First Quarter 2018 Investor Letter

Vivaldi Investment Research

Q1 **2018**

VIVALDI
CAPITAL MANAGEMENT

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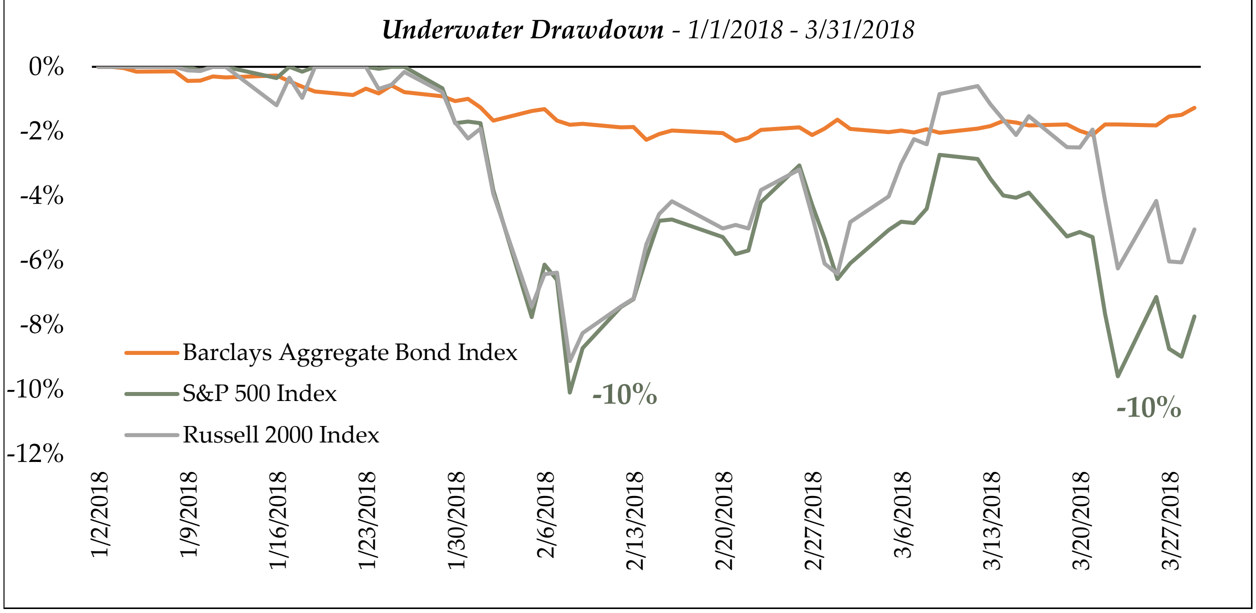
Market Perspective

The first quarter of 2018 proved to be an eventful one. You may recall that we spent much of our fourth quarter update discussing what we thought was a critical move in interest rates and the high likelihood that this shift would cause a reversion to the mean in broader market volatility. While we may not have expected to see those forces play out so quickly, we certainly weren't surprised that the record-setting calm of the second half of 2017 came to a notable end. While the S&P 500 Total Return Index ("S&P 500") may have finished the quarter down just -0.78% overall, that index closed the quarter nearly 8% off its January high. Importantly, that was also near lows for the most recent peak-to-trough drawdown. As shown below, the S&P 500 touched down -10% two separate times during the first quarter alone.

