VIVALDI
ASSET MANAGEMENT

Investor Letter

SECOND QUARTER

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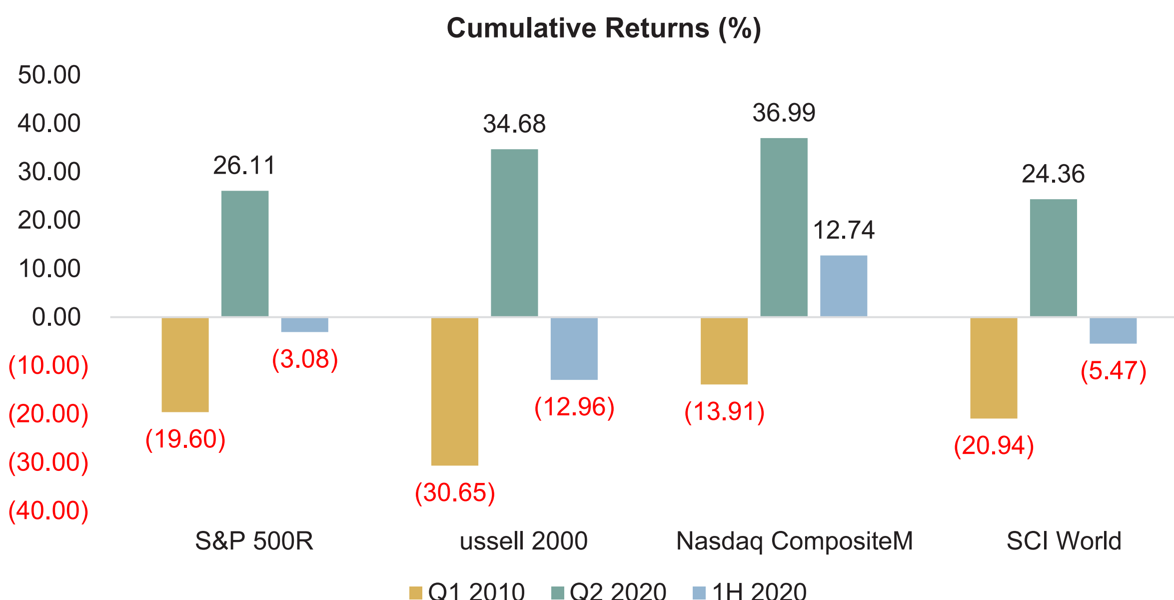
We wanted to share with you our Research Team's market analysis of the second quarter of 2020, which was provided to our wealth management clients. We think you might find it of interest.

