

Second Quarter 2018 Investor Letter

Vivaldi Investment Research

Q2 2018

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VIVALDI
CAPITAL MANAGEMENT

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Market Perspective

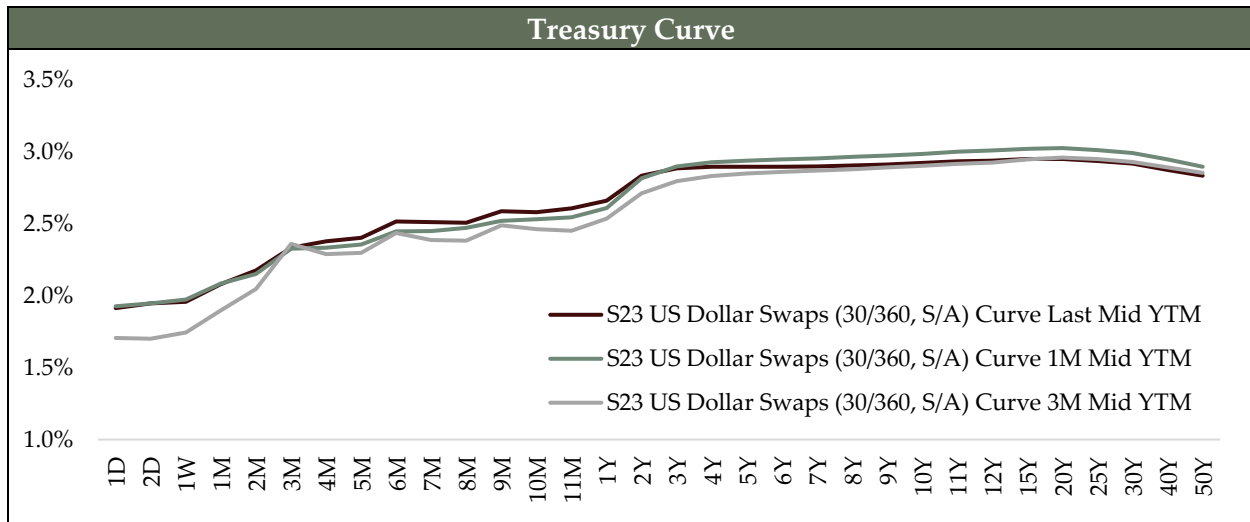
The second quarter was largely constructive for most segments of the equity markets, though sector leadership changed materially over the first quarter. While 2017 saw the majority of equity sectors perform strongly, 2018 strikes a different tone with three of the nine sectors performing well while the balance were either near-neutral or negative on a year to date basis. What is consistent, and what continues to drive the overwhelming majority of returns, is the largest weighted sector, information technology. The weighting on information technology has only been higher during a 10-month window from December 1999 to September 2000.

S&P Performance by Sector		
	<i>YTD (as of 6/30/18)</i>	<i>2017</i>
<i>S&P 500 Index</i>	2.6%	21.8%
<i>Consumer Discretionary</i>	11%	23%
<i>Information Technology</i>	9%	34%
<i>Energy</i>	7%	-1%
<i>S&P 500 Index</i>	3%	22%
<i>Real Estate</i>	2%	3%
<i>Health Care</i>	2%	22%
<i>Materials</i>	-3%	24%
<i>Financials</i>	-4%	22%
<i>Industrials</i>	-5%	24%
<i>Consumer Staples</i>	-8%	13%

Source: Bloomberg

In addition, the markets continued to digest the step-function rise in interest rates that took place over the course of the first half of the year. Much of the equity market gains were registered in May, as broader indices continued to climb a “wall of worry” higher. Namely, geopolitical headlines around tariffs and potential impacts of a more aggressive trade war were largely negated by continued solid economic growth and a fairly benign domestic outlook. On the other hand, fixed income markets were more mixed than equity markets during the quarter.