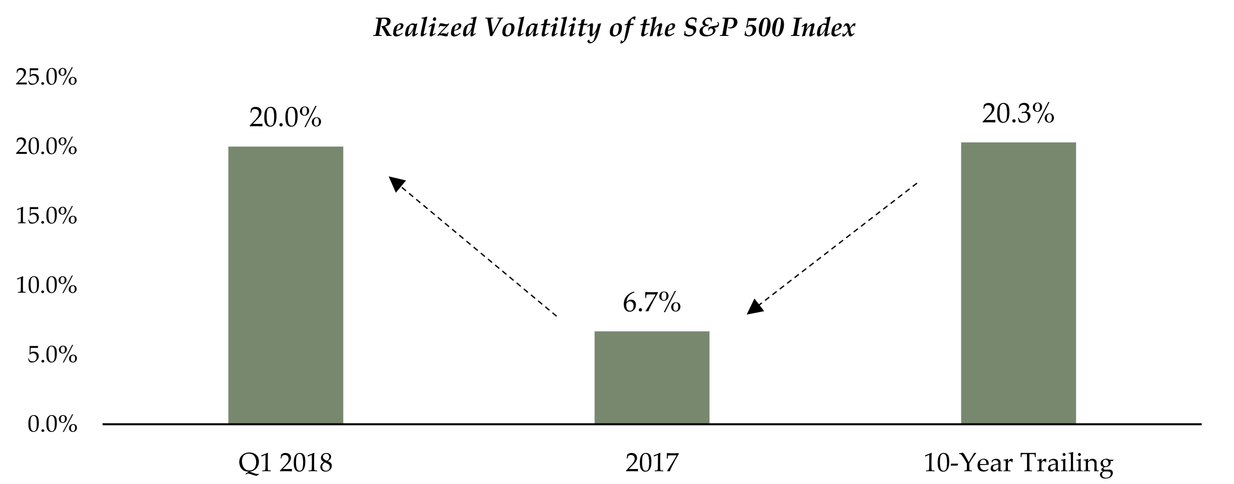
Multiple -10% Touchpoints for the S&P 500 in the Q1 2018



Source: Bloomberg

Ever since the 2008 financial crisis, asset allocation portfolios have benefited from the fact that even the most modest equity market corrections have been accompanied by flight-to-quality trades that have benefited broader fixed income exposure. In our last two letters we noted that the secular shift higher in rates was likely to prevent that same correlation benefit from playing out in the next equity market correction. Unfortunately, many investors have come to view that negative correlation as fundamental in nature as opposed to circumstantial. Indeed, the Barclays Aggregate Bond Index ("Barclays Aggregate") declined -1.45% during the first quarter. While it has, thus far, been fairly muted in scale, that plain vanilla fixed income index has been in the midst of a drawdown since early September of last year. While the back-up in rates did temper itself toward the end of the quarter, and the equity market staged two notable attempts to hold recent lows on major indexes, we believe that the first quarter is a harbinger of a materially more eventful 2018 when compared to 2017. We do not believe that these fundamental forces will be as transient as the handful of bouts of market volatility have been in recent years.

