VIVALDI
CAPITAL MANAGEMENT

Investor Letter

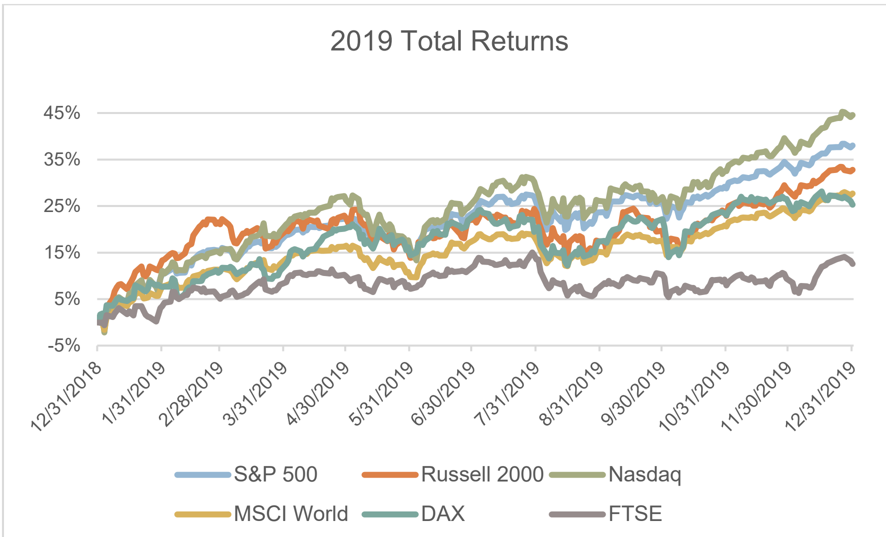
Fourth Quarter 2019

By: Vivaldi Investment Research

February 6, 2020

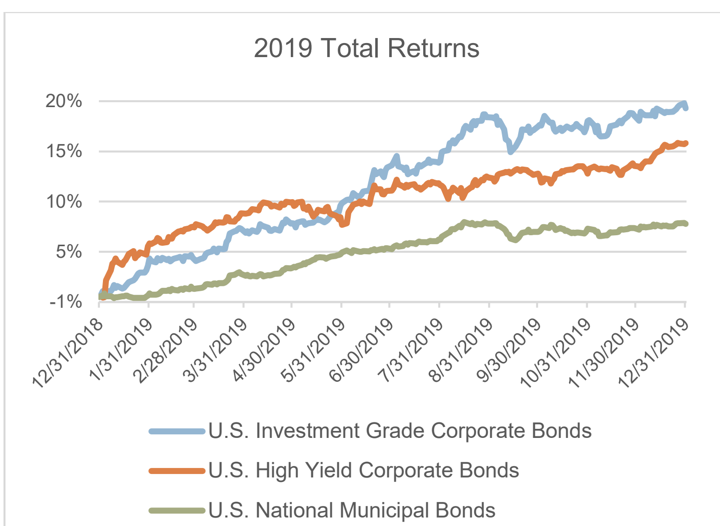
Market Perspective

The fourth quarter of 2019 provided the melt-up market move that both equity and credit markets seemed to be moving toward throughout the year. Domestic equity markets closed the year effectively at or near all-time highs across the full market capitalization spectrum. With that said, there was a fair amount of dispersion within that equity landscape, particularly once one moved beyond solely domestic benchmarks.