Specifically, market participants have been keeping a close eye on the shape of the yield curve, which has become increasingly flat as the front end of the curve has been more responsive to the increase in the fed-funds rate than the long end of the curve. Many people believe a flat or inverted yield curve is indicative of an impending economic contraction or recession, though fundamentals do not yet support that potentially bearish view.

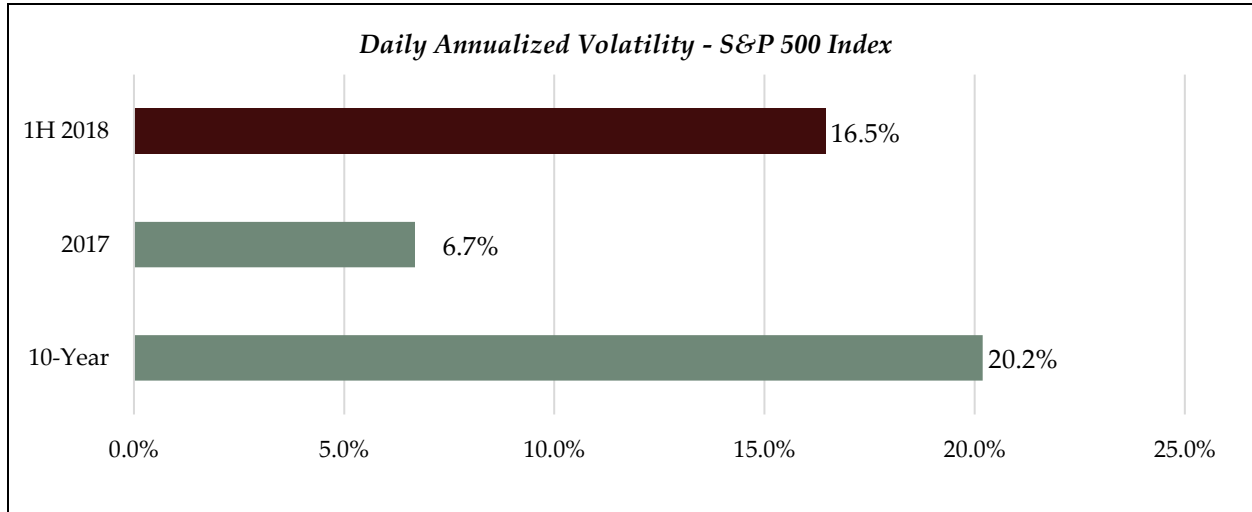


Source: Bloomberg (as of 6/30/2018)

One market dynamic that we would like to highlight from the second quarter is the normalization in equity market volatility that was observed in the first half of 2018. A topic that we wrote about often in 2017 was the absolute dearth of volatility, specifically within equity markets. The full year of 2017 saw the S&P 500 produce a realized daily volatility of just 6.7%¹. In a historical context, this was likely somewhere around half the volatility level that we would judge to be “normal.” When we pair that compressed volatility picture with the fact that the S&P 500 Total Return Index gained +21.8% for the calendar year 2017¹, we thought it was important to stress that these types of periods where a broad equity index produces at return/risk ratio well in excess of 1.0 tend to be short-lived. To provide context the historical return/risk ratio for the S&P 500 Total Return Index is approximately 0.60¹. While we believe the fundamentals continue to look strong we are believers in reverting closer to the mean. What we have seen in the first half of 2018 is a reversion towards the mean in equity market volatility that we ultimately think is healthy. Is this outsized return/risk ratio in both equity and fixed income indices a canary in the coal mine – and more importantly what does this mean for clients and portfolio construction? While for the past nine years clients were rewarded for allocations to “beta” or simply exposure to market indices, we feel clients should be recalibrating their overall exposure to beta and increasing their exposure to alpha generating strategies.

