VIVALDI
CAPITAL MANAGEMENT

Investor Letter

First Quarter 2019

By: Vivaldi Investment Research

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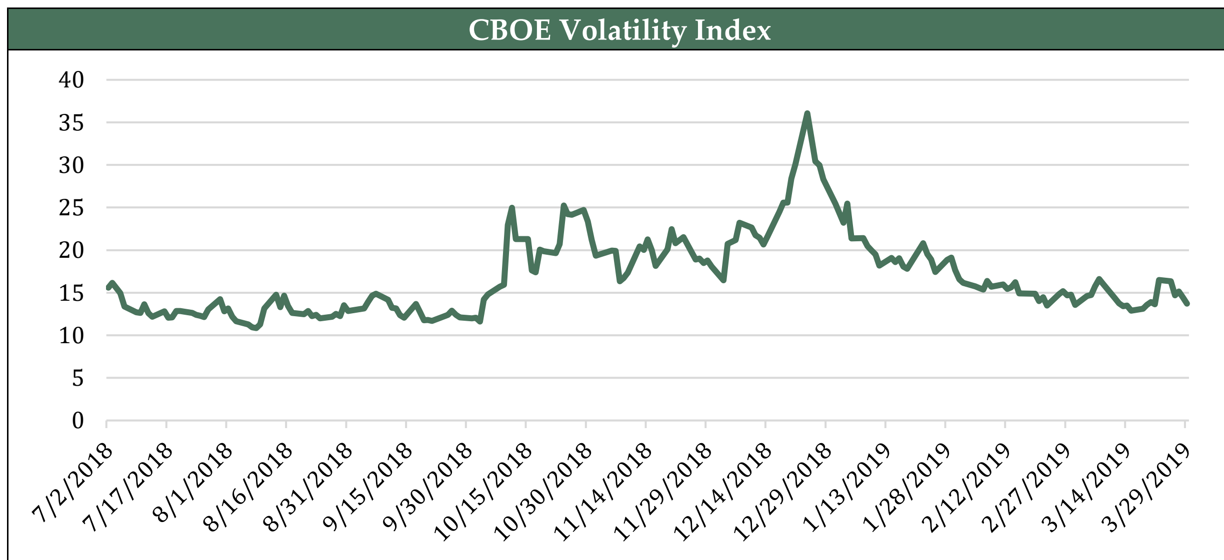
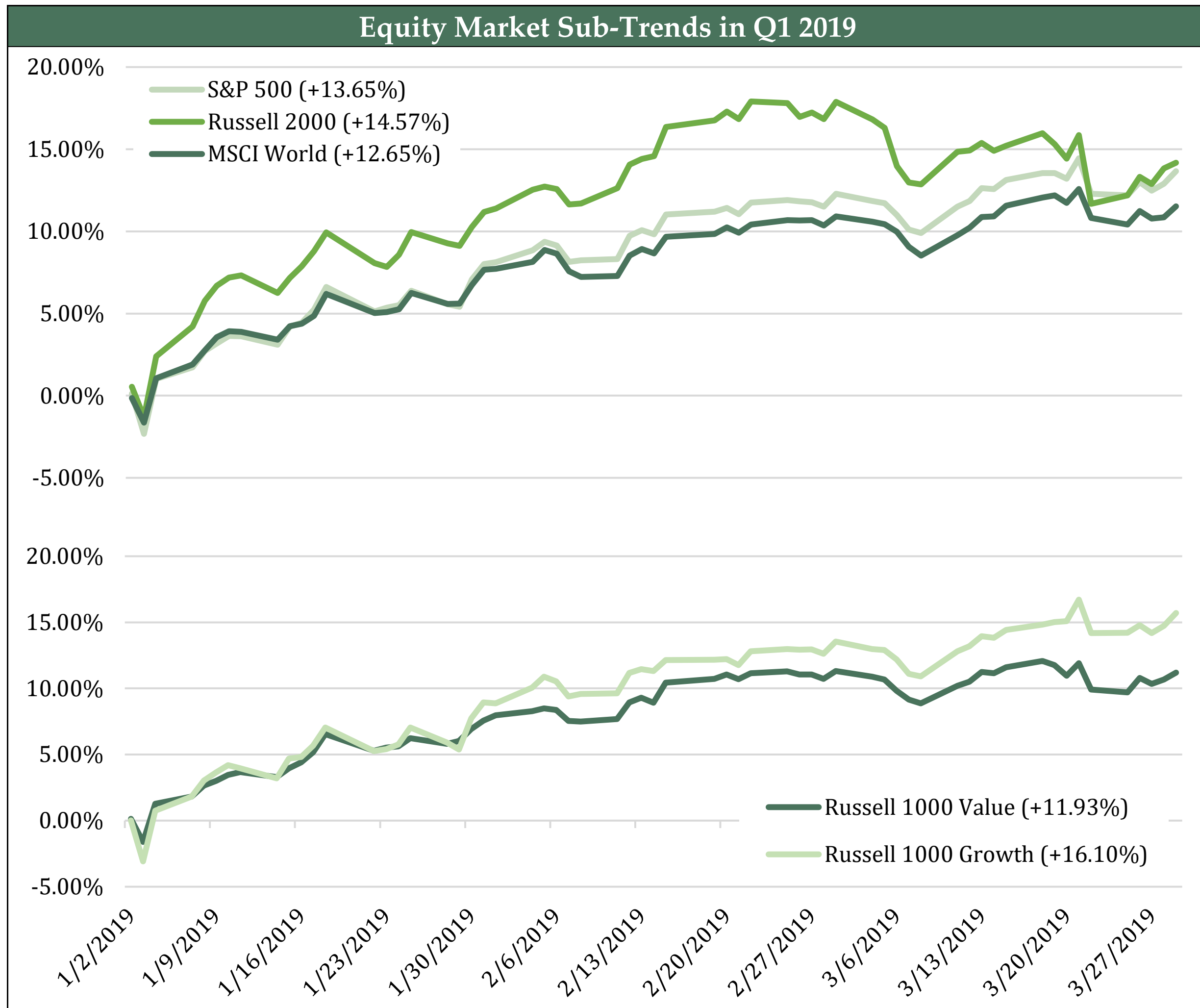
April 26, 2019

