Investor Letter

Fourth Quarter 2018

By: Vivaldi Investment Research

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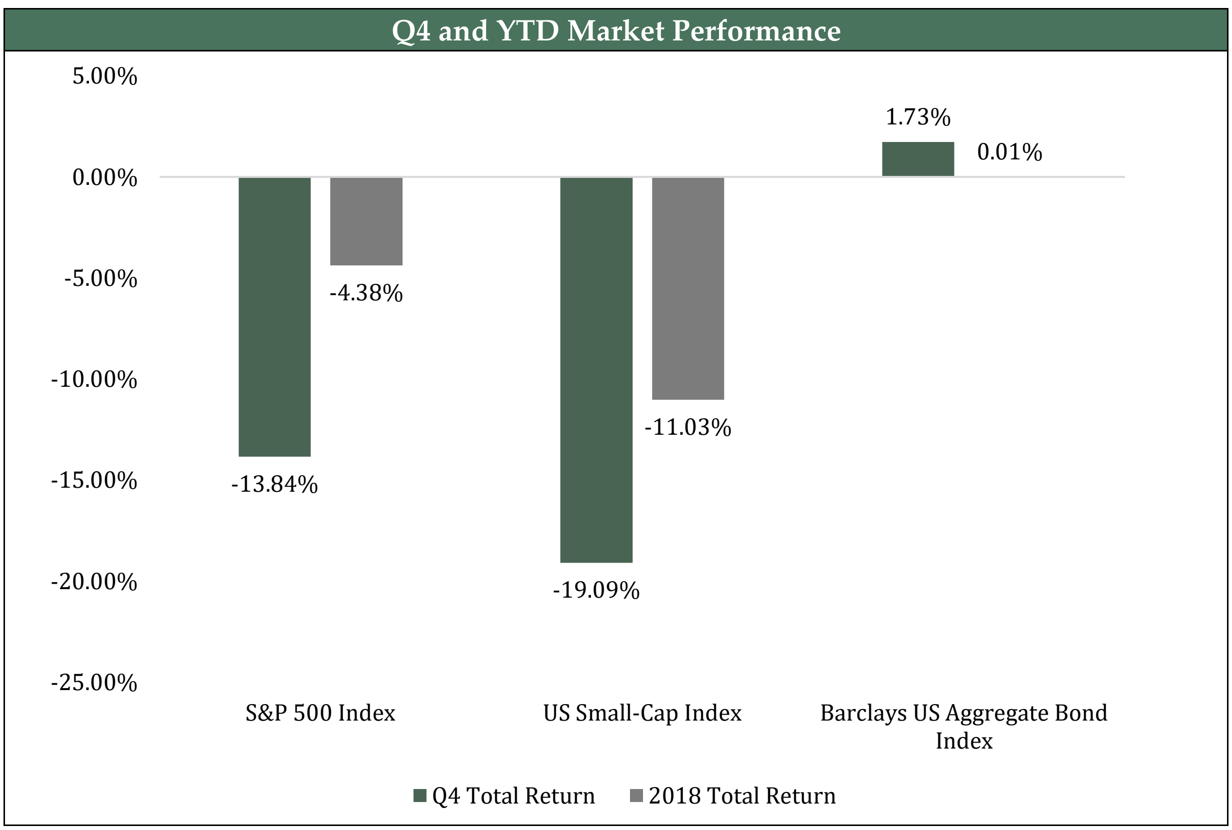
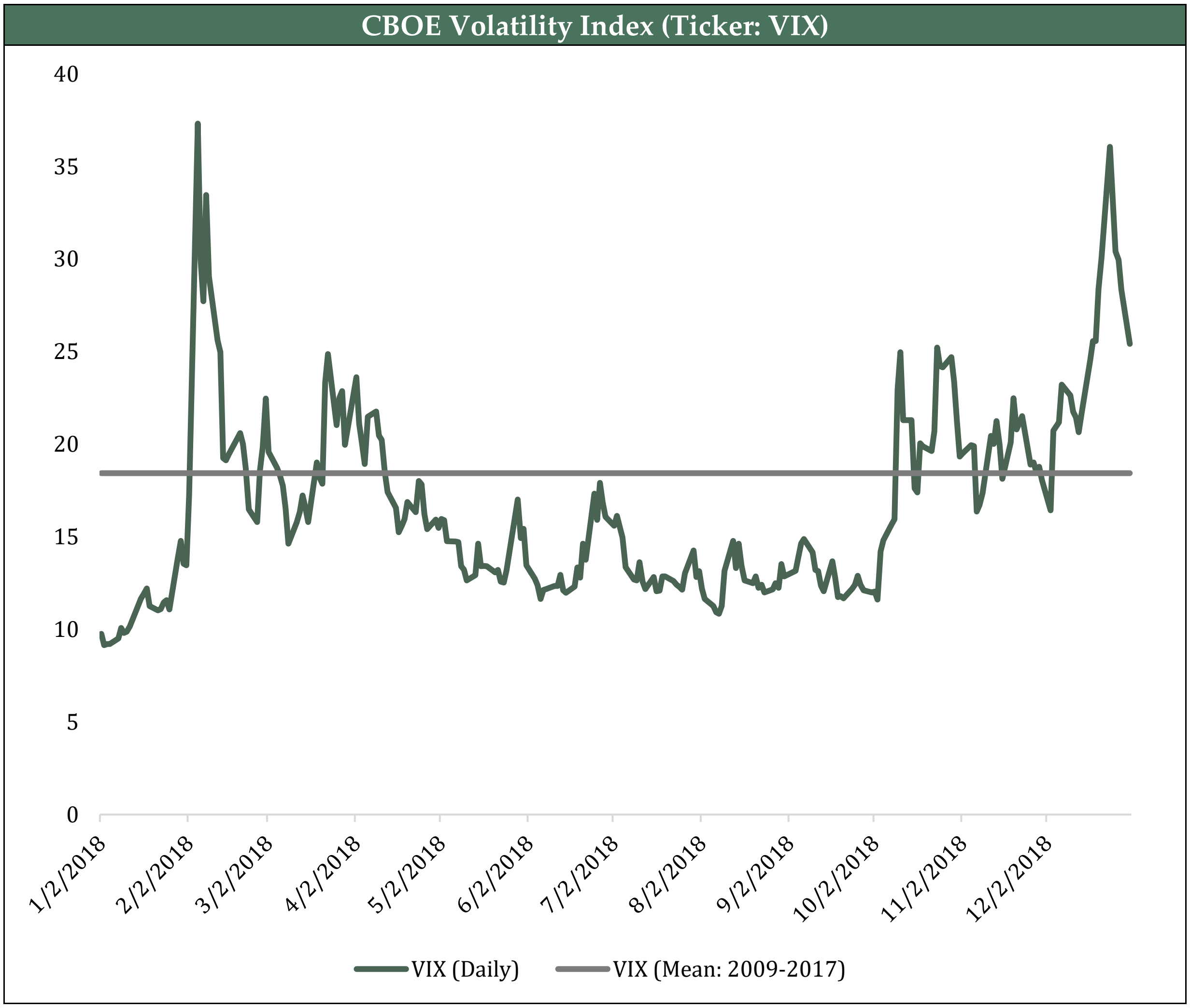
Market Perspective

