Third Quarter 2018 Investor Letter

Vivaldi Investment Research

Q3 **2018**

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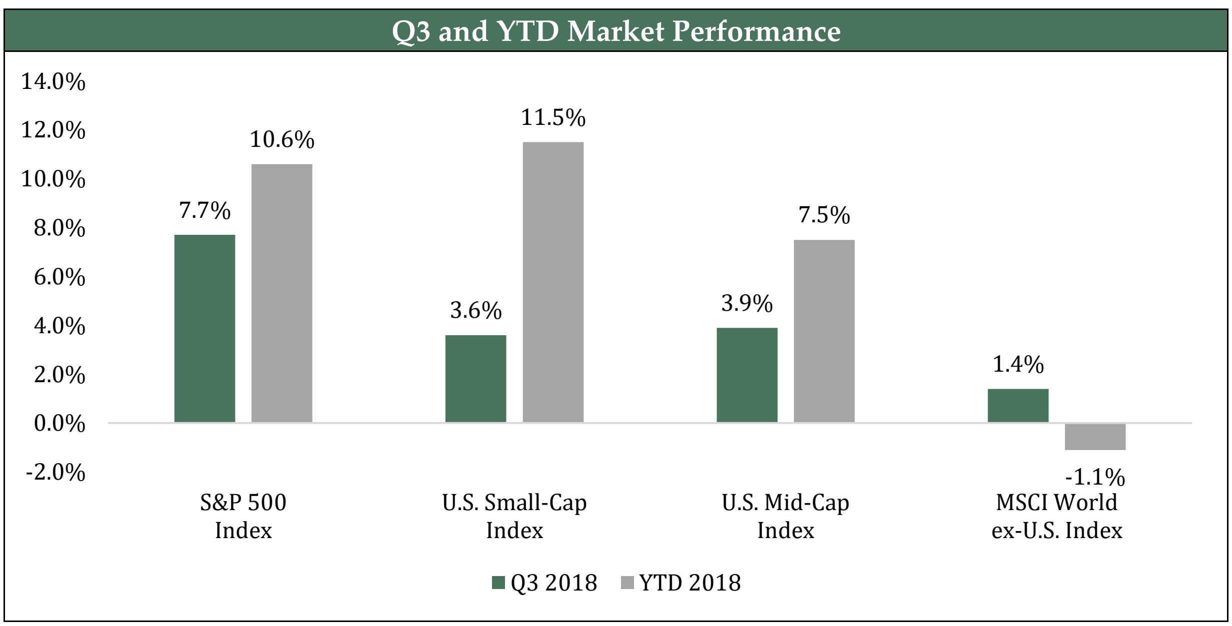
Contents