Market Perspective

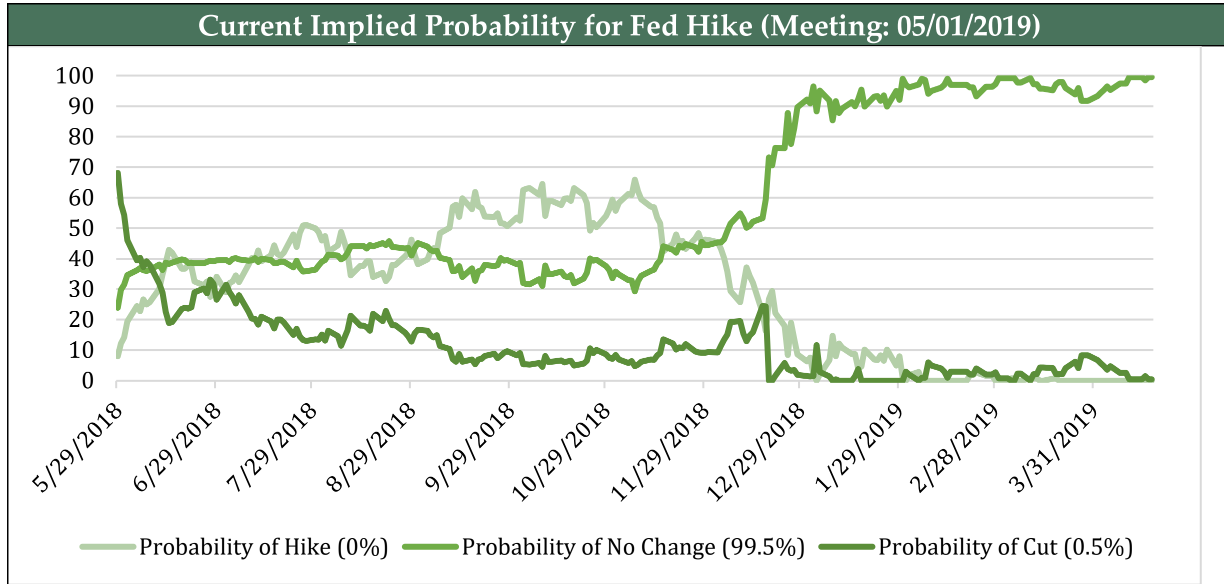
What a difference a quarter makes. In our year-end update, we dedicated much of our *Market Perspective* to what we believed to be volatility-driven dislocations in credit markets and other sub-markets that are tangential to credit. In our view, equity market volatility during what is seasonally a very weak trading volume period (December) produced some highly abnormal market movements. As we often highlight in these notes, we are not macro investors nor do we consider ourselves particularly insightful macro thinkers, but we do monitor these high-level asset class trends in an effort to be more thoughtful in our tactical portfolio construction and allocations. All else equal, we would like to be more active during periods of dislocation and less active in more benign environments.