Even just a few weeks into the new year, we can begin to put the market volatility that we saw in the fourth quarter of 2018 into some historical context. The broad risk-off action that we saw begin in October and accelerate in December was unique relative to other recent pockets of equity market volatility in a few key ways. Notably, we did not see as dramatic a rally in the general flight-to-quality asset classes. While the very tail-end of the equity market sell-off did spur a rally in Treasuries, for much of the period of market volatility, fixed income portfolios did not benefit. This is a dynamic that we have been highlighting in recent quarterly letters as the secular shift in the direction of interest rates, especially at this stage of an economic expansion, could reduce the extent to which the fixed income side of client portfolios provides a natural buffer to periods of equity market volatility.



Source: Bloomberg (as of 12/31/2018)

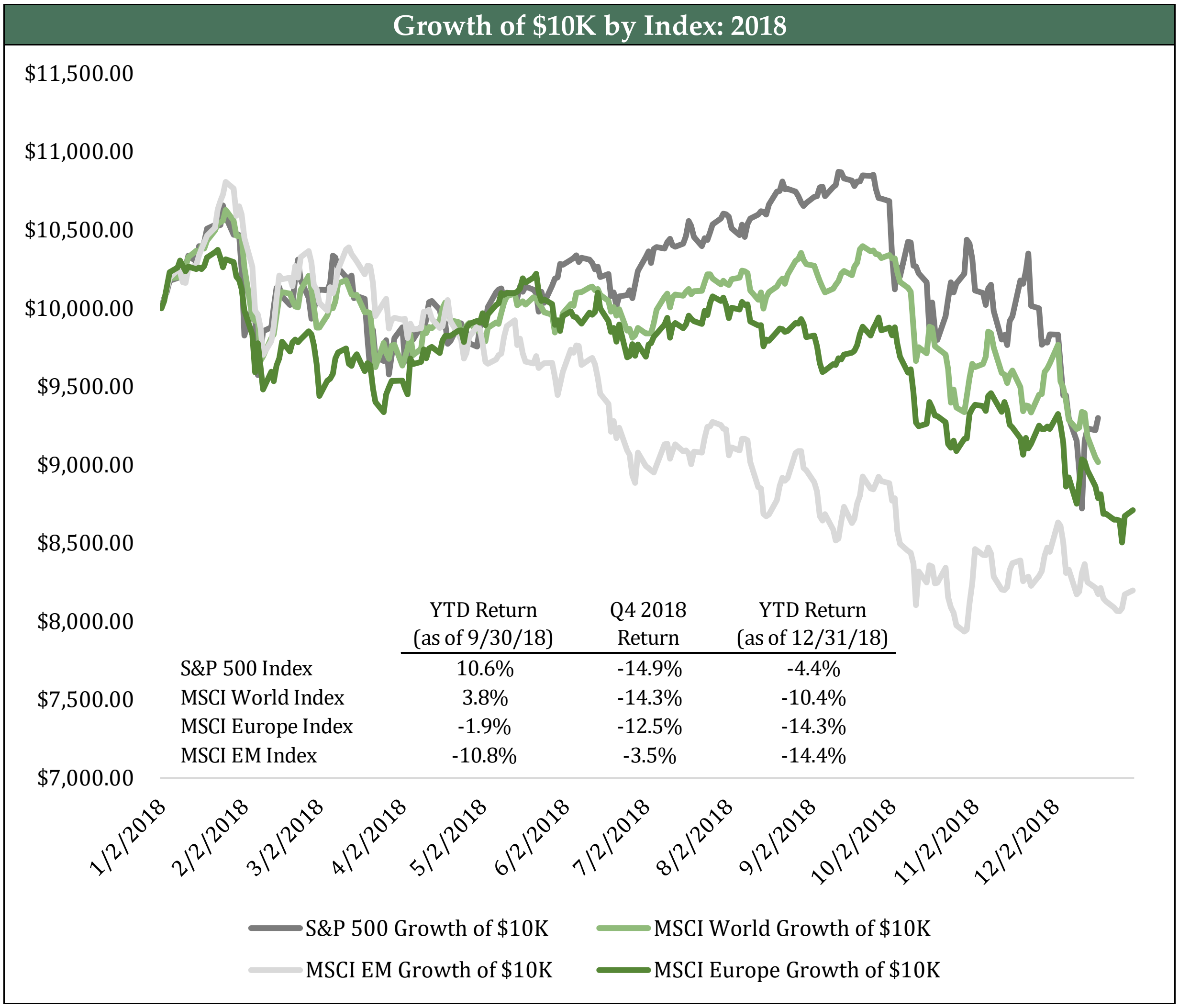
The other unique thing about the fourth quarter correction was when it happened from a calendar perspective. To see an aggressive and accelerating sell-off take hold in the back half of December was particularly concerning given the natural lack of liquidity that typifies that time period. December is, more often than not, the lowest realized volatility month in a given calendar year – and it is almost never the most volatile.



Source: Bloomberg (as of 12/31/2018)