Market Perspective

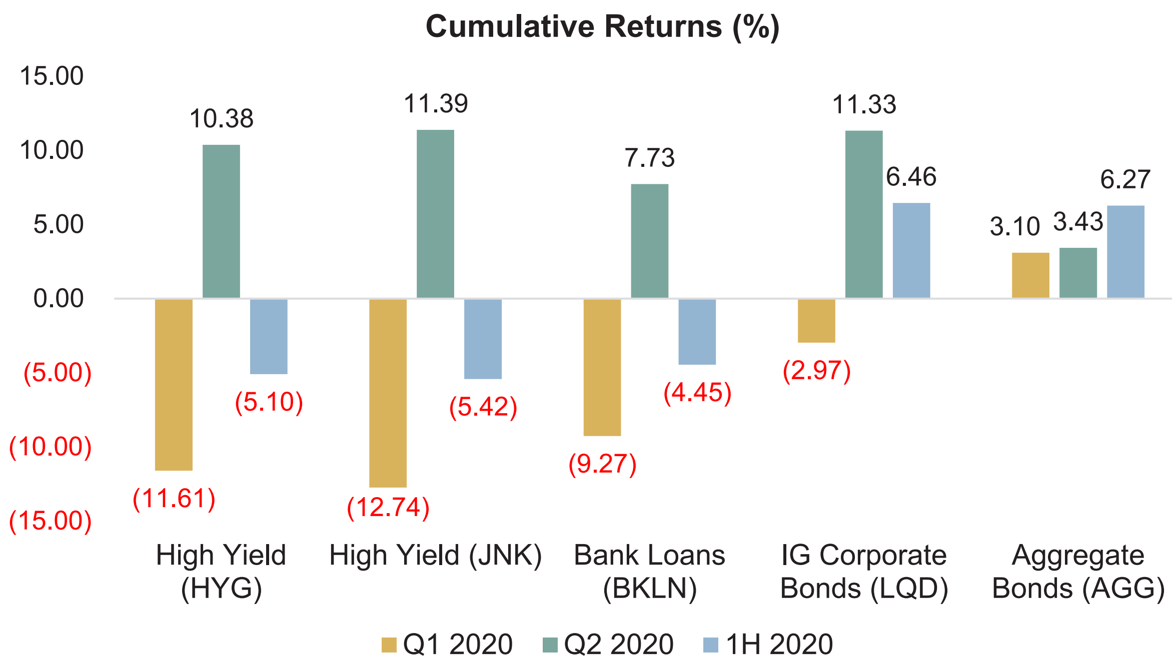
As we continue to navigate this global health crisis as a firm and team, we want to send wishes of good health to all of our clients and their families. We are proud of the work our broader Vivaldi team has done to adapt to these challenging times and the extra effort that many of them are now putting in from home as they balance any number of competing responsibilities. While this letter will focus on market commentary and outlook, we continue to prioritize the health, safety, and stability of our firm and team so that we can continue to advocate for our clients and their investment portfolios.

What a difference a quarter makes. With the staggering market correction and dislocation that occurred at the tail-end of the first quarter, the equally as impressive rally in many asset classes in the second quarter represents yet another environment over the last decade where very large market moves have been nearly erased in what feels like the blink of an eye. This narrative does not stand up to scrutiny if one really digs beneath the surface of broad-based domestic equity indexes (which is certainly where we spend most of our time), but the simple fact that equities saw a snap-back rally of this magnitude in the midst of a global pandemic is truly impressive. Below is a snapshot of a collection of widely quoted equity indices.