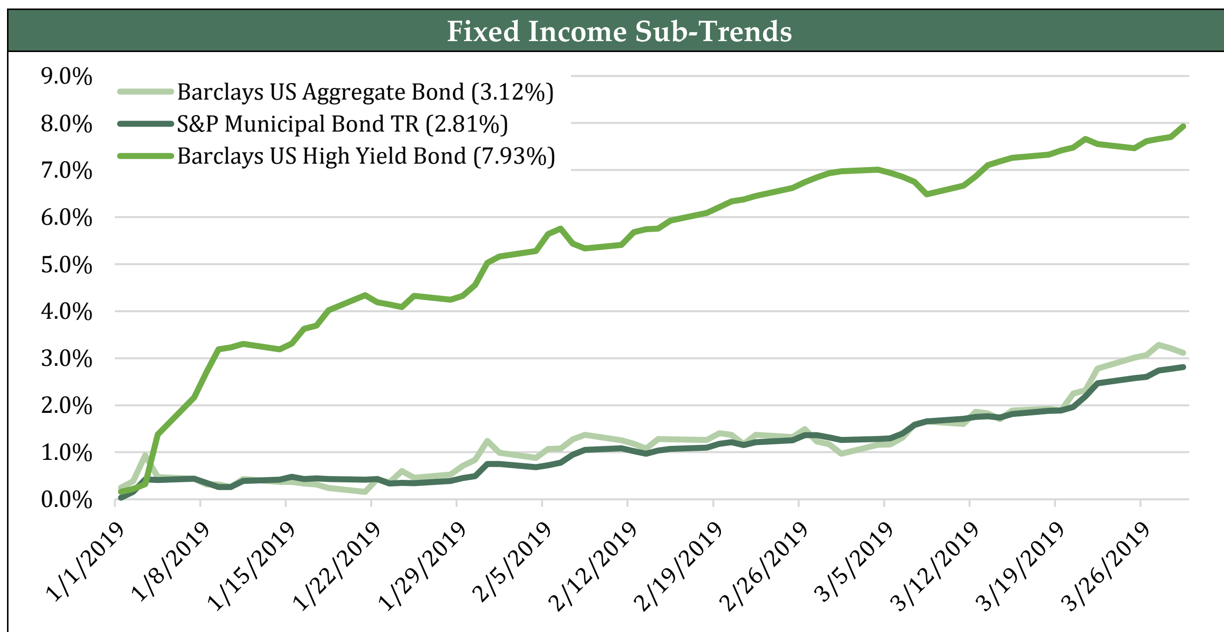
As has been the case for much of the last decade, the pocket of dislocation we witnessed in the fourth quarter was very short-lived. We now sit roughly half-way through April, equity markets have returned to all-time highs and credit markets have largely healed (though there are some exceptions to this narrative on the credit front which we will touch on later). Yet again, domestic equity markets have distinguished themselves relative to international peers. In fact, the first quarter was one of the strongest quarters for domestic equities in recent memory. The only notable sub-trends within those equity markets were that smaller capitalization indices outperformed for much of the first quarter (though they gave back some of that outperformance in March) and there was a long overdue rationalization in the performance spread between the value and growth style factors. The latter event is particularly notable for many of our active equity investment strategies which tend to have a modest bias toward value metrics.