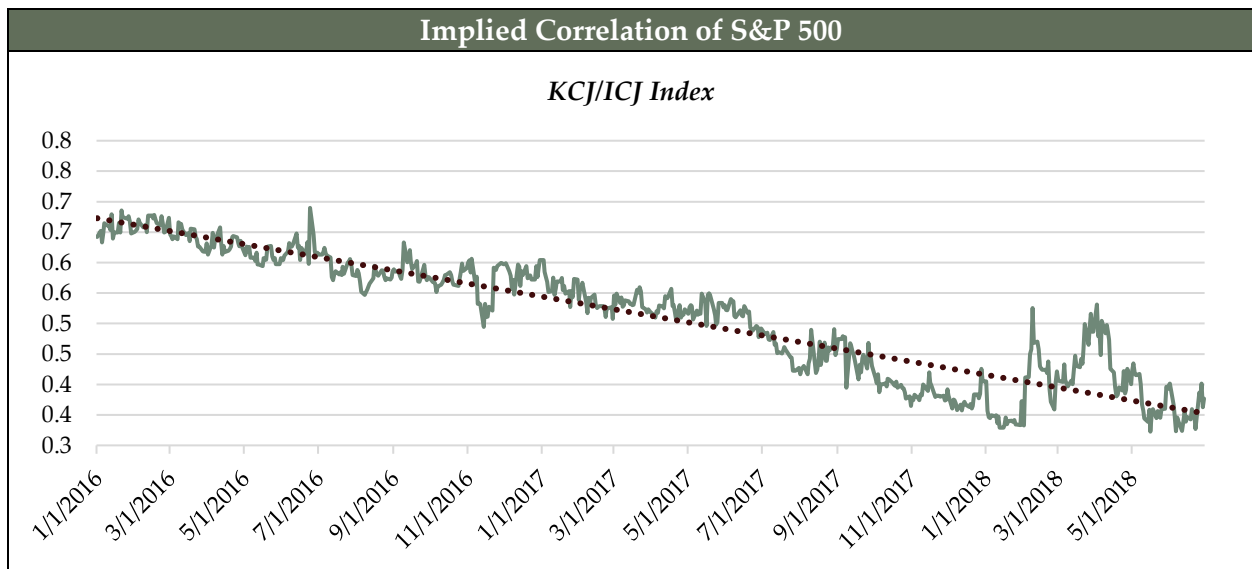
¹ Source: Bloomberg

Equity Market Volatility



Source: Bloomberg

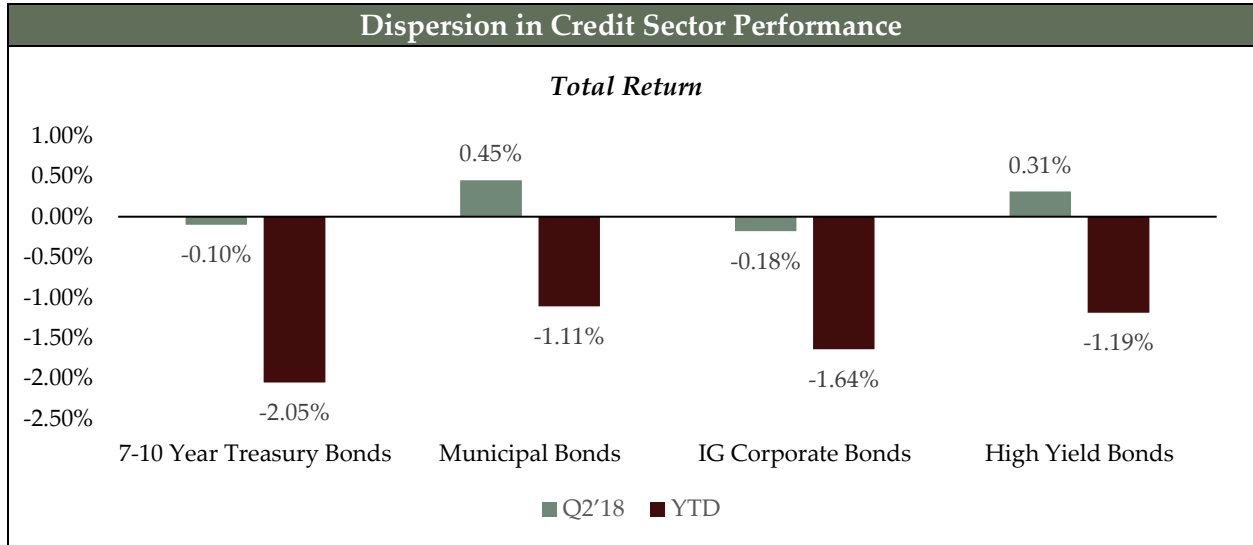
A direct result of this aforementioned normalization in equity market volatility has been a dramatic improvement in the opportunity set for fundamental stock pickers. Given our firm’s belief in the value of this bottom-up fundamental approach, we have welcomed the return of dispersion both within market segments but also across them.



