though it is not a quantitative approach, the process is both logical and repeatable.

As an example, we may come across an industry that is rapidly consolidating. Assume the industry contains strong players and weaker players that generally have 'high yield' balance sheets. In this circumstance, we may consider a multitude of relevant bonds, but we may immediately narrow our search down to bonds of a particular vintage; bonds issued in the credit crisis, for example, when terms were very restrictive. Alternatively, we may focus on a few bonds that were issued under stress, where the company issuing the bonds had to accept unattractive (investor-friendly/restrictive) terms to finalize the deal. Bonds that bear restrictive covenants are great starting places. Since these corporate events are usually strategic priorities for a company, management may be compelled to simply retire the bonds at a large premium in order to get rid of their restrictions and the uncertainty they could present to a transaction. When corporate events have occurred or are likely to occur, Structural Value can often be discovered by those who have the patience and care to pore over the right articles of fine print found in a bond indenture.

4. *Equity Hedges*

Equity Hedges are discovered through both qualitative and quantitative approaches. Given the average high yield company typically has more than one kind of headwind to generating equity value, we look to stack the odds in our favour by focusing on lower quality companies for our Equity Hedges at advantageous moments in time. Promising places to look for debt-equity disconnects include:

- Leveraging Events: We look for corporate events that are bad for debt pricing and positive for equity pricing (i.e. acquisitions or other debt-funded recapitalizing events). We find that immediately following these events, the difference in perspectives between debt and equity markets can be particularly acute.

- Private Equity Exits: We look for public equities still owned by private equity. Sponsors can make fairly reliable sellers through secondary offerings, which may act as a headwind on equity appreciation, while public equity investors tend to like companies that are paying down debt.
- Structural Value Situations: We find that at certain points in time, a company may have a debt security that is so restrictive it needs to buy the debt back, at a premium, in order to get the flexibility it needs to operate the business. Often the stock does not move up until the cumbersome debt is eliminated.

- Quantitative Screens: We use proprietary screens that overlay company credit fundamentals with security-level valuation to uncover differing expectations between credit and equity. We then assess whether the divergences we identify are justified.

- Capital Flows: At the margin, short-term changes in high yield pricing are increasingly influenced by fund flows (i.e. money coming into or exiting the asset class). The timing of equity fund flows is usually different resulting in opportunities across capital structures.

- Informational Disparities: The high yield market is principally a U.S.-based market. There are many high yield companies where the equity is traded outside of the U.S. and these equity prices often reflect new information more rapidly than the debt. Many resource companies issue high yield debt in the U.S. market, which is traded over fixed income desks in New York, while the equity of the company is traded over Toronto-based stock exchanges. This silo effect can generate a significant expectation gap for a company's performance, creating a divergence between the stock and bond prices.

SELL DISCIPLINE

"The ideal time to sell is when you've found something that you like immensely better."
– Charlie Munger

When to sell is an important, but often overlooked, part of the investment process. We believe that decision-making is systematically improved by minimizing the impact of emotions. Similar to when we purchase securities, we employ a game plan that allows us to make dispassionate sell decisions. We apply several rules to selling:

1. Sell if the initial thesis is proven wrong. Often investors will buy something for Reason A, later discover that Reason A is no longer true, but convince themselves to retain the investment for Reason B. This is called thesis creep. The human mind dislikes loss and inconsistency. The natural tendency when a decision does not work is to distort reality to avoid recognizing a mistake. We counteract this tendency with process. We justify each investment in writing and regularly refer back to our original thinking. If our justification is proven wrong, we sell the stock.

2. Sell if we find something considerably better than what we already own. New ideas should drive sell decisions, rather than reacting to investments that have become unattractively valued. Due to the higher transaction costs in the high yield market, we look for substantial mispricing before investing. However, when the market fully values a security we own, we will sell it. We also view this constant search for better-valued securities as a risk management tool through which the portfolio's aggregate margin of safety is maintained.

3. Sell securities when the market is serving us. Unlike equity markets which can have bid-ask spreads measured in pennies, the high yield market's bid-ask spreads can be measured in dollars. We commonly see bid-ask spreads quoted at 1% or more. In high yield, this dynamic regularly causes a significant transfer of value from liquidity seekers to liquidity providers, particularly when fund flows (in or out) are high.

FOCUSING ON AFTER-TAX RETURNS

Tax is always an interesting area of investing that is generally outside the primary field of view for individual investors investing in funds or directly in the markets.