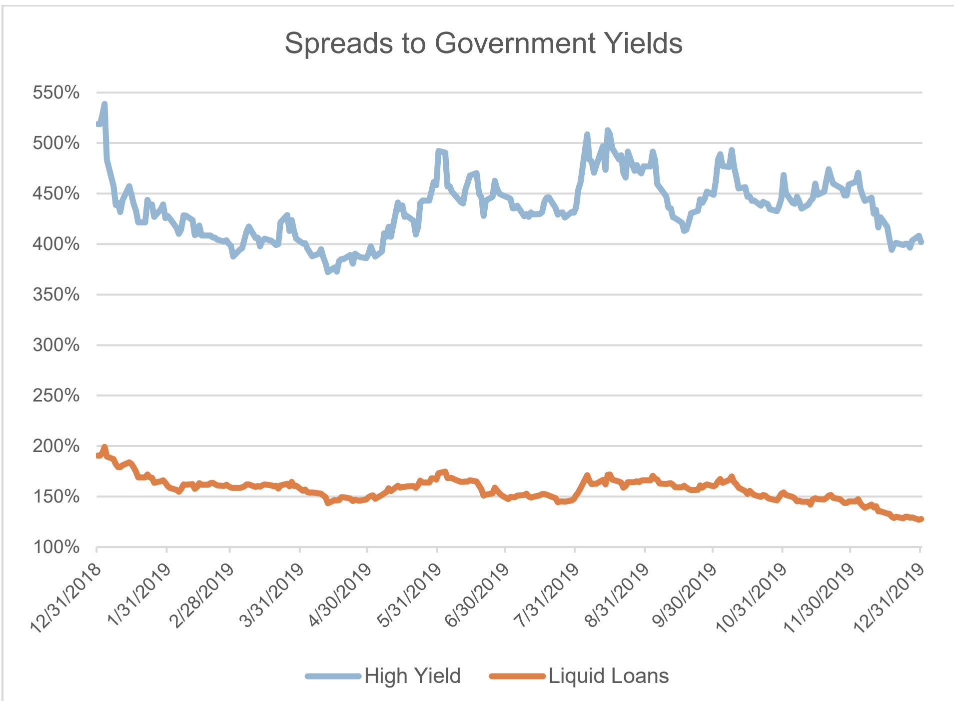
Source: Bloomberg

Perhaps even more impressive was the remarkable rally in 2019 across the liquid credit spectrum. Everything from municipal bonds to domestic high yield saw a historic move higher that was nearly uninterrupted throughout the year. Outside of a hiccup over the summer in the leveraged loan space, driven mostly by technical (liquidity-driven) market structure in that sector, there was hardly a downtick in broader credit benchmarks.

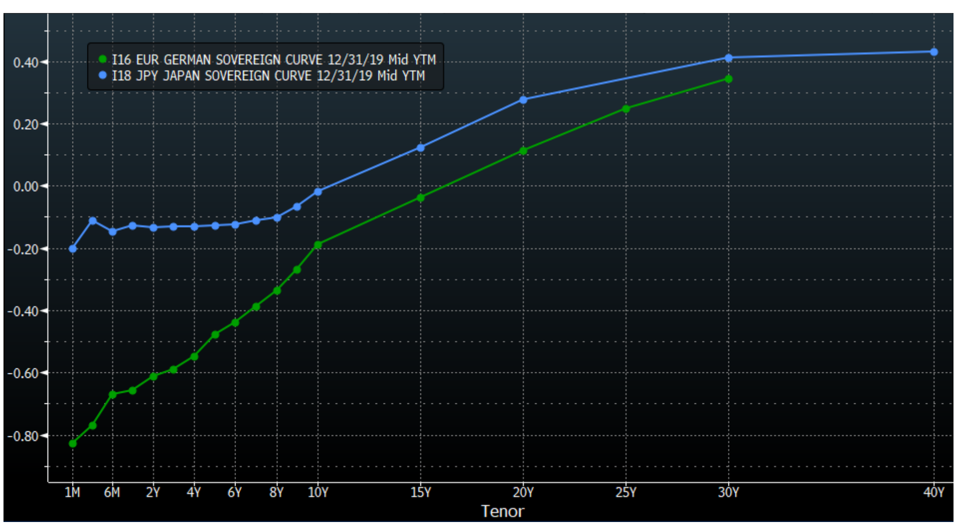


Source: Bloomberg

While there were plenty of sector and sub-sector themes that one could write about with respect to 2019, the story in the credit landscape seemed to be the more liquid a sector was, the better it performed. Investors relentlessly piled into risk assets while rates were stable-to-lower and equity risk appetite increased steadily throughout the year. With that said, it is worth noting that credit spreads broadly are not yet at all-time tights across most sectors, even if they are at or near nominal lows. The average credit investor continues to struggle to adapt to a world that is dominated by increasingly negative risk-free rates across the globe. While the United States has continued to see tepid economic growth persist (and inflation expectations stay marginally positive), much of the rest of the world has seen an ever-increasing portion of their yield curve slide into negative territory.