Away from equity markets, the most notable development within fixed income/credit was that the Federal Reserve more formally moved to the sideline on rate hikes. Several leading economic indicators showed early signs of moderation and the Fed is clearly on edge about being overly hawkish should the economy begin to slow more materially. While the drum-beat of criticism for the rate and pace of the normalization in interest rates has been nearly even from both sides of that debate, the Fed has a clear sensitivity to the prospect of slowing growth and the exogenous risks posed by global unknowns such as Brexit. Even as inflation remains benign they decided to telegraph their desire to let things breathe for the balance of the calendar year.

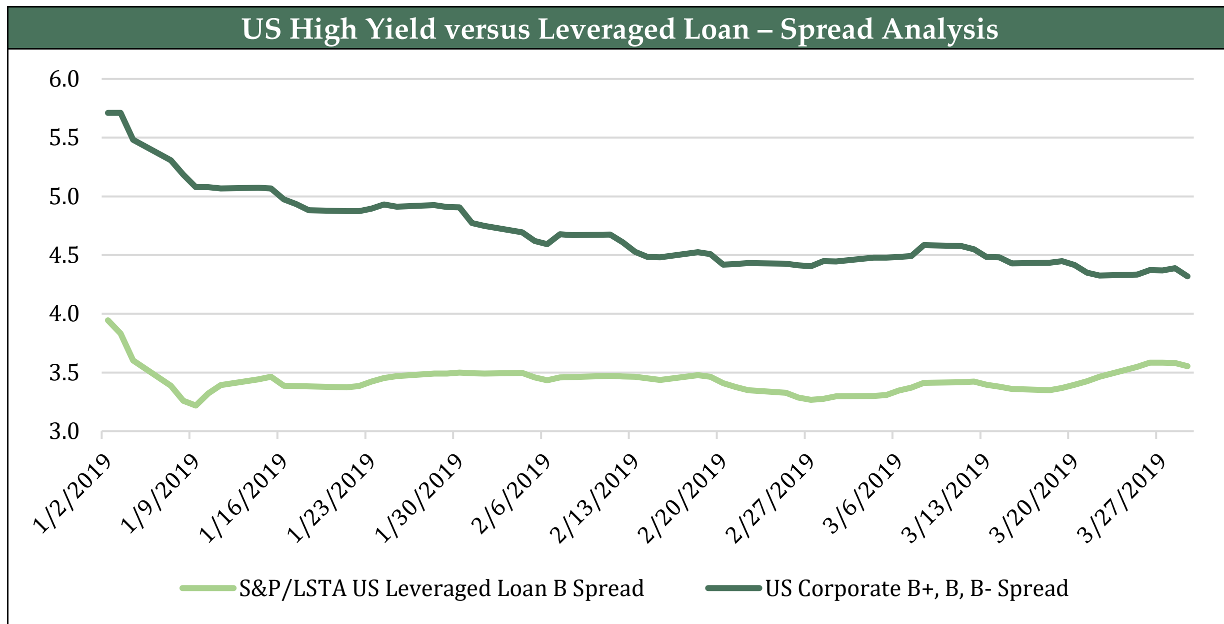


That confluence of factors noted in the preceding paragraph produced one of those odd periods in which we saw a rather dramatic rally in interest rates paired with an equally impressive magnitude rally in equity markets. All things risk-on saw notable bounces off their fourth quarter lows while all things duration-sensitive saw the tailwind of lower interest rates across the curve.