Naturally, investors are predisposed to look at pre-tax returns highlighted by managers in fund marketing documents. Based on that, they will have an impression of a return, generated in a given year, without having taken into account the investment's actual after-tax return. Those two figures can be drastically different especially in the world of fixed income investing where ordinary income, which is taxed at the investor's marginal rate, tends to predominate the stream of a return. Rather than focussing on the true after-tax returns, investors' gaze is typically drawn to the pre-tax outcomes while their accountants handle the true return at tax time.

If an investor in fixed income is targeting a 5%-8% annual return profile, the tax implications of the components of the return need to be considered. The extreme comparison on the notional 5%-8% return is, at one end of the spectrum, the return is derived purely from capital gains. Diametrically, the return may be generated from investing in bonds that are priced at a premium to par, earning a large coupon (taxed as ordinary interest income) and actually having capital losses on the price of the bonds offsetting that interest income. That results in a terrible after-tax outcome.

Within these tax goal posts, it is important to understand where, and how, the fixed income returns are generated. Many of our Limited Partners in the Flexible Fixed Income Fund are high-net-worth individuals, taxed at the top marginal rate, and thus, tax is something we care deeply about.

The fixed income markets do not care about the tax implications or the tax characteristics of different bonds. In other words, bonds generally trade without regard to differences in tax treatment. A primary reason is that the North American fixed income markets are dominated by non-taxable institutional capital (pension funds or investment managers who are investing on behalf of endowments and pension funds). By virtue of their non-taxable status, these institutional players have the luxury of making their fixed income investment decisions without regard to tax implications.

For example, you can find a 10.5% coupon bond, issued by the Canadian government, due in 2021, that has the exact same yield as a coupon bond with a 0.75% coupon due in that same year. Clearly, a taxable investor is certainly not going to want to own the 10.5% coupon on which they will be paying tax on its hefty interest income at the investor's (high) marginal rate of tax (over 50%), compared to paying tax on interest income of 0.75% with the lower coupon option, where, instead, the return from the investment is generated from the steady rise of the bond's price to par. That is a huge difference.

As mentioned, fixed income fund managers tend to advertise the performance of their fixed income portfolios on the basis of pre-tax return. They suggest that pre-tax performance is shown because each client has a different tax situation, which is both logical and fair. However, since the ‘success’ of the funds, and their personal compensation, is based on pre-tax returns, of course these managers frequently optimize the portfolio to maximize this number, without regard for the after-tax implications of their decisions.

For high-net-worth investors, this leaves a lot of the actual performance of the investment lost in the weeds in terms of how the investor gets from point A to ‘money in their jeans’. The bottom line is, managers are generally not incentivized and aligned to care about after-tax returns except for those who are personally invested in the funds or have the majority of their capital from high-net-worth clients.

We continually focus on finding investments that produce better after-tax returns for our clients. Since inception, the Flexible Fixed Income Fund has produced a substantial portion of its investment returns through capital gains rather than interest income.

Part Four
THOUGHTS ON RISK

CREDIT RISK

"You get paid for taking perceived risk." – Wilbur Ross

A bond is a contractual relationship between a borrower and a lender, not a piece of paper, the value of which experiences price fluctuations on a screen. The borrower will lose ownership and control of its assets unless it repays the lender according to the contract.

The root of the word "credit" is the Latin "credo" which is the verb 'to believe'. We are ultimately trying to answer two questions:

1) Do we believe the borrower will repay us?

2) Are we being adequately compensated for the risk that our belief may be wrong?

Our Flexible Fixed Income Playbook guides our approach depending on the quality of the underlying company. The Durable Business play favours higher quality companies that possess a natural suitability to credit investing. If unavailable, a lower quality asset or business may be acceptable, provided that it has a Credit Maker involved. If the business is not Durable or lacks a Credit Maker, we lose confidence in its ability to service its debt. In these instances, we tend to focus on investments that are driven instead by structural dynamics, rather than by company performance or capital strategy. A helpful feature of the Structural Value play is its shorter horizon which leaves less time for something to go wrong. Finally, we use Equity Hedges when they can reduce our investment risk more than our expected return. We routinely identify over-optimistic equities. When these are identified in the same companies of our debt investments, we have the opportunity to reduce risk with an Equity Hedge. In doing this, we are able to continue earning an attractive yield on our debt investment, but as the equity's optimism wanes, or if there is a negative company event, the equity tends to fall disproportionately relative to the bonds. This outcome provides a very attractive and direct way of managing credit risk.