A Return to More Normalized Levels of Volatility

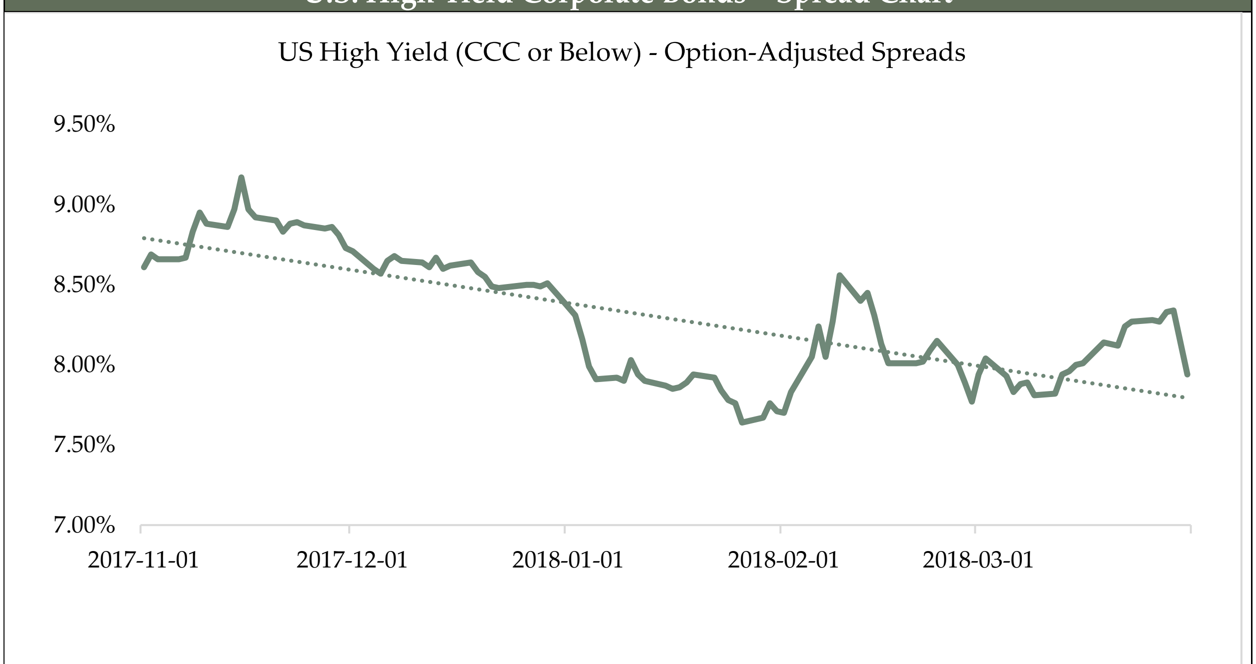


Source: Bloomberg

One of the main focuses of our fourth quarter letter was that a more normalized volatility environment was needed in the equity markets. As one can see from the related chart above, the first quarter of 2018 delivered that result in spades. Earlier in the first quarter, Vivaldi Portfolio Manager Brian Murphy was speaking at a conference of wealth advisors in Boston where the topic of the conversation was how client portfolios should be positioned across equities, fixed income, and alternatives. Specific to equities, the Vivaldi viewpoint was that the trailing 5-10 years had been a highly abnormal period for equity market returns. This was not because markets were up substantially, which is not atypical for a long-term period, but instead that broader equity indexes had achieved these large gains with increasingly less-and-less realized volatility. Brian noted that the S&P 500 had run with a return-to-risk ratio over 1.0 for the trailing 5-year period – something that has never been sustainable historically. The Vivaldi view has not been that equities are in a bubble that needs to burst. Rather, we are believers in reversion to the mean and that a normalization closer to the historical averages for realized volatility is highly probable. Equity markets are not supposed to feel like fixed income or credit markets and we welcomed the more normalized environment in the first quarter, something that we feel will ultimately be healthy as risk premiums return to markets. As always, we highlight this view as the foundation of our work in maintaining balance in client portfolios, especially in the face of abnormal environments that can distort risk taking by less disciplined investors. For investors interested in reading our white paper called "The Case for Proper Asset Allocation", please access the report by clicking here.

We dedicated a large amount of space in our last update to how focused we were on monitoring the back-up in interest rates that began in the fourth quarter of 2017 and accelerated early this year. We were of the view that this move in rates was finally going to be "stickier" or more persistent than previous moves. Broadly speaking, many market participants believed that a material move higher in rates would unleash volatility and downside price movements in all things credit. Interestingly, there has been a big bifurcation in how that narrative has played out. Fixed income sectors with the longest durations like municipal bonds and long-dated Treasuries have certainly felt the pain that many had anticipated. Importantly though, that same impact has not flowed through to many credit-sensitive sectors, even for those that have moderate rate duration exposure. In our view, despite the very clear signs towards a structural shift in rates higher, many market participants underestimated this potential change in market dynamics. Given the significant bifurcations that we are seeing across fixed income securities, we think that active management is poised to outperform relative to benchmarking strategies, such as passive exchange-traded funds (ETFs). Our logic for overweighting actively-managed opportunistic credit coming into the year was predicated on our strong view that the way to generate outsized returns at this point in the cycle is to source and underwrite managers with a deep industry expertise and ability to take advantage of these market dislocations within sub-segments of liquid credit, rather than accept a further sell-off in traditional credit like many benchmark hugging/indexing strategies.