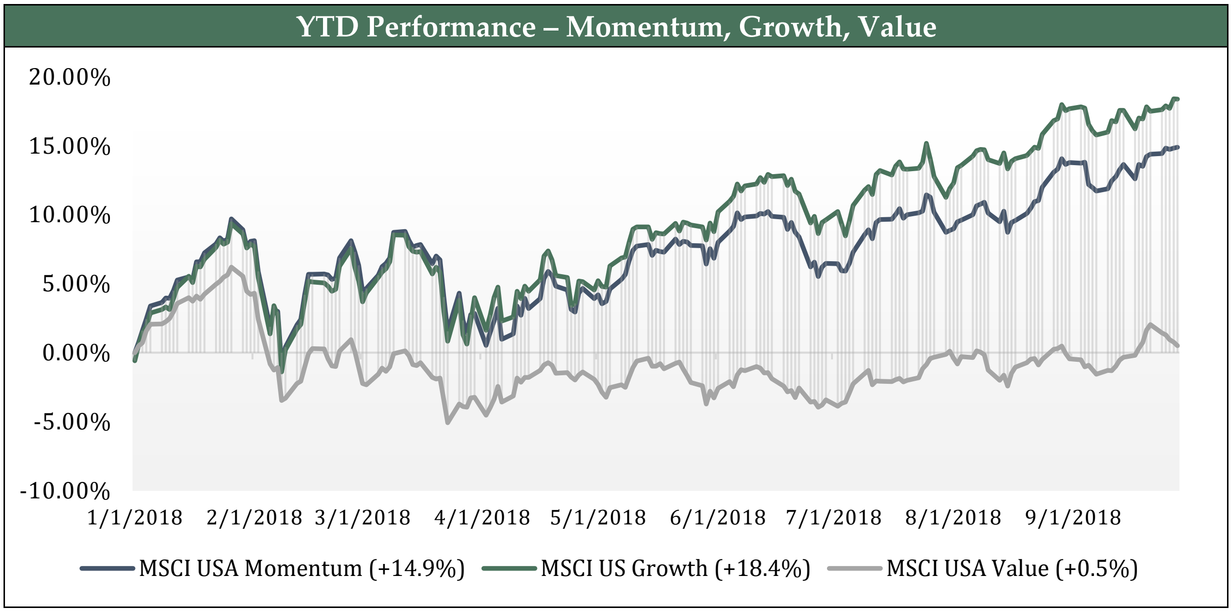
Market Perspective

Penning our third quarter letter just a week or two into the fourth quarter feels like writing about what was a uniformly strong quarter for risk markets from a distant future. To isolate the widely-followed S&P 500 Index, the +7.71% gain in the third quarter was generated through accelerating gains month-to-month across the course of the period with almost no material pull-back in that upward momentum. That bellweather benchmark closed the quarter up +10.55% for the year-to-date period, a very solid return for the first three quarters of a year in any reasonable historical context.



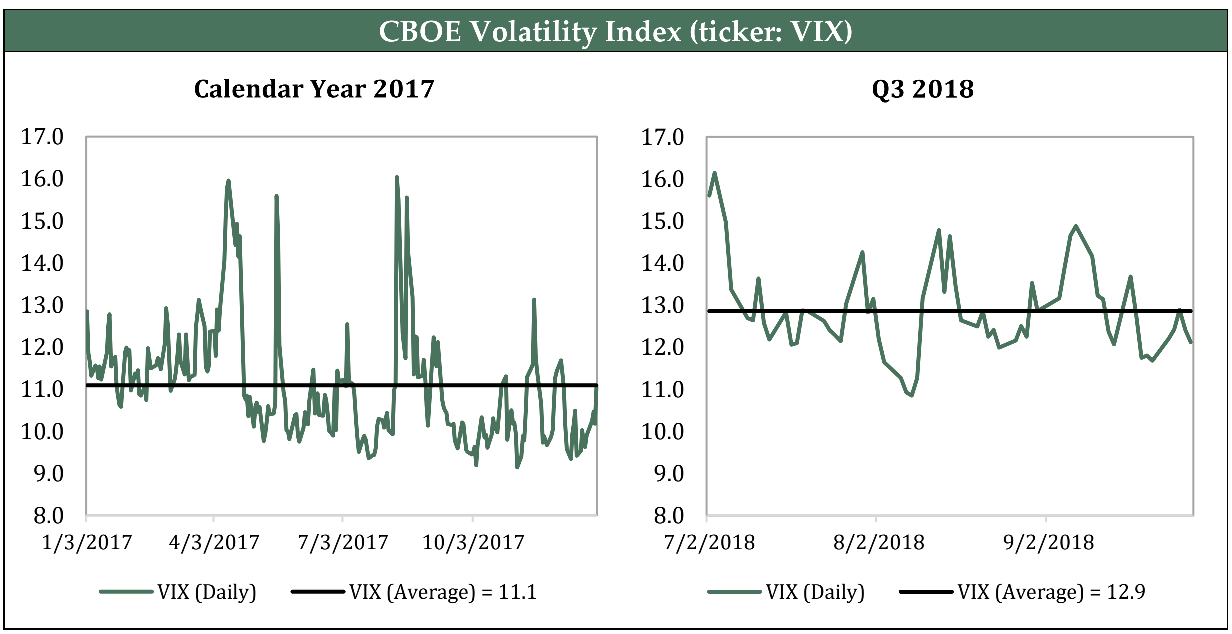
Source: Bloomberg (as of 9/30/2018)

This continued equity market rally was led by growth and momentum names, with a continued widening in the spread between those factor exposures and the value factor.