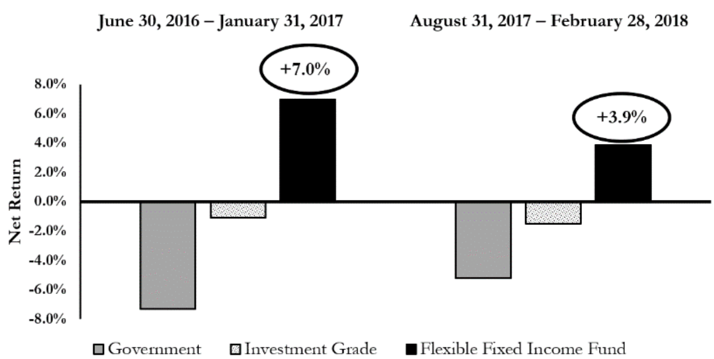
INTEREST RATE RISK

"We're already in a rising-rate environment." – Jeff Gundlach

Interest rates are arguably the most important driver of fixed income returns. However, predicting interest rates is difficult because they are influenced by many factors including inflation, fiscal and monetary policy, unemployment and other measures of economic health or price stability. We generally refrain from directionally trading interest rates. Nevertheless, if we believe a government bond position will reduce the portfolio's risk of a downward move in price, we may use these bonds as hedges in our portfolio.

While interest rates drive the fixed income asset class as a whole, they do not drive all areas of fixed income equally or in the same direction. High yield bonds often move in the opposite direction of government bonds. The reason is that the return of high yield bonds is driven disproportionately by company factors rather than from movements of interest rates. For instance, an unexpectedly strong economy could trigger inflation fears, leading to higher interest rates (and thus lower investment grade bond prices). However, a strong economy usually strengthens the credit quality of marginal (i.e. high yield) borrowers which can justify a lower credit premium (and higher high yield bond prices). The performance history of high yield bonds demonstrates that the benefits of favourable economic and corporate developments usually outweigh the headwinds created by rising interest rates.

We have seen two periods when interest rates rose more than 1% since the inception of the Flexible Fixed Income Fund. The performance of the Fund was relatively favourable, consistent with the historical experience.



Source: Bloomberg. Government bonds and Investment Grade bonds are represented by ICE BofAML Current 10-Year Treasury Index and ICE BofAML US Corporate Index, respectively. These benchmark indices are provided for information only and comparisons to benchmarks and indices have limitations. Investing in fixed income securities is the primary strategy for the Fund, however the Fund does not invest in all, or necessarily any, of the securities that compose the referenced benchmark indices, and the Fund's portfolio may contain, among other things, options, short positions and other securities, concentrated levels of securities and may employ leverage not found in these indices. As a result, no market indices are directly comparable to the results of the Fund.

LIQUIDITY RISK

"There's usually plenty of liquidity for those who want to sell things that are rising in price or buy things that are falling. That's great news, since much of the time those are the right actions to take." – Howard Marks

High yield bonds are less liquid than other common fixed income securities. This volatility can present tremendous investment opportunities while simultaneously creating risk for the unprepared. It is important that we match the liquidity characteristics of our investments with the liquidity terms of our Fund. We are also extremely reluctant to commit our capital to direct lending or to debt issues that trade on an exceptionally infrequent basis. The largest cost associated with illiquid investments is that we forgo optionality by restricting our ability to take advantage of better opportunities in the market; this is a cost that we believe is usually underestimated by the market.

Our Fund has three important competitive advantages which allow us to more adeptly manage liquidity risk that exists in high yield.

1) Size. We believe our relatively small size presents one of the most compelling advantages. We believe we can generate returns compensating investors for liquidity risk, while bearing significantly less liquidity risk than the average market participant. To illustrate this example, assume there are two funds; "Small Fund" and "Large Fund" with the same portfolio position size of 2% in a bond. Small Fund owns $4 million of the bond, and Large Fund owns $40 million of the same bond. Since this is a lesser traded, "off the run" bond, the market requires extra compensation, in the form of more yield, for owning it. If Small Fund owns $4 million and the bond trades in $2-4 million lots a few times a week, it should be expected that this fund can sell its position reasonably quickly, and perhaps with only one phone call. However, it could take Large Fund weeks to sell its $40 million position to be able to purchase another, more attractive, opportunity. By then, the more attractive opportunity may be gone. Clearly, the market, which is dominated by Large Funds, is right to demand a premium for holding smaller issues.