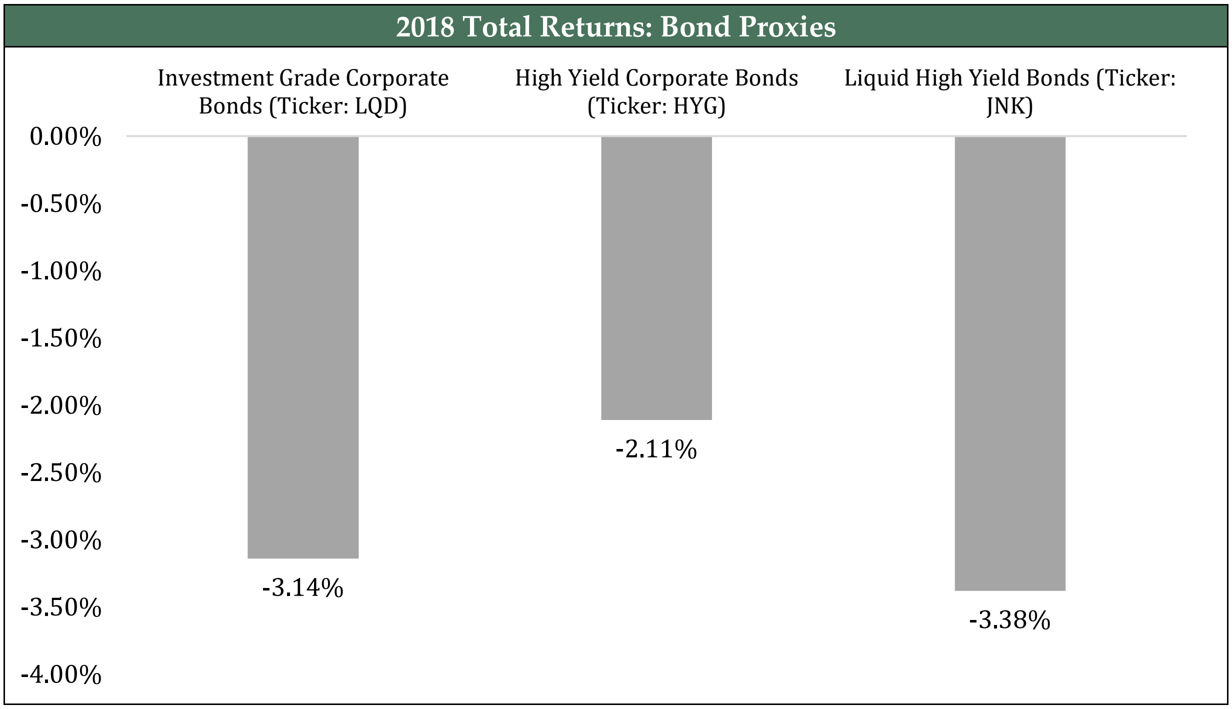
We pay attention to these very high-level macro issues not because our team is looking to make an active bet on the direction of rates, equities, or volatility. We monitor these trends because they have large implications for how we think about constructing balanced portfolios. We believe that many market participants have been lulled into a sense of complacency over the course of the last decade as there was very little need to do anything other than run a standard 60/40 asset allocation portfolio. This construct could be even further simplified by just focusing on the domestic U.S. markets, yielding even better results compared to a more diversified global portfolio.

We think one of the most notable stories of 2018 was how long U.S. equity markets held on to a historic outperformance gap over nearly every other global equity market. While the size and diversity of the U.S. economy can allow for periods of decoupling, our team's historical experience has taught us that we should also be highly skeptical of these periods when they become particularly extended or pronounced.



Source: Bloomberg (as of 12/31/2018)

Away from equities, much of the story for the first three quarters of 2018 was how portfolio managers dealt with interest rate duration risk. We saw a distinct shift in the direction of broader interest rates and a firm commitment from the Federal Reserve to continue to normalize monetary policy. One of the dynamics that we highlighted in our mid-year letter was that, across the full complex of credit and credit-like markets, we saw a healthy percentage of this rise in rates being compensated for by tighter credit spreads. Whether we looked at capitalization rates on commercial real estate or credit spreads on more liquid bonds, loans, or structured credit securities – all of these sectors saw spread tightening in the face of higher benchmark rates. The fourth quarter finally saw a rationalization in that tightening within many of the most credit-sensitive sub-sectors. While there were certainly headline risks that market participants pointed to for a fundamental basis for this widening, it was also undoubtedly compounded by the technical set-up of unsustainably tight spreads in the face of increased economic uncertainty, rising rates and higher equity market volatility.



Source: Bloomberg (as of 12/31/2018)

This rationalization was particularly pronounced in the tranches of credit that are viewed as the most susceptible in the event of a material deterioration in company fundamentals. Despite no actual deterioration of the credit performance metrics for these markets, the market clearly became very nervous around any tranches that weren't considered "bullet proof" in the event of an economic downturn.

Source: Bloomberg (as of 12/31/2018)

In a lot of ways, we welcomed this increased volatility in equity and fixed income markets. Given that much of our model portfolio construction is usually focused on minimizing these directional tilts, the magnitude of the average client drawdown was manageable, particularly when compared to broader asset class benchmarks. The key for us in the midst of these market sentiment shifts/unwinds is to weather the period in good enough shape to be able to play offense in the areas that have dislocated once volatility begins to subside. We are, incrementally, more constructive on the opportunity set within many sub-sectors of credit and structured credit as we make our way through the early weeks of 2019. It is our view that we are being paid a more reasonable risk premium to take some directional credit exposure than we have been since the start of 2016.