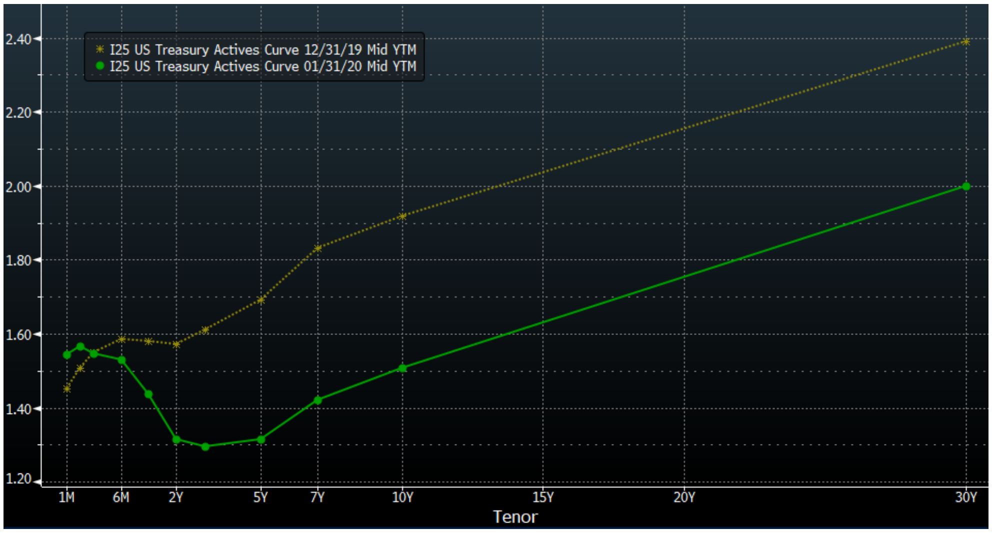


Source: Bloomberg



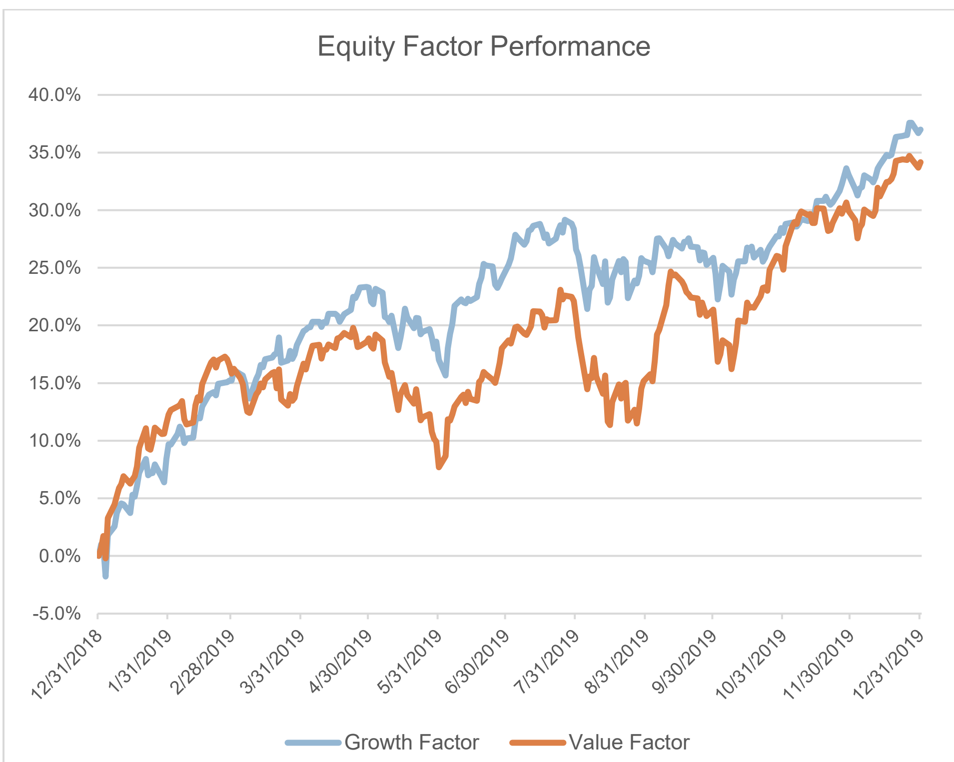
Source: Bloomberg

There was no greater beneficiary from this compression in rates domestically than municipal bonds, which saw both a tightening in credit spreads but also a large duration tailwind as rates rallied aggressively. That trend has continued into the first few weeks of 2020 as investors who were temporarily worried about higher rates in 2018 are now scrambling to position themselves for flat or lower rates for the foreseeable future.



Source: Bloomberg

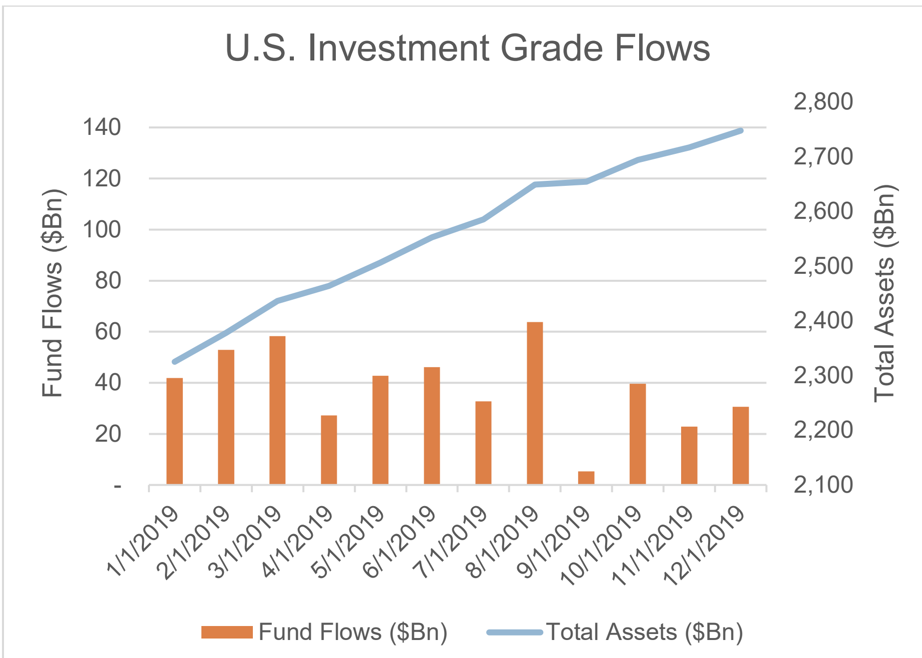
Back within domestic equity markets, we saw a mid-year factor rotation by which value and growth dislocated from each other before reverting to close the year in line with each other.