At the risk of noting the obvious, we would like to highlight that the extra return the market demands on this bond is *shared equally* among its investors, as everyone receives the same yield. On the other hand, liquidity risk is *not shared equally* because different holders bear different levels of liquidity risk based on the quantity of bonds they own.

If size is such an important advantage, why do most funds not stay small? Owners and executives of asset management firms tend to place asset gathering ahead of investment performance. We believe that in high yield there are some advantages to size, but as this example shows, these advantages are overshadowed by the handicaps that emerge as an investment manager travels into the billions.

2) Our Risk Management Approach. Aside from fund flows, it is common to find an investor looking for liquidity following a negative corporate event. At this point, buyers may be hard to find, or only willing to pay prices much lower than is acceptable to the investor. The investor has a choice to sit on an investment with a potentially broken thesis or seek liquidity and sacrifice another few percent as a cost of exit. At Ewing Morris, we routinely protect against adverse events by hedging with equity. This has several favourable consequences.

Firstly, the Equity Hedge typically should offset most, if not all the loss of value on the bond investment. This value preservation provides two benefits to our management of bonds in adverse conditions:

- It saves us money in situations where we have experienced an unanticipated setback.
- We are less likely to fall victim to the emotional pitfalls that can come with circumstances of loss.

Secondly, because high yield borrowers are often small or mid-cap equities, the same dynamics of one-sided liquidity may be equally apparent in these companies' stocks. We believe that being able to offset some of the liquidity risk in our bond position through an offsetting position in the company's own, similarly liquid, equity can be a very effective tool to manage both credit and liquidity risk.

3) Our Limited Partners. Our Limited Partners are our greatest asset. Having carefully selected partners with long-term orientations allows us to have greater confidence in our capital base and reduces the risk of fund flows moving the wrong way at the wrong time. We focus on attracting like-minded investors to our partnership. Like-minded investors are important because when clients share the same values as we do, and they strongly believe in the long-term merits of our investment strategy, these investors are more likely to add capital when liquidity is extremely valuable, rather than retreat when the market is punishing those heading for the doors.

DIVERSIFICATION

"Diversification is not how many different things you own but how different the things you do own are in the risks they entail." – Seth Klarman

At the heart of defensive fixed income investing lies diversification. Unlike an equity portfolio where upside is unlimited, a bond has limited upside. On the other hand, an unsuccessful bond investment can have a downside that is many times its expected return, although this should happen less frequently. Given this downside asymmetry, we strive to avoid and protect from downside circumstances rather than targeting flashy returns. With the understanding that we will be wrong from time to time, we believe that diversification is a key management tool for dampening the impact when we are wrong. A fixed income portfolio with no cash and ten carefully selected investments can more easily lead to dissatisfying results since one misstep, or unlikely event, can have a significant impact on a portfolio. At the other extreme, a portfolio with more than 100 positions can have a tendency to deliver returns that look increasingly indistinguishable from the market.

We believe superior security selection is our core source of delivering strong results over time. This means the portfolio has to be sufficiently concentrated to make our best ideas count. However, our commitment to diversification for risk management dictates that we do not put all our eggs in one basket. We think a middle ground of 25-50 investments satisfies our goal of sufficient diversification while allowing the results of security selection to shine through. In addition to allocating capital across numerous investment ideas, we are also mindful of ensuring that the portfolio is diversified along several dimensions including 1) investment play 2) credit quality 3) maturity/duration and 4) industry/business drivers. In this way, a portfolio of 30 investments that is well-diversified across these four areas can have less risk than a portfolio of 100 investments that uses a simple 'safety in numbers' approach to diversification.

In terms of position sizing, because fixed income ranges all the way from bank term deposits to distressed debt, portfolio position sizes tend to be deceiving in terms of the risk or volatility that each may introduce to a portfolio. This is why we have a flexible approach to position sizing. Notwithstanding this, we believe any relatively large investment in the portfolio should have a very low risk of loss, be it through Structural Value or having protection through an Equity Hedge, for example.