As has been the case for our last several quarterly letters, the landscape just a few short weeks into the new quarter already looks different. We have seen a rally in risk assets that has seen benchmarks recapture much (if not all) of their fourth quarter losses. A common refrain from us in these letters is that there is nearly always a "wall of worry" narrative that can be built at a given point in time. Today is, of course, no different with the government shutdown, increased odds of a hard Brexit (i.e. Britian leaving the European Union without a prenegotiated trade deal), an ongoing trade war with China, and the Fed's delicate dance of trying to be less accommodative without spooking the market. We attempt to be cognizant of these headline risks without seeking to market-time their potential impacts. With that said, we do take advantage of these moments of uncertainty to focus on strategies or niches that are being dislocated and ask ourselves whether they represent strong return-to-risk propositions. These types of environments reward us for being more active as we look to shift capital to areas that offer compelling opportuntiy sets and in that way, we are excited about the environment today.

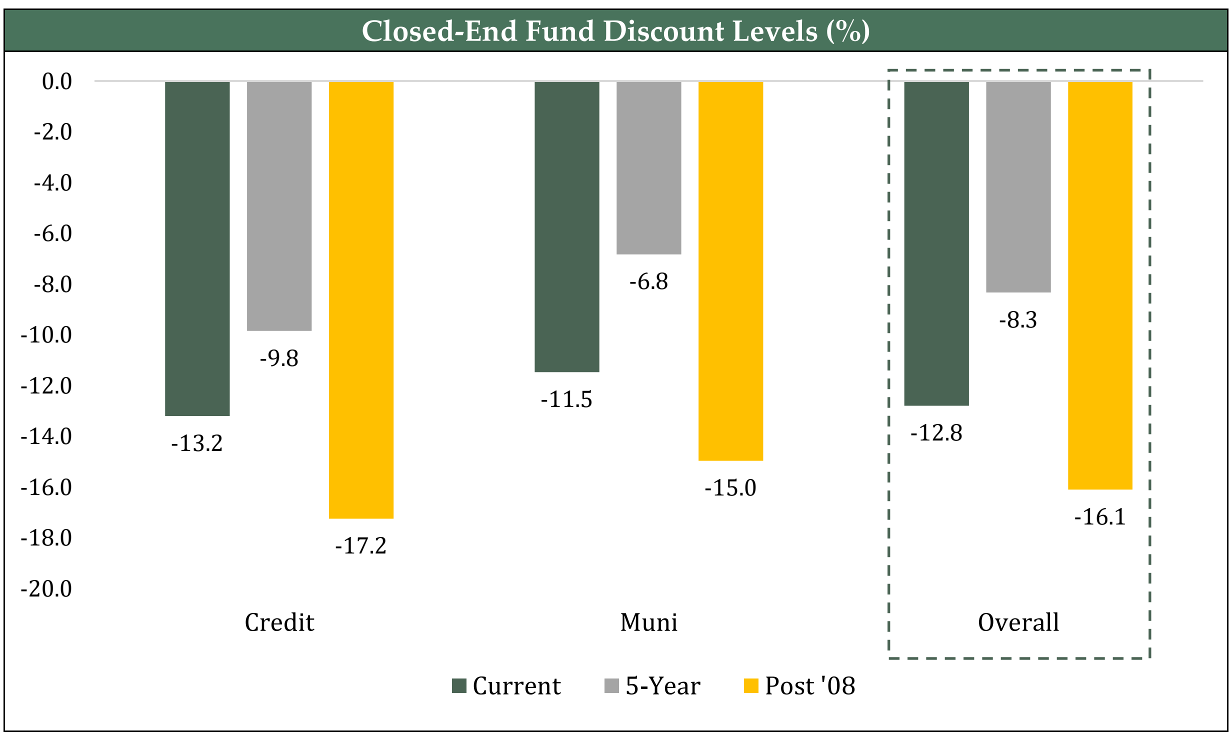
Highlighted Research Process

In this segment of our letters, we typically choose to highlight either a new investment opportunity that we think is particularly timely, or we delve into an aspect of our diligence and underwriting process to give our clients a better understanding of what the team is digging into day-to-day. In our third quarter letter, we discussed the depth and breadth of work our team had completed in the non-QM mortgage space, providing an update on the opportunity set in that sector and how our specialized manager (Angel Oak) has been evolving. Our Angel Oak investments fall within our illiquid credit bucket that can only be responsibly exploited via "private equity style" drawdown-fund vehicles. These funds tend to have extended lives (5+ years), allowing a manager to exploit illiquidity premiums without creating asset-liability mismatches the can spell disaster in periods of market dislocation.