Source: Bloomberg

For much of the last few years we have faced the headwinds of very high correlations within and between sectors. This backdrop is particularly critical for the long/short equity universe, as well as the fundamental long-only equity community which collectively make up a large swath of the broader investment universe.

This dispersion has not been ring-fenced to equity markets either. The second quarter saw a notable dispersion in the performance of various credit sectors.



Source: Bloomberg

While this may now seem like the distant past, it is worth remembering that there was a point in the first quarter of this year where both equity and fixed income markets were moving lower in tandem. The year-to-date losses registered by the vast majority of fixed income/credit markets is a reminder that the lack of correlation between the two sides of a traditional “asset allocation” portfolio – which has been a great tailwind to investors for much of the last decade – is not fundamentally guaranteed. There are a whole host of investors that have never seen a market environment in which their portfolio faced equity and fixed income losses at the same time. The “flight to quality” effect would have to overcome the secular rise in rates that is putting steady pressure on fixed income markets. We do not think that enough investors appreciate the challenges of this type of investment environment, one in which we view it as highly unlikely that the Federal Reserve would move to cut rates even in the face of an equity market correction. We believe that this dynamic will have large implications for the potential returns for a traditional 60/40 portfolio in 2018.

It bears reminding investors that it is nearly always possible to create a negative market narrative based around headline risks and geopolitical concerns. Certainly, today’s focus on global trade concerns have far-reaching implications and very tangible consequences should tensions escalate into corporeal consequences. With that said, it is difficult to manage an investment portfolio with these types of tail risks in mind because that could very well keep capital on the sidelines in periods that are largely constructive for returns. In these letters, we often choose to focus on those things that concern us out of an abundance of prudence. As we enter into the second half of 2018, we actually remain rather constructive on the near-term prospects for the domestic economy and broader risk markets as a proxy for that economic health. We do, however, believe that the current operating environment will require more nuanced exposure than a standard asset allocation portfolio. For us, this namely means a focus on more active management.

Highlighted Research Process

In this segment of our letters we typically choose to discuss either a timely investment or provide some detail around an aspect of our investment sourcing, diligence, and oversight in hopes of providing our clients more visibility into our process. With that said, this quarter's topic is somewhat of a hybrid of both those categories. A topic that many of you are likely familiar with is our preference for finding managers earlier in their fund's life. In many instances, we believe that sourcing these smaller, more nimble managers, can allow us to capture a larger portion of a manager's potential performance upside. For many of the niche strategies that we tend to prefer, an extended track record of outperformance and the asset growth that often comes along with that can begin to erode a manager's ability to produce alpha. The practical implications of doing this earlier-stage work is that we cast a very wide net across the universe of investment talent, often looking for the talented portfolio manager who is spinning out of a larger, more established firm in an attempt to build enterprise value in their own stand-alone firm. The challenges of doing this type of research are fairly obvious: a lack of an auditable track record in many cases; teams that are comprised of members who may not have worked directly together before; and the heavy lifting of trying to find groups that have built truly repeatable and exhaustive work-flows for their own research and portfolio management process. Another aspect of this work that can sometimes be less obvious, however, is the operational due diligence that our team does specific to smaller or newer firms.