Concentration allows for the intelligent purchase of securities in well-researched companies and capital structures in order to avoid loss. Diversification affords an investor the ability to survive mistakes. In the spectrum of concentration to diversification, we like to be positioned within the area where security selection still counts but when mistakes are made, the setbacks of each are manageable.

APPENDIX

TODAY'S BILLION DOLLAR MISTAKE IN CANADIAN FIXED INCOME

Randy Steuart – August 8th, 2017

Contributed to The Globe and Mail

People invest in bonds because they don't want to lose money. But the problem is that many investors are not paying attention to the after-tax returns of their bond investments. Today, there are negative expected after-tax returns on billions of dollars of corporate bonds in Canada.

If financial market history serves as a guide, what worked in the past will not necessarily work in the future. Many short-term bond investments (individual bonds, mutual funds and exchange-traded funds), are at risk of not working as one would expect. Here's why:

In fixed income, the "yield to maturity" is the return the investor receives over the term of the investment, expressed as an average annual percentage rate. This return is a combination of two things: the expected price appreciation (or depreciation), and the interest income produced by the investment.

So how do taxes come into the picture?

Income payments are taxed at the investor's marginal rate, whereas capital gains are taxed at half of the investor's marginal rate. In order to minimize investor taxes, an investor should want as little return as possible to come from income since earning returns through capital gains are much more attractive. Unfortunately, we are currently seeing interest income on bonds that is high enough to turn a positive before-tax investment into an after-tax money loser.

To illustrate how this happens, take a bond index used for a popular short-term bond ETF that has approximately $1 billion in assets. As of May 31, this index had an average interest payment of 2.5% a year, yet the index had a yield to maturity of 1.15%, with an average maturity of three years. What this means is that investors can expect an average annual pretax return of 1.15% over time. However, at top marginal tax rates, annual taxes owing on the 2.5% of interest income would take away about 1.25% of return, making it a negative after-tax return of minus 0.1% (1.15% less 1.25% in taxes), even though the advertised "yield" would indicate the product should earn a positive return.

If investors choose to hold this investment for three years, they are virtually guaranteeing a loss in after-tax dollars. What is most astonishing is that this negative result is before an ETF's management expense ratio and, if the investor pays for investment advice through a financial adviser, an additional investment advisory fee.

The sales pitch du jour seems to be "we charge less." Indeed, fair fees should be an important focal point for investors; however, there is a limit to the value of low fees particularly when a product is no longer set up to achieve an investor's goal. As the above tax dynamics demonstrate, after-tax risk-adjusted returns should be an investor's primary focus. This must consider fees, but not be defined by them.

But what is a conservative alternative? Invest in an actively managed bond fund that avoids the use of leverage and is designed to provide: 1) stability of value, 2) portfolio diversification and 3) after-tax returns that are reasonable relative to the investment risk taken.

One final consideration is regarding alignment of interests. Fixed income funds often fail to consider tax implications because the fund's assets are composed primarily of tax-exempt institutions such as pensions and endowments. Understandably, this leads to before-tax evaluation of investments in the portfolio-construction process. For taxable investors, finding a fixed income manager whose incentives and investor base are well aligned from a tax perspective can be as important as the strategy itself.

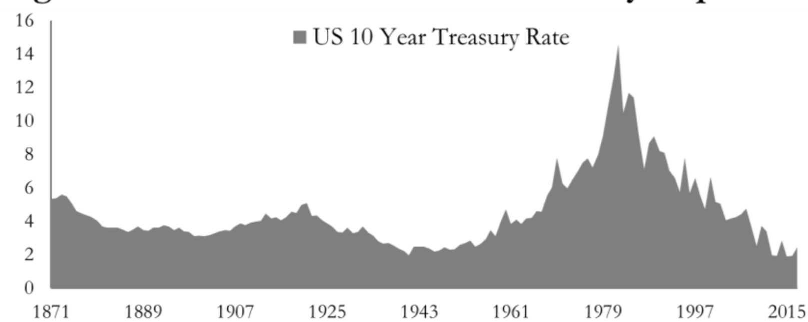
A NEW TAKE ON FIXED INCOME

Randy Steuart – January 2nd, 2018

MARKETS LOOK EXPENSIVE

In trying to make thoughtful asset allocation decisions, many investors see both the fixed income and equity markets as currently overpriced and unattractive. The historical record certainly supports this idea. Bond yields are near the bottom of their 150-year range and stocks have surged to levels that clearly imply weak long-term return expectations. This issue is compounded by the fact that the highest quality bonds (i.e. investment grade; fig. 1) and stocks (i.e. S&P 500; fig. 2) are some of the most expensive components of the broad markets. Valuations are not comforting.