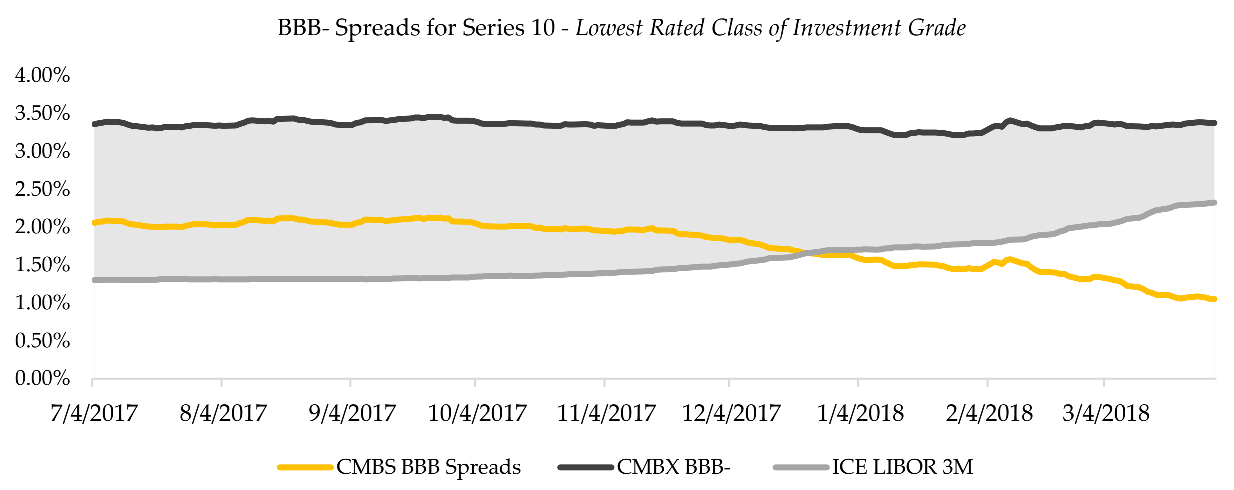
U.S. High Yield Corporate Bonds – Spread Chart



Source: FRED, Bloomberg

The chart above (and on the prior page) shows the culprit here by which a healthy amount of the outright increase in baseline interest rates has been buffered by a continued compression in credit spreads. This has been the case across the credit risk spectrum, though it has been most pronounced in the higher quality bucket. We attribute this dynamic to the continued high levels of cash that are searching for yield as well as a rotation away from more equity-oriented assets. Investors seem reluctant to redeploy those equity dollars into true fixed income based on the duration exposure opting instead to buy high quality credit. While this shift has worked for the first quarter, we would note that credit spreads were already at historically tight levels. While absolute yields may be up due to the move in rates, the spread buffer for any actual deterioration in underlying corporate credit performance is razor thin.

Commercial Mortgage-Backed Securities (CMBS) – Spread Chart



Source: Markit, Bloomberg

We would also note that this broader compression in credit spreads has impacted the structured credit markets writ-large. It is worth paying attention to the action in these spreads as many more traditional fixed income managers have ventured in the structured credit space to find yield without picking up more interest rate duration. For instance, as illustrated in the chart above, Commercial Mortgage-Backed Securities (CMBS) spreads have rallied considerably behind that interest from yield-hungry investors. Generally, when "tourists" become large players in esoteric markets, the performance of those sectors can be heavily impacted by asset flows. Less specialized firms may prove to be weak hands in the event of spread widening or mark-to-market volatility that causes them to retrench in areas of greater core competency. As such, we have been paying attention to these flows as they could have serious technical implications for various credit sectors in which we invest.