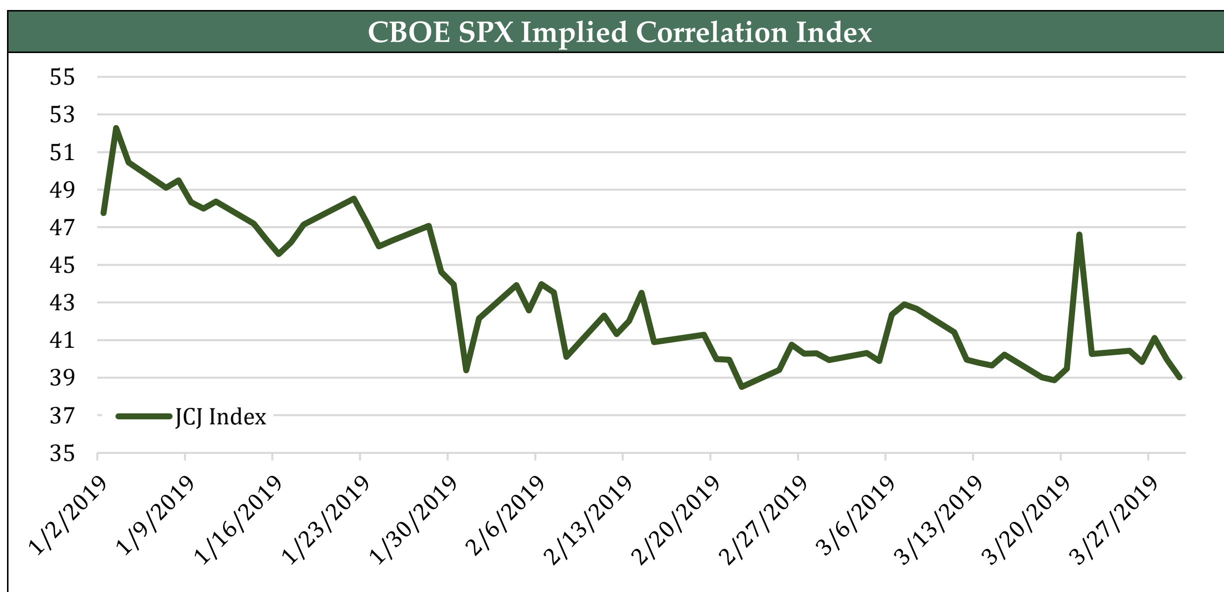


As we noted above, the improvement across domestic equity markets was largely uniform regardless of sector or style. The same was not true of the credit markets. While the dislocation that we saw in the fourth quarter fanned out across the credit risk curve as one would expect (high spread duration assets were hit the hardest) the bounce back in some of those sub-sectors has been more disparate. Specifically, we have not seen the leveraged loan market and related CLO market rally back as dramatically as broader domestic high yield has. This has been

particularly true down the credit spectrum where the riskiest high yield segment has seen more spread narrowing than the equivalent junior CLO tranches.



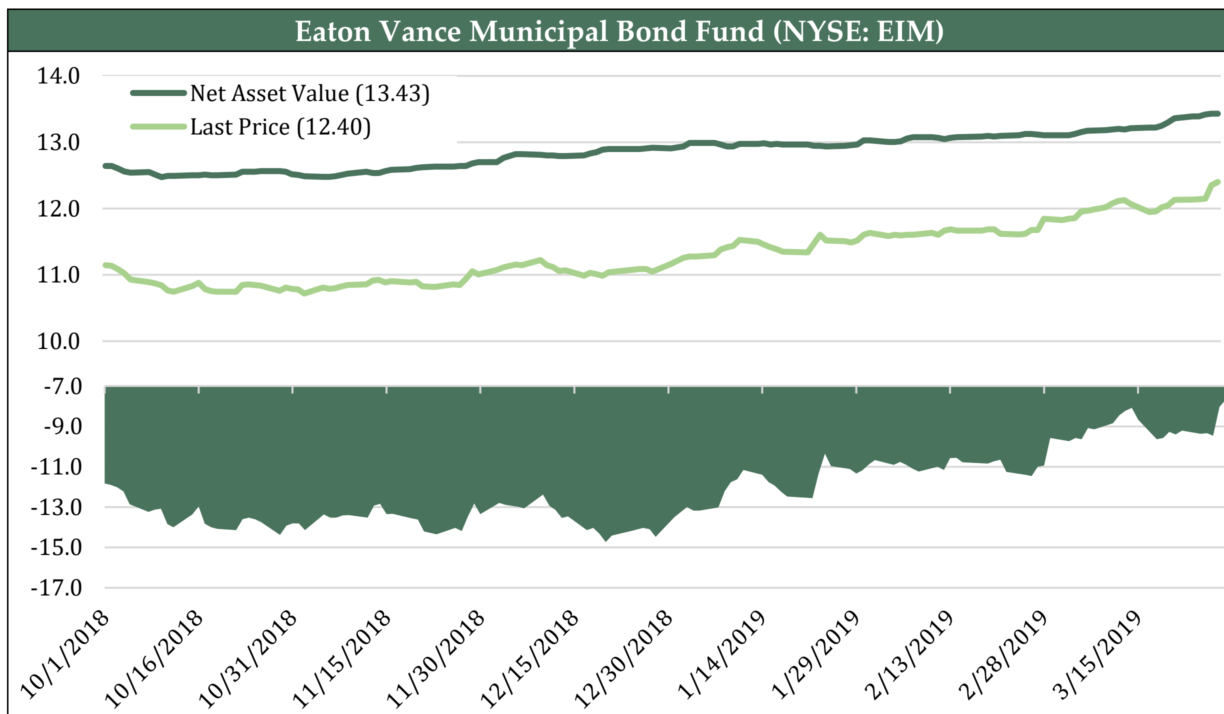
Finally, we want to make a note on the level of overall dispersion that we observed in the first quarter. The start to 2019 has proven to be one of the most robust quarters for active management that we have seen for some time. Overall dispersion within equity markets has improved markedly over the fourth quarter. We highlight this dynamic briefly as it is a key tailwind for much of what Vivaldi Investment Research looks to source: active managers with a defined niche.