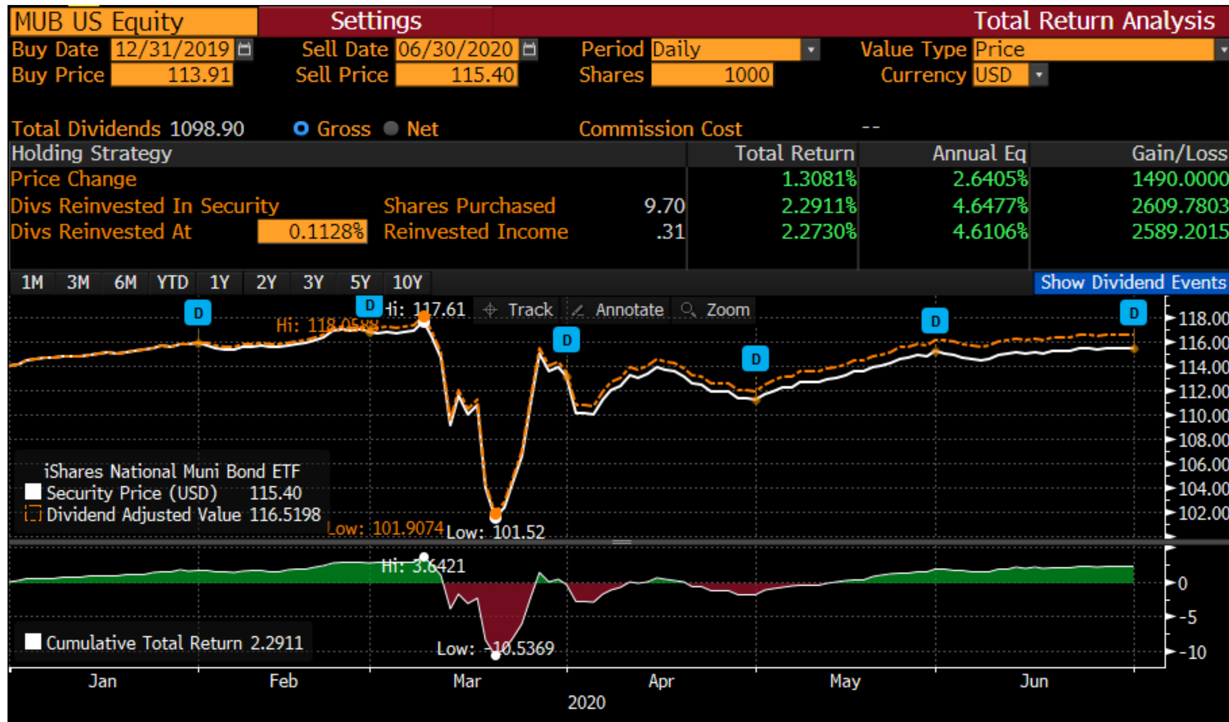


Something we highlighted in our first quarter letter that we believe is worth revisiting is how disparate was the dislocation across credit and equity markets. In many different sub-sectors we saw credit securities trade worse than their related equity securities. The snap-back in markets in the second quarter proved consistent with this dichotomy as equity markets recovered first and most significantly, while many related credit markets have rallied but not by the same magnitude. We understand the nature of market liquidity differences that drive these

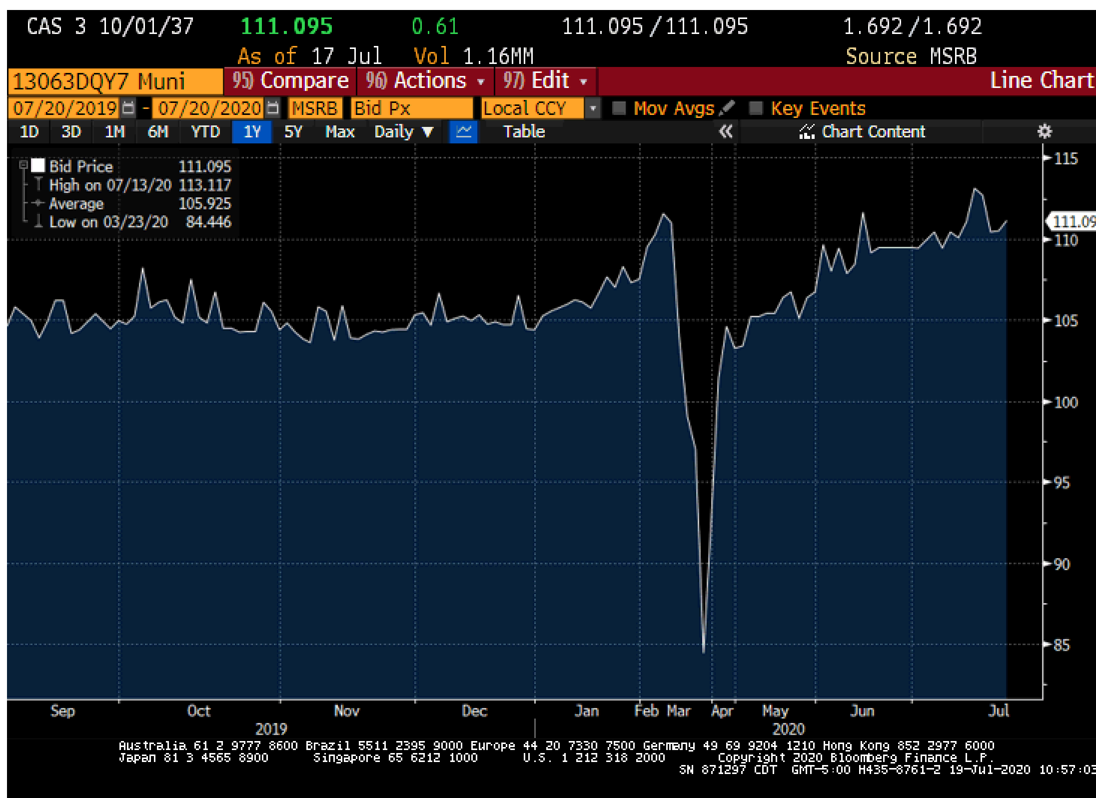
types of dislocations over short timeframes, but eventually these imbalances will normalize based on the fundamental order of priority within a capital structure. Below is a snapshot of a collection of broad credit benchmarks to put these comments into context.