Often, we find ourselves in the seat of having material influence over the potential shape of an underlying fund's operational structure. In that role, we would like to think of ourselves as a resource that has a unique insight on industry best practices. In addition, we will often use our position to push for more investor-friendly terms and structures. This will usually include a conversation around advantaged economics for our capital as well. The task of working through these issues requires resources from both our investment research personnel as well as our operational team. The all-hands-on-deck nature of this work is the exact reason that we chose to imbed the head of our operational due diligence ("ODD") within our Investment Research group as opposed to placing that role under the operational umbrella. This structure reflects how critical we believe ODD is to our overall due diligence process.

By way of a live example of how this integrated process works, we recently completed the investment committee approval process for a differentiated long/short credit manager. We have invested our first tranche of capital into this fund in just their second month of operation, a rarity for us even in the context of the emerging manager work that we perform. Undoubtedly, there is a higher standard/bar for us to invest at such an early stage with a start-up firm. Ultimately, we became comfortable with the investment due diligence we performed, which was due in large part to the pedigree, breadth, and depth of the investment team. We believed that this was one of the highest quality new launches we had come across in several years. We were also impressed with the workflow/infrastructure that the team had built pre-launch and completed a great deal of channel checking on the principals' level of success and their prior firms. In this instance, the lead Portfolio Manager for the fund was putting up \$50MM of his own capital as a limited partner (LP) in the fund as well as another \$10MM in working capital, which was invested into the fund but would be drawn on as needed to fund the business operations. Our ODD process ramped-up

in earnest, especially as we approached the point at which we believed the fund had a high probability of making it to our investment committee decision.

There are several things that our ODD team focused on. First, the team did a great deal of detailed work on the nature of the PM's investment into the fund, verifying one of the strongest qualitative positives behind our desire to invest. In addition, our ODD process uncovered some details around fund liquidity, fund expenses, and certain terms in the PPM that we viewed as being potential sticking points for us. Over the course of several weeks we were able to not only clarify those terms but also receive a commitment from the fund that they would amend the fund offering documents to make appropriate changes for all LPs the next time fund documents were updated. A non-exhaustive list of these items included limitations on the marketing-related expenses that could be borne by the fund as well as a clarification around how the GP could forcibly redeem investors.

As we have noted historically, the only aspect of either our investment or operational diligence process that is outsourced is the formal employment and background checks on key investment professionals. In this instance, that background check on the lead PM did produce a few follow-up questions around other entities that he controlled. Ultimately, those entities proved to be a non-event for our process, but we highlight this aspect of our work to note that we are always making sure to turn over every rock possible in an effort to ask every pertinent question before a dollar of capital is allocated to a fund.

Organizational Update

In recent years, we have been fortunate enough to provide details on additions to our team in this section of our letter. We are proud of the commitment that we have made to scaling our business well in advance of points at which the additional resources would be mission critical. This has included adding team members to our advisory team, our mid- and back-office groups, as well as our research team. In the second quarter, we added two new members to our research team. First, Jacob Puccetti joined the investment team as a Junior Analyst. Jacob comes to us shortly after graduating from the University of Dayton with a degree in Finance. Outside of a stellar academic record, Jacob brings with him a handful of applicable summer internships. Jacob has already ingrained himself into the broader research team, and we are happy to have him as our newest member. Our second hire during the quarter was for a newly created stand-alone position: Director of Operational Due Diligence. Historically, that role had been tackled by a platoon of investment team professionals along with the assistance of our COO and CFO. To fill this dedicated role, we recruited Nick Lotysz who joins Vivaldi after nearly a decade in a key ODD role at Mesirow Financial's fund of hedge funds group. In addition, Nick is a Certified Public Accountant (CPA) and a CFA charter holder. We could not be more excited about Nick's addition to the team, and we are very happy to say that he has already been accretive to our process.

As always, we thank you for your continued support and intend to work hard to maintain it.

Kind Regards,



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