Fig. 1 - Fixed Income Markets Historically Expensive



Source: Yale Economics (Robert Shiller), 2017.

Fig. 2 - Equity Markets Historically Expensive

Source: Bloomberg, 2017.

Asset classes that have historically been safe harbors amidst market storms could now be the most dangerous places to hide. It is no surprise that prudent investors are anxious in this current market context.

In the past, investors have been, at worst, cushioned or at best, rewarded by inaction. Falling interest rates have been a boon for almost all asset classes. Today, however, **the consequences of inaction are real**. As an example, in both the 2013 'taper tantrum' (fig. 3) and the recent U.S. election season (fig. 4), investment grade bond investors witnessed meaningful declines in investment value. In short periods of time, investors lost years of interest income.

Relying on old assumptions regarding traditional fixed income's ability to preserve capital is no longer adequate. Treasuries and investment grade corporate bonds are now potentially at high-risk should we enter a fast-rising interest rate environment. Therefore, a thoughtful approach to capital preservation demands new, alternative perspectives.

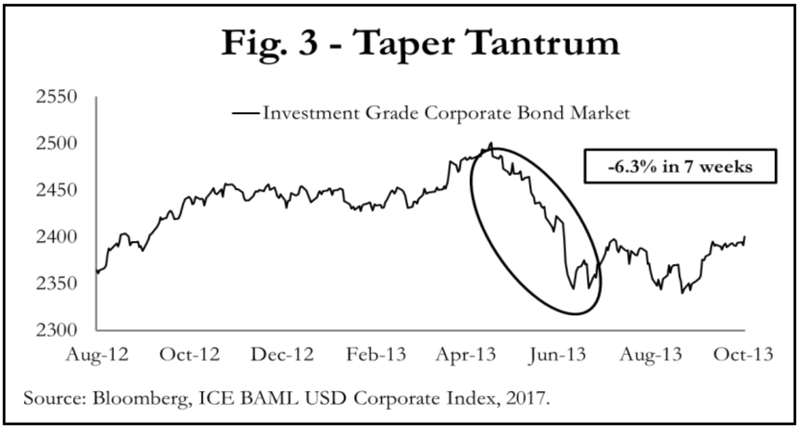


Fig. 3 - Taper Tantrum

Source: Bloomberg, ICE BAML USD Corporate Index, 2017.

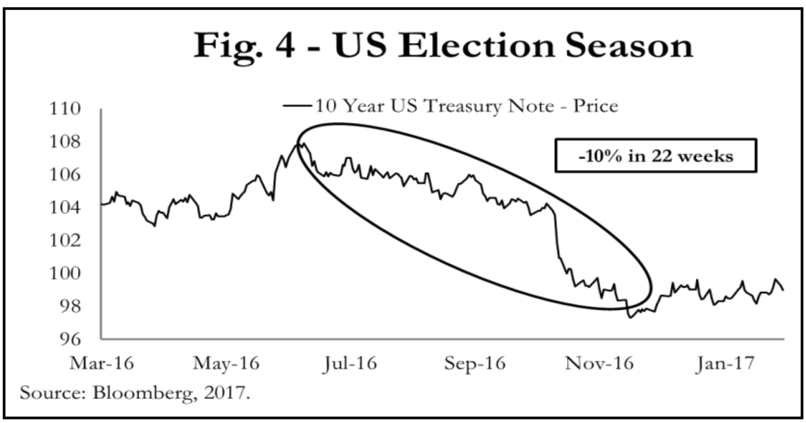


Fig. 4 - US Election Season

Source: Bloomberg, 2017.