In this quarter's letter, we would like to highlight a more "traditional" market sector that looks to take advantage of these types of liquidity-driven inefficiencies but without the structural limitations and headaches of limited partnership investing. Specifically, we saw the underlying opportunity set in the closed-end fund market reach a level of attractiveness that we have not seen since the 2008/09 timeframe.

As many of our clients know, we have been long-time allocators to various strategies in the closed-end fund space. We like this market sector for several reasons that we believe lend themselves to outsized risk-adjusted return opportunities. As with many of our preferred market sectors, the closed-end fund space is relatively small and requires niche-expertise. The underlying investor base is heavily retail investor dominated, with few large institutions able to participate in the kind of scale that they require to move the needle. This niche status and retail ownership can often produce dislocations driven entirely by liquidity/technical market aspects that have little or nothing to do with underlying fundamental performance. This is the type of backdrop that we look for when looking at a strategy that requires us to be tactical or active.

The closed-end fund space is dominated by fixed income funds. The closed-end fund structure is a great way for investment managers to raise a fixed pool of capital that they can invest in less liquid fixed income and credit securities while still allowing investors the ability to generate real-time liquidity as the funds themselves are exchange-listed equities. The mechanism that allows for this is that closed-end funds can trade at a premium or discount to their actual underlying net-asset-value ("NAV"). If an investor wants to sell shares in a closed-end fund at a material discount to NAV, that allows the buyer to effectively buy a portfolio of securities at a better cost basis than is available in the cash market. Vivaldi has long been active in closed-end funds that invest in municipal bonds, high yield bonds, leveraged loans, convertible bonds, as well as structured credit. Based on the prevailing levels of discounts or premiums across these closed-end fund sectors, we may choose to have some percentage of our fixe d income allocation in these securities instead of other types of fixed income vehicles.