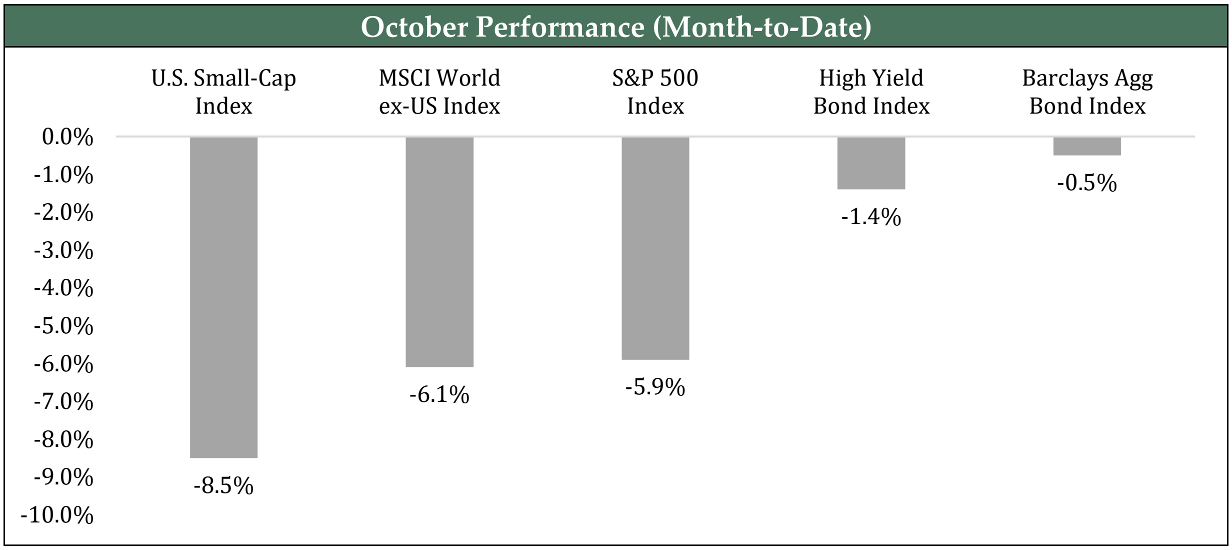
Source: Bloomberg (as of 9/30/2018)

The relentlessness of that equity market move also compressed equity implied volatility as measured by the CBOE Volatility Index (VIX), though that measure remained well above the lows that we saw for effectively all of 2017. All that is to say that the third quarter was a great period for those willing to lean long equities, especially domestically.