One credit market that we were particularly focused on and active in during the market dislocation was the municipal bond market. Municipal bonds are the poster child for understanding how liquidity rather than credit risk can sometimes drive price movements in bond markets. The municipal bond space is highly fragmented compared to similar credit markets, replete with millions of different bond issuances, all with their own specific indentures and nuances. That market is also highly opaque, dominated by retail-to-broker and broker-to-broker trading. Finally, the ownership base of municipal bonds is itself highly fragmented and often relatively passive, with many more investors looking to invest simply by adhering to specific credit ratings and durations rather than by any fundamental bottom-up work on a specific credit. This ownership dynamic is important because it means that when municipal markets dislocate, there are few investors who are well positioned to be aggressive buyers of specific credits based on an informed view of the credit risk of a specific name. All of these factors were further compounded by the fact that the uncertainties of a global pandemic and the implications on cash flow and business performance raised questions around even seemingly bulletproof cash flow streams. For instance, there are not many economically-driven environments where toll road revenues would be down 80% in a month; however, we saw just that in certain municipalities in March and April. To put the municipal market behavior into context, below is a price chart of the largest municipal bond ETF (MUB):



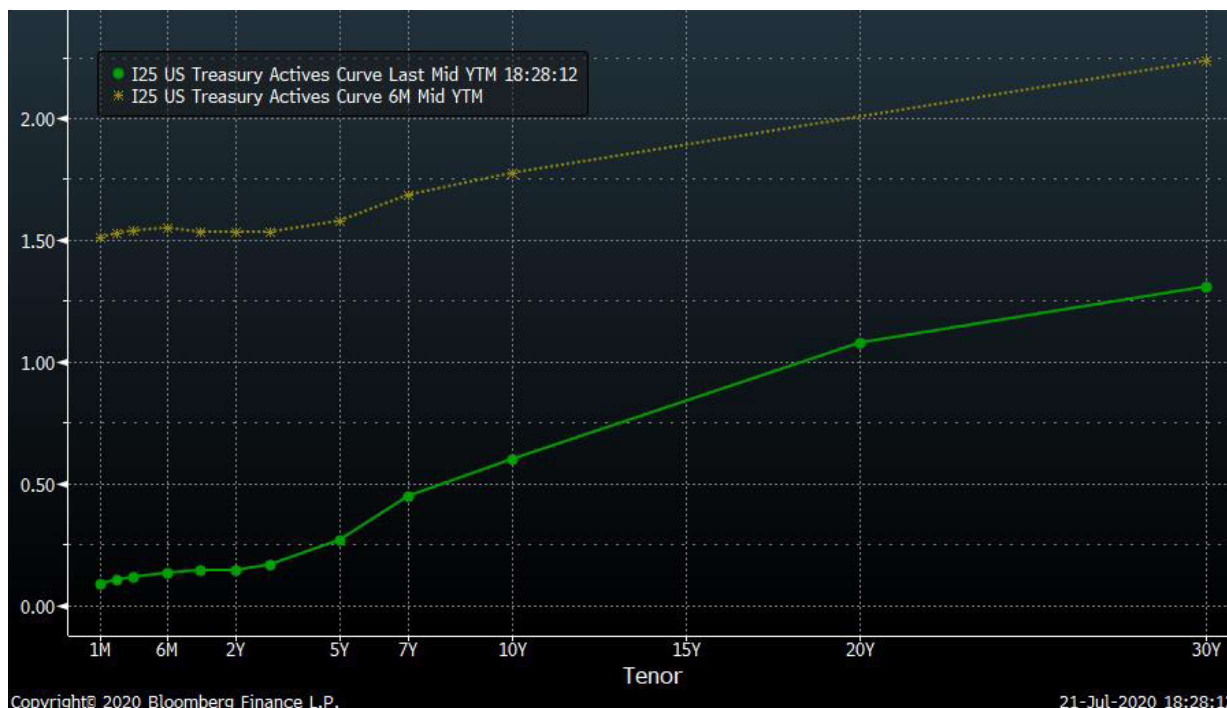
The combined fundamental and technical/structural aspects of the municipal bond market left it particularly poorly positioned to weather a liquidity crunch in capital markets where bond traders were working from home offices that quickly turned into unsupervised daycare centers. Conversely, a view that our team held in mid-March was that interest rates had rallied incredibly and that the highly interest rate duration-sensitive municipal bond market should probably rally as well. While the headline risk of falling municipal revenues is an easy one to ascribe to, the actual underlying credit picture of such a fragmented market is much more nuanced. By way of example, California has been plagued with a bad headline reputation when it comes to municipal finance dating back several decades. The reality is, however, that the state has been operating with a balanced budget ever since the last financial crisis. Paired with a new constitutional requirement that mandates contributions to a “rainy day fund”, California enjoys one of the most robust state municipal balance sheets in the country. That, however, did not stop California revenue bonds from trading down over 25 points within a two week window, depicted in the chart below.