A NEW TAKE ON FIXED INCOME

1) The "Spectrum" Perspective

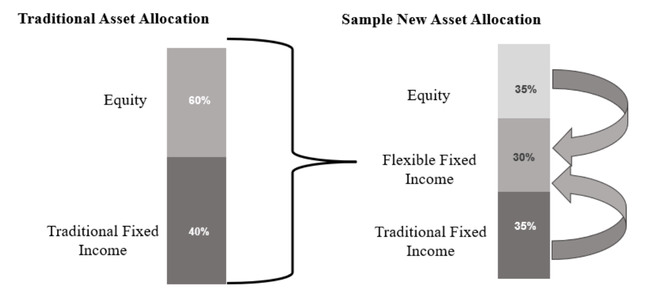
The investment opportunity set available in markets exists as a risk-reward continuum, where the expected returns are assumed to be commensurate with the risk undertaken. However, there are circumstances where the risk-reward equilibrium become ‘dislocated’ and some areas of the capital markets offer exceptional risk-reward opportunities relative to other asset classes. For example, in 2009, the U.S. high yield bond market returned 59%, more than doubling its small cap equity counterpart, the Russell 2000, which returned 27%[5].

This concept is also applicable for identifying risk-reward opportunities within the fixed income asset class, where we can compare the risks and rewards of investment grade versus high yield, Canada vs U.S., short-term vs long-term, etc. Today, we are seeing exceptional value in the intersection of smaller, Canadian Dollar denominated, shorter-term high yield bonds and debentures of healthy credits. We have constructed the Flexible Fixed Income Fund’s portfolio to earn returns safely from these areas.

It is possible to construct a portfolio with shorter duration, less volatility and higher yield than traditional fixed income or large cap equities. We are confident that a flexible approach to investing in the North American credit market will outperform on a risk-adjusted basis.

We recommend investors consider (and actively debate) rotating out of long-duration fixed income and equities into alternative fixed income strategies that are positioned to deliver mid-to-high single digit returns with less expected risk (fig. 5).

Fig. 5 - Action



Over time, we think the pockets of value we have identified in fixed income can provide a superior risk-adjusted return than what can be offered from a traditional mix of debt and equity investments.

2) A New Take on Cash

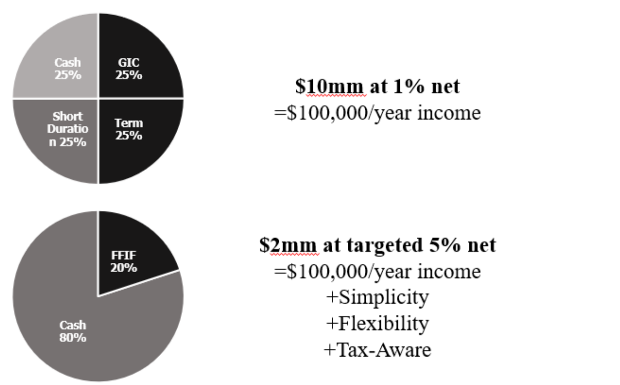
A conversation that concludes with ‘everything is expensive’ should be followed by a conversation challenging conventional customs of cash management. Most strategic asset allocations have some allocation to cash and short-term investments – 5% is not

[5] U.S. High Yield Bond marked is represented by the iShares U.S. High Yield Index (CAD-Hedged). Source: Bloomberg.

uncommon. This cash is typically used for operating capital or as 'dry powder' for opportunistic investments. Given most short-term rates are around 1%, the allocator would expect $100,000 annually from a $10mm investment.

We think there is a better way to invest cash than the short-term rate in the above example. Our "new take on cash" solution is a 'barbell' approach inside the short duration fixed income space. Using the same $10mm example, the allocator could earn the same $100,000 by owning $2mm in the best-value areas of fixed income, which earns closer to 5%, with strong confidence in capital preservation over a one-year period. The approach has the benefit of generating the desired income while also leaving $8mm of liquid capital available for opportunistic investments or operating requirements (fig. 6)[6]. The value of liquid capital will prove to be underestimated as markets become more expensive and inevitably sell off.

Fig. 6 – Traditional vs. New Perspective: Cash



CONCLUSION

Everything is expensive, and no one knows what to do. We think it makes sense to reallocate part of both traditional fixed income and equity mandates into fixed income strategies that can access the narrow segments of public fixed income markets. This approach presents good value while controlling (i.e. hedging) for risks like interest rates. By investing in the Flexible Fixed Income Fund, you increase the defensive nature of your portfolio while also earning higher income than traditional cash or cash-equivalent allocations.

[6] 5% represents the target return of the Flexible Fixed Income Fund. There is no guarantee that the Fund will achieve this targeted return.