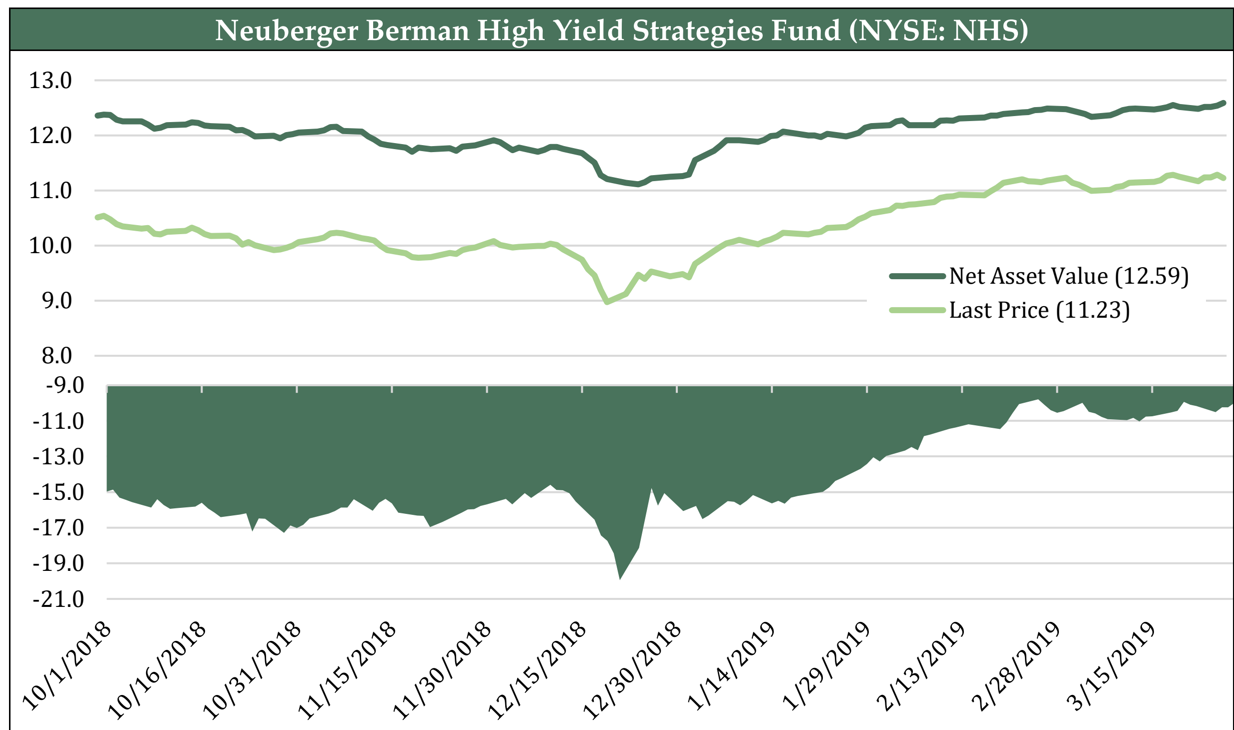


Update on Year-End Highlighted Opportunity

If you will indulge a brief recitation of our year-end letter, we chose to highlight what we thought was a technically-driven dislocation in the closed-end fund marketplace. Specifically, we spoke about a nearly historic dislocation in both municipal bond and domestic high yield/loan closed-end funds. We discussed the confluence of factors that we believed combined to make the late 2018 sell-off in this space particularly bad (equity market volatility, low liquidity during the holiday season, tax loss selling from less sophisticated advisors and retail investors, etc.) and thus why we thought this dislocation represented a compelling tactical investment opportunity. Seasonally and historically, the first quarter tends to be a constructive period for closed-end fund discounts narrowing. That traditional discount narrowing, combined with the additional tailwind of the bounce back in credit on top of the rally in duration-sensitive assets essentially created the best technical environment for this sector very shortly following the worst technical environment.

The overall result of the above narrative has been an impressive performance from the closed-end fund sector overall and our Tactical CEF strategy in particular. Below we highlight the discount and total return charts of two of our holdings, one municipal bond CEF and one high yield CEF. As one can see, the technical improvement in discounts has been material while total return has outstripped that narrowing through the rally in underlying portfolio NAV.





Highlighted Research Process

Frequent readers of these quarterly letters know that VIR members are firm disciples of the concept of an illiquidity premium. In short, we believe that the ability to deploy capital without the constraints of immediate or continuous liquidity provides the opportunity to increase expected returns materially. Almost more than any other tenet, VIR believes in the durability of this incremental spread that can be achieved through greater patience and flexibility. Historically, the illiquidity premium has been one of the main underpinnings of the "endowment model" of asset allocation that heavily emphasizes less liquid asset classes such as private equity, illiquid credit, hedge fund, and real estate investing. The ancillary correlation benefits that this model has are also attractive to those organizations, institutions, and individuals that have the flexibility to hold these less liquid portfolios.