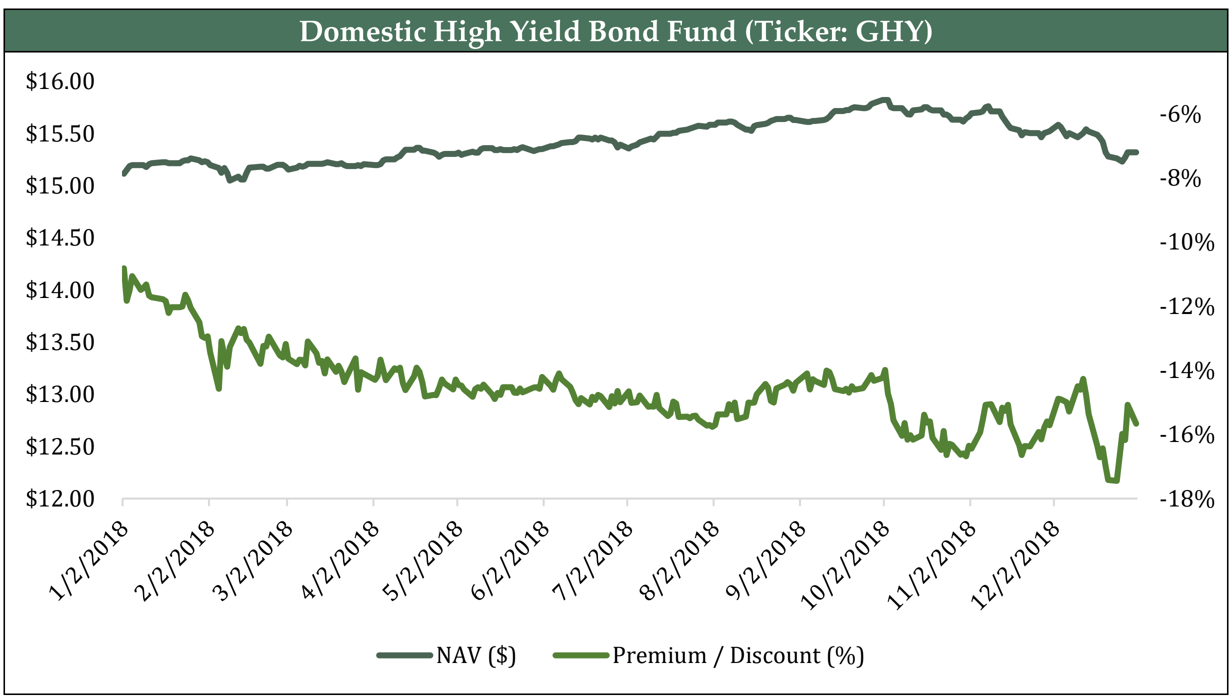


Source: Bloomberg (as of 1/22/2019)

Our most active strategy in this sector is our Opportunistic Closed-End Fund Strategy. That portfolio aims to build a fairly diversified book of both municipal and credit closed-end funds where we will actively shift capital allocations to the sub-sectors of those markets where we see the greatest discount dislocations. The strategy is tactical in the sense that if there were no sub-sectors trading at attractive discount levels, we have the ability to (and have historically) liquidated the entire strategy and allocated those dollars elsewhere.

The most common cause of discount widening is a lack of market liquidity. What we saw in the fourth quarter was somewhat of a perfect storm that drove discounts across the entirety of the closed-end fund space to near all-time wide levels. First, the fourth quarter tends to be seasonally weak for discounts as retail investors and their advisors engage in tax-loss selling, often during a time period when market liquidity is not optimal. Second, the volatility that we saw across 2018 in both interest rate-sensitive and credit-sensitive fixed income markets spooked many retail investors, driving them to liquidate their closed-end portfolios more aggressively. Finally, equity market volatility tends to flow-through to the closed-end fund space as many retail participants disregard the actual underlying of the closed-end funds themselves (bond portfolios) and look to raise liquidity as they worry about mark-to-market risk since closed-end funds can trade with elevated correlations to equity markets in risk-off environments.

In the fourth quarter, the confluence of these factors was dramatic. By way of example, we have highlighted just one line-item within our Tactical portfolio. As you can see, the fund saw material discount widening throughout the course of 2018, despite a very solid performance from the portfolio management team within the actual underlying bond portfolio they managed.



Source: Bloomberg (as of 12/31/2018)

The acceleration of that discount widening into the close of the year also likely drove more follow-on selling as non-institutional investors capitulated to the negative price action. It was against this backdrop that we moved to increase client exposure to this balanced fixed income portfolio. While it is impossible to know when these types of liquidity-driven dislocations will subside (and we did begin to press that exposure before the ultimate trough in the sector) we do believe that the absolute and relative discount levels reached a point where the reward-to-risk was significantly skewed in our favor.

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 two new resources to our client service team. Rachel Levine and Meaghan Wirtz joined the firm as a Client Service Associates, and we believe that our clients will see the positive impact and high quality of those additions in their interactions with firm. During the quarter, Marc Bassewitz took over the role as Chief Compliance Officer & General Counsel. We have worked with Mac for several years through one of the firm's joint ventures and believe that his formal additional represents a substantial ramp-up in our compliance team. Jennifer Yong, CPA joined the firm as a Compliance Manager as we continue to build-out our bandwidth in this critical operational team. Finally, you may have seen the news of three exciting additions to our advisory team: John Eberle, Asha Goldstein, and Dan Jones. We have included a brief press interview with our President Michael Peck on those aforementioned advisory additions.

On final update: This past year, Vivaldi Capital Management engaged its regulatory compliance consultants, ACA Compliance Group ("ACA"), to conduct a mock U.S. Securities and Exchange Commission ("SEC") exam review of our firm's compliance program. ACA completed its week-long onsite review of Vivaldi and issued a clean report summarizing their findings. In its report, ACA shared that Vivaldi and its affiliates continue to maintain a strong culture of compliance with well-tailored controls to address potential material compliance risks of the firm. ACA's report also contained suggestions to further enhance the Vivaldi's compliance platform. Since 2017, ACA has provided regulatory consulting services to Vivaldi including: conducting annual mock SEC exam reviews of the Vivaldi's compliance program; providing training seminars to the Vivaldi's personnel; and reviewing Vivaldi's marketing materials. Vivaldi will continue to use ACA's services to ensure that the Advisor is maintaining a best-in-class compliance program.

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

Kind Regards,

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