As seen above, this particular bond had traded at a premium to par for its entire life, largely due to the AA- credit rating, which historically means there is little to no fundamental credit risk in the bond. The price decline from 110 to 85 in March was not reflective of any actual deterioration in the fundamental credit risk of this bond. Rather, this was purely a liquidity driven dislocation in which either municipal-focused mutual funds being forced to sell bonds to meet redemptions, or retail investors looking to flock to cash at any cost, were willing to sell a bond at 85 that, given the underlying credit strength of the issuer, should never pay back anything less than par. While the market anomoly in this particular bond was arbitraged away in short order, we continue to see dislocations like the above that have yet to fully recover from their March lows.

While we generally would not dedicate this much of our letter to a single sub-sector of the fixed income space, we think it is worthwhile as we all attempt to find our footing on the back of a dramatic spike in market volatility, even as that environment has abated despite the fact that we remain in a highly uncertain time. We may never again see a move like we did in March within the high grade municipal bond space, but it is yet another data-point demonstrating the importance of understanding mark-to-market risk versus fundamental risk, particularly when liquidity is scarce.

The last market metric we would note is the continued compression in interest rates across most points in the yield curve. The importance of the level and shape of the U.S. Treasury curve cannot be overstated, as it has implications for just about every sector and asset class in which we invest. Whether it is fixed income, credit, equities, real estate, or venture capital, all of these sectors are tied to and affected by the broader interest rate environment to differing degrees. Below is a chart of U.S. Treasury rates as of July 21 compared to six months prior. Note that the United States has remained the one large developed capital market where sovereign rates have not yet gone negative, at least at the front-end of the interest rate curve. We think focusing on where the front-end of the curve moves as the country makes its way through this recession is going to be critical.



All Chart Sources: Bloomberg

Highlighted Research Process & Investment Opportunity

We spend much of the space in these letters discussing the trends and developments that we think may be of interest in understanding investment performance and the opportunity landscape. Most often, those observations happen at the asset class, sector, or potentially at the strategy level. The reality, however, is that the Investment Research team spends the vast majority of our time focused even one layer deeper at the manager level. Most of our efforts are not expended trying to make a macro-level call or tactically allocating to an asset class or sector based on a top down view, but instead we focus on identifying talented teams that we believe can outperform, within their respective peer group, over a full market cycle. Our own research process is geared toward attempting to find those teams, underwriting their investment process, portfolio construction, and risk management frameworks. We then hold those managers accountable to that underwriting via our oversight work. Over the long-run, our team believes that we will add more consistent value at that micro level, and that one of the most important steps in building an investment portfolio is aligning yourself with the right teams. Picking the right organization and team should help in environments that are rife with opportunity as well as those that are more fraught with risks. We tend to think more about that alignment specifically in times of stress. In that vein, given the truly historic dislocation we witnessed in the credit markets in the first half of the year, we thought we would provide some insight into how one of those teams in one of the most impacted credit sectors fared.