A core focus for the research team here at Vivaldi over the course of the last few years was to find more easily accessible ways to take advantage of this structural illiquidity premium. While we as a firm are always skeptical of new financial product development, one area that we have been seeing increasingly promising product launches has been the interval and tender-option fund space. These registered funds provide the regulatory and structural protections of the '40 Act, but via entities that provide only intermittent and partial liquidity in order to give the fund advisor much greater flexibility in what types of assets they can invest in. We have found that these structures, specifically in the credit interval fund space, have been able to generate gross yields 150-200 basis points above their mutual fund counterparts by capitalizing on more nuanced and less liquid credit instruments without taking on substantially more risk. These interval fund

structures are hugely advantageous relative to their daily liquidity mutual fund peers where we have been increasingly wary of the inherent asset-liability mismatch that continues to worsen, especially in segments of the credit markets.

The net result of our diligence in the interval fund space has been a substantial improvement in the variety and quality of investments that are available to those investors that may not be eligible for the least liquid limited partnership investing that has long been a staple of VIR's opportunity set. Importantly, this new area of product expansion comes with many structural nuances and unique characteristics that need to be fully understood and managed. We believe that we are on the leading edge of the knowledge curve on these structures and strategies and we see it as an area of tremendous opportunity and growth that will hopefully benefit our advisors and clients for years to come.

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 added Jennifer Yong, CPA, as Vivaldi's compliance manager. Jenny is working closely with the Chief Compliance Officer (CCO) to ensure the firm and its activities comply with all relevant rules and regulations. Prior to joining Vivaldi, Jenny was an assurance manager at Ernst & Young LLP in the Chicago office. At EY, Jenny was part of the Financial Services Office and worked on a variety of different wealth and asset management clients, including registered investment companies, private equity funds, hedge funds and funds of funds. She received a B.S. in accounting and management information systems from the University of Arizona. Jenny is a Certified Public Accountant (CPA) in the state of Illinois.

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

Kind Regards,

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