As has become somewhat typical, our market commentary may read as being overly cautious. We find it more useful to invest our time and attention to areas that could produce risks to an otherwise healthy economic environment. Additionally, we believe that now more than ever is the time to focus on specialization within asset classes versus broad based exposure. Broad exposure to equities and fixed income worked extremely well post crisis. The top item on every client's agenda should be reviewing overall exposures to each of the broader asset classes and determining whether there should be any changes at the margin that could help protect during a more normalized volatility environment. Counterintuitively, Vivaldi's house view remains reasonably constructive on most of the areas in which we invest. We aren't seeing a fundamental deterioration in housing, or corporate earnings, or any weakening in borrowers' access to capital markets. With that said, a more normalized volatility regime should provide for larger risk premiums in many sectors of the market. Given that much of what we do on the investment front is looking to take advantage of those risk premiums, we are encouraged by that dynamic. Nevertheless, we will remain focused on being vigilant about those areas where risk premiums are compressing even as broader market volatility is expanding, with the idea of reducing our exposure to those areas.

Highlighted Research Process

As many of you reading this letter are likely aware, Vivaldi prides itself on the level of detailed research that we perform on underlying managers. As we noted in our last letter, our investment team takes hundreds of meetings and phone calls, attends dozens of industry events, and travels relentlessly in an effort to stay on top of our existing managers, source and diligence potential opportunities, as well as stay in the broader information flow of the industry that can ideally help us make better tactical decisions about capital allocation. We like to think of that as our "bottom-up" work with the goal of making ourselves more effective at our core responsibility: preserving and growing client capital. The research team's work does not end with this fundamental work however. Another aspect of our interactions with existing and potential underlying managers is to take advantage of our willingness to invest with new and emerging managers focused on niche or complex opportunity sets. An important evolution in the alternatives industry in recent years has been the ability of early adopters to drive economics and terms and that reality has become part of what the research team explores, on a parallel track, as our diligence process reaches critical junctures.

Increasingly, Vivaldi has been able to drive outright economic alignment (revenue shares or general partnership ownership) and/or fee concessions from both emerging and large institutional managers. We view this is a crucial differentiator relative to other boutique-sized firms that often do not pass these revenue streams on to clients. We would always stress that these conversations would never be the leading driver of our interest in an investment (as it is for seeders or stake-taking platforms), nor would the lack of the ability to negotiate terms preclude us from investing in a manager that we thought was highly differentiated and valuable. Instead, it is simply one more aspect of our research process where we try to improve the alignment of interests and upside/downside potential for a given investment.

Outside of outright economics, this work can often lead to improved structures or incentives as well. Just in the past few months we have: successfully lobbied to have investor-level gates removed from a manager where the asset-liability match of the fund didn't require such restrictive liquidity terms; spurred a portfolio manager to upsize his personal investment alongside us in his fund from an amount that we deemed to be immaterial to $6 million (an amount we believed was material); and successfully promoted an improvement in the cash control procedures of an underlying firm. This aspect of our research and operational due diligence process may not be what we talk about in client meetings, but it is a tangible representation of our efforts to always fight to improve our foundation for clients in any investment. In many cases, those managers end up viewing Vivaldi as a value-added relationship as we push both best practices and more clear-cut alignment. We are constructive on our ability to continue to achieve these types of advantages as we continue to move forward.

Organizational Update

More often than not, we have been fortunate over the past few years to have the opportunity to inform you of an addition to one or more of our business verticals in this segment of our letter. The first quarter saw us expand our advisory team with the addition of Josh Pilson as Portfolio Strategist. Prior to joining Vivaldi, Josh spent three years working for a CTA focused fund manager here in Chicago. Prior to that, he spent a year working for a financial advisory firm in Austin, Texas assisting in portfolio management and investment research. Josh graduated from Ohio University with a master's degree in Financial Economics and an undergraduate degree in Finance. In addition, we are in the latter stages of the hiring process for both a junior analyst for the research team as well as a much more senior level hire for that group. We look forward to updating you on both of those searches in our second quarter letter. We are firmly committed to investing in our intellectual capital and continuing to expand on our capabilities. We believe strongly that this is the only way to maintain our edge and stay ahead of an ever-changing investment and industry landscape.

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

Kind Regards,

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