QUALITY ISN'T WHAT IT SEEMS WHEN IT COMES TO BONDS

Randy Steuart – March 11th, 2018

Contributed to The Globe and Mail

In the traditional corporate bond world, year to date returns have been ugly. For example, the largest corporate bond ETF, the iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD), has delivered a negative 3.5% return so far this year[7]. Investors are likely asking themselves, "I was only expecting a 3 %return, why should I be down 3 %to 4 %already?"

Indeed, this is a good question. Sure, it's been a difficult ride in fixed income since rates started to rise in 2016, but it is important to pay attention to the encouraging fact that not all parts of fixed income have responded to rising rates in the same way. Rates started to rise in July 2016, and we've seen a stark difference in performance of two parts of the corporate bond market: the investment grade bond market, which is composed of bonds of very high credit quality (credit ratings of triple-B and above) and the high-yield bond market, which is composed of bonds with medium- or low-credit quality (below triple-B credit ratings). Since this time, high yield's bellwether fund, the iShares iBoxx $ High Yield Corporate Bond ETF (HYG), returned 10.5 %while investment-grade bond returns (as measured by LQD) have been negative 0.5%. The 11 percentage-point performance gap is meaningful and is contrary to the opinion that all bonds fare poorly in rising-rate environments. What, then, explains this difference?

In order to accept credit risk, corporate bond investors typically demand additional compensation compared with a risk-free government bond (termed "credit spread"). In rising-rate environments, corporate outlooks typically brighten and bond investors' willingness to accept lower credit spreads serves to offset rising rates, which explains why high yield bonds, in particular, tend to outperform when rates rise. High yield bonds aren't your ordinary fixed income investment.

Despite its track record, many investors dismiss high yield because it is simply deemed to be a "low quality" space. Investing in "high quality credits" might be an effective marketing pitch; however, it is not an investment strategy because it pays little regard to valuation. Given the low interest rates we saw in 2016, the investment-grade bond market was being undercompensated for the chance of rates rising. This wasn't the case with high yield, as the 11% performance gap demonstrates.

Unfortunately, many investors conflate the quality of a company with the quality of its bonds as an investment. This "quality" mindset is a reasonable approach for long-term stock investments, but it is far less useful for fixed-income investments. To bring this "quality" distinction to life, consider Johnson & Johnson. A global industry leader, Johnson & Johnson holds commanding market shares across numerous medical and everyday consumer product lines. The company is fantastically profitable, has a sustainable competitive advantage and, most importantly, is one of a handful of

[7] Source: Bloomberg

companies that remains triple-A-rated, the highest-quality credit rating available. Despite all these marketable attributes, since rates started their ascent in July 2016, the price of J&J's 3.55% bonds due March 2036, fell by about 14%[8]. When taking the bond's interest income into account, investors lost 8%. Clearly, a triple-A rating does not always produce a triple-A investment result.

Now, consider a bond of a "medium quality" company: L Brands Inc. L Brands is best known for its Victoria's Secret business unit, which produces the majority of the company's profit through the retailing of lingerie. At about US$17 billion in value, the company is substantial[9]. Importantly, of this total value, less than 30% is in the form of debt – a very manageable debt load. Granted, the credit quality of L Brands is no J&J as it carries a double-B rating, but it should be noted that the double-B default rate has averaged only 0.7 % since 1981 – hardly something to be nervous about. Despite this modestly higher credit risk, L Brands' 6.875 % senior notes due November 2035, boasted a yield of about 7%, providing a generous amount of compensation for the extra credit risk taken. And this extra yield provided a cushion for the investment: It allowed the bond to better absorb interest rate changes. Over the same period of time that the J&J 2036 bonds lost 8 % owing to rising rates, L Brands' bonds delivered a 9 %return because of its higher income production and reasonable valuation. What a difference "quality" makes.

The high-yield bond market comprises only 3.5%[10] of the shelf space in the North American fixed income supermarket, but for the few locals who know how to shop that aisle, there remains bonds that can produce all-weather results.

[8] Source: Bloomberg.
[9] Source: Company filings, 2018.
[10] Source: Bloomberg.

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About Ewing Morris:

Ewing Morris & Co. Investment Partners Ltd. is a value driven Canadian investment firm established in September 2011 by John Ewing and Darcy Morris. Our aim is to achieve preservation and growth of capital for our Limited Partners by focusing on inefficient markets. We do this by relying on fundamental analysis, high conviction and the use of flexible capital. We manage strategies with a focus on small and mid-cap companies. We manage investments for individuals as well as charitable organizations, institutions and corporations.

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