As many readers have likely seen, there has been no shortage of headlines calling for major trouble ahead in the leveraged loan market. After the last global financial crisis, the leveraged loan market became one of the preferred ways for companies to finance themselves, pushing that sector to consecutive years of all-time record issuance. As is the case with most credit sector booms, as more dollars move into the space, the balance of negotiating power between creditor and borrower tends to shift in the borrower's favor. This paradigm was certainly true of the leveraged loan space, with deals in recent years becoming much more "covenant-lite". One feature of the leveraged loan space that made it particularly attractive for borrowers is that the loans originated

are generally floating rate in nature, benefiting borrowers as global interest rates continued to march lower. The large acceleration in issuance coupled with the stripping away of covenants prompted many concerns about what would happen to the leveraged loan market once we hit our next recession and the financial performance of borrowers was negatively impacted. We are now certainly finding out the answer to that question.

Just over three years ago we began to invest with a credit specialist firm based out of Kansas City. The firm is focused on all forms of credit securities but has a particularly deep experience and expertise in the leveraged loan market and the related collateral loan obligation ("CLO") market. The firm is an asset manager that operates different investment funds trading in primary and secondary credit markets, but is also a CLO issuer that manages underlying loan pools as an asset manager to those CLOs. We have known and worked with this group for some time and have come to regard their credit team as a conservative and rigorous underwriter of credit risk. We also believe that their relatively boutique size has allowed them to be more nimble and opportunistic in an effort to generate better risk-adjusted returns as opposed to simply gathering assets alongside some of the much larger credit managers they compete with. Vivaldi began working with this group by investing in one of their interval funds where they look to trade the loan, high yield, and structured credit markets broadly. With that said, we also developed a deeper relationship with the firm that allowed us to begin to co-invest alongside the firm in one of their CLO programs. We consider those co-investment opportunities to be the purest exposure one could obtain to the raw credit work being done by their credit team and the structuring work being done by their capital markets team, both of which we feel are top tier in their sector. While there was some stress in early 2016 in the loan market, namely around energy-related credit, the first half of this year marks the first real extended credit cycle since we underwrote the firm. With data that now carries us through July loan payments, the firm has performed in the top decile of CLO managers on every credit-quality metric we could hope to look at. Not only were their portfolios more conservatively positioned coming into this event but they have also fared materially better in the first large wave of company bankruptcies. While we know we are only at the outset of this credit cycle, we also know that there is no way to fake this kind of portfolio resilience in the face of numerous downgrades and accelerating loan defaults.

We highlight this not as a victory lap as if we had seen the global pandemic coming, because there are certainly areas that we could have allocated capital to that were less economically sensitive than leveraged loans. We just do not believe that we would have a very high hit rate in making those top-down macro calls, specifically as it relates to environments like a global health crisis which are nearly impossible to foresee or predict with any reasonable confidence on timing and severity. Instead, we attempt to align ourselves with the best teams we can find across sectors to give ourselves a better probability of weathering the storm whenever it comes and however disruptive it is.

Organizational Update

Amidst these unprecedented times, our primary focus is to deliver our clients the same wealth management experience they have come to expect. Since March, our entire organization has worked remotely, and we are grateful for the energy they have committed to maintaining our strong corporate culture. As we continue to operate with an uncertain road ahead both in route and duration, we are focused on investing in our human capital and technology as we not only adapt but ideally take advantage of a highly unusual environment to think critically about areas in which we can improve our team processes and structure not just to survive this period but to come out of it better on the other side. As a firm, we continue to have several new hires in the pipeline across the functional units of our business and we are committed to continuing to invest in those resources that will be beneficial to us in the intermediate and long-term despite the near-term uncertainty. We look forward to sharing the backgrounds of the professionals that are joining us as they come on board later this summer.

Kind Regards,

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