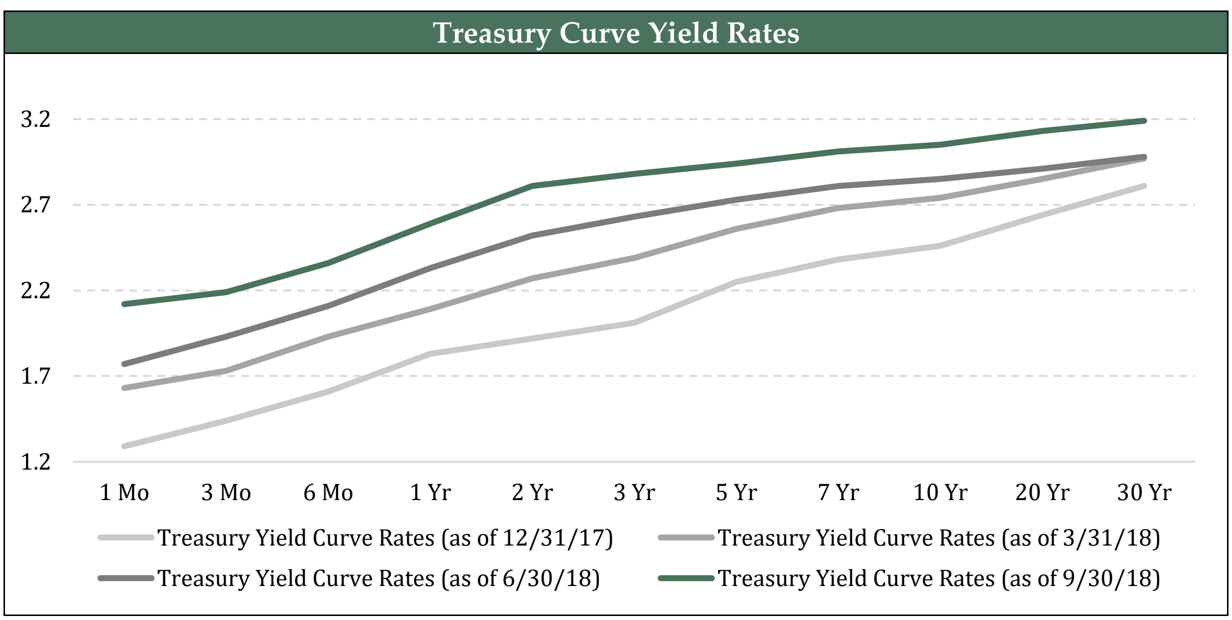
Source: Bloomberg

If we fast-forward to the middle of October, the year-to-date backdrop suddenly looks radically different. While the S&P 500 Index has held to roughly half of its year-to-date gains, the story within more narrow pockets of equity markets has deteriorated entirely. While it is impossible to know from two weeks of price action if a true reversal in market leadership and momentum has transpired, those market participants that were longest the highest momentum exposures likley feel like it has.



Source: Bloomberg (as of 10/15/2018)

For frequent readers of this letter, you will recall that over the last few quarters we have continued to highlight both the level and shape of the U.S. interest rate curve as being more of a focus to us than the rally in equities. Since the fourth quarter of last year, we have been paying close attention to the pressure upward on rates and the flattening of, particularly, the very back-end of the curve. While there have been momentary respites from that shift in rates, that backdrop of increased fixed income volatility and greater risk for assets with any material duration has been front-and-center for us in how we have constructed our alternative portfolios.



Source: U.S. Department of Treasury

We are not alone amongst market participants in being wary of that duration risk over the last few years, but the rate and pace of the change in that backdrop in recent weeks has surprised many. While we maintain our view that a normalization in rates could very well be a positive thing for the economy in the long-run, we continue to highlight the implications for many investment strategies that have been predicated on seemingly permanently low absolute levels of rates and ever-tighter credit spreads providing incredibly inexpensive financing for assets. That dynamic has real implications for where we have chosen to deploy capital, irrespecitve of our fundamental view on the health of the U.S. and global economy.

A central point of our Market Perspective for each quarter of 2018 has been that the last decade of negative correlations between domestic equity markets and fixed income markets was not guaranteed to last into perpetuity. While we did see some incremental flight-to-quality action in Treasuries at the very depths of the recent market sell-off, it is worth continuing to point out that it remains possible, if not likely, that fixed income and credit marekts could move lower as equity markets also experience negative returns. Asset allocation portfolios have not had to deal with that dynamic since 2008 and the "60/40" portfolio has appeared infallable since that timeframe. It is notable that we again saw long-only equity indexes produce Sharpe Ratios in excess of 1.0 over the trailing 12-18 months at the close of September. We will always be skeptical that those types of metrics are in any way sustainable outside of very short timeframes.

For the last few quarters we have closed this section of our letter by noting that, fundamentally, things aren't nearly as scary as many headline risks would lead one to believe. As we said last quarter, it is always possible to create a heavily bearish outlook based on potential tail risks or geopolitical headline concerns. While today's environment geopolitically certainly seems as dangerous as ever, no era is without its high-level risks. What we believe we are seeing in markets in the last few weeks is a more normal rationalization in several market factors that became tremendously stretched. While near-term volatility is likley to exacerbate moves in both directions, certain spreads (i.e. Growth vs. Value) essentially needed to narrow. While much of the above commentary makes us sound very "top-down" in nature, the reality is that we have always been and continue to be focused on building balanced portfolios that can weather the inevitable cycle of market imbalances building and then normalizing. While this can limit our participation in the asset classes that are "working" in any given moment, it also alleviates us of the impossible responsibility of timing shifts in market sentiment that often unwinds those trades quickly (i.e. the recent move in interest rates).

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. Last quarter we detailed two additions to our research team resources, both of which have settled in nicely and added robustness to our research backbone. In the third quarter we continued to add bandwidth to our wealth management team with the addition of Jonathon Merickel. Jonathon is a Wealth Adviser who focuses on clients from the TD Ameritrade

Advisor Direct referral program. Prior to joining Vivaldi, Jonathon worked as a Financial Advisor at IHT Wealth Management where he advised high net worth families. He also has previous work experience at E*TRADE Financial, Fidelity Investments, and JPMorgan Chase.

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

Kind Regards,

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