Source: Bloomberg

We highlight this event both because it shows the underlying market movements that take place even during calm equity markets as well as due to the fact that this spread tends to be what most fundamentally-focused hedge fund managers are structurally exposed to (either long or short that spread) depending on if they are "value" or "growth" fundamental managers. Given how violent these rotations can be, we continue to aim to build a hedge fund portfolio that is balanced across those key factor risks.

Against this backdrop of seemingly never-ending risk appetite, we continue to monitor the areas in which we invest for improving or deteriorating opportunity sets. As is likely evident from our comments above, we are becoming increasingly skeptical of the rally in liquid credit (investment grade bonds notably) as well as sub-sectors within private credit that have become overly competitive. While we are not "macro" investors, we do pay close attention to how capital flows impact asset prices to understand where investors are flooding cash.



Source: Bloomberg

Investing in a world of slow or no growth where marginal or negative interest rates abound remains incredibly challenging. While you would be hard-pressed to find a strategy that did not make money in 2019, it is important to keep in mind how those strategies generated that performance and what their opportunity set and landscape may look like moving forward. With the ever-present geopolitical headlines spooking markets again as we close January of the New Year, it is certainly possible that 2020 will see less of a rising tide for all boats than the year just passed.

Highlighted Research Process & Investment Opportunity

As we noted in our market commentary, we have become increasingly concerned about the extent to which liquid credit markets have repriced for both historically low interest rates and rather tight nominal credit spreads. This, of course, begs the question of what an investor should do to deal with that prevailing backdrop. The phrases "chasing yield" or "moving out on the risk curve" are likely familiar to readers of financial commentaries like this one. The implication of those phrases is that an investor must inherently run after riskier sources of return when credit markets face the kind of structural realities they are dealing with today. Certainly, we see this type of behavior in several markets and sub-sectors, particularly in liquid credit. Where we see a greater bifurcation of investor activity, however, is in less liquid or private credit.

Private credit has its fair share of crowded trades as well, but many areas that we have done work in are either too small or too complex to attract the large institutional capital that has been the primary culprit in compressing yields in larger, more liquid credit sectors. We have seen this dynamic play out in real-time in one of our private credit investments which we detail below to provide insight into our work flow and oversight work as a research team.

Going back to January of 2018 our team sourced a niche commercial real estate lender. That team was focused on providing short-duration bridge loans backed by commercial real estate collateral where the borrower had run into either asset-specific or borrower-specific issues that had locked them out from more traditional and cheaper forms of commercial real estate financing. At the time, these loans were being done at fairly high interest rates (9-13%) and fairly low loan-to-value ("LTV"). The opportunity that this operator was capitalizing on largely came around their sourcing mechanism as well as their willingness to work with borrowers and assets that had some level of complexity around them. The core competency of the team, outside of that sourcing effort, was their ability to quickly ascertain a value for the real estate collateral and extend a loan, often on a timeframe that no commercial bank or more traditional real estate lender could meet.

Over the course of a year, our team became comfortable with this operator and their ability to execute on their strategy. The background of the key investment professionals matches well with the stressed nature of many of their lending situations as well as the team's ability to work-out loans where the borrower ended up in technical or term default. We understood going in that many of these high interest rate loans to borrowers who had credit profiles that could be dicey were more likely than the average real estate bridge loan to end up in a work-out scenario and the team's demonstrated ability in that area was key. Ultimately, we were making a bet on this operator's ability to appropriately value the underlying real estate collateral and then go take that collateral in the handful of situations in a given year where that process would be required for us to be made whole on the loan.

This was a relatively new firm operating at a sub-scale base of assets and there were several operational investments that we required before investing. We asked them to upgrade the quality of their fund documents, CFO/COO personnel, and third-party service providers, including onboarding an institutional-quality third part administrator. We also negotiated advantaged fees for our allocation, receiving a material discount on asset management fees given the potential scale of our allocation. After all of this diligence and structuring work was complete, we made our initial investment in the fund.

Over the prevailing two years, we have completed six onsite meetings with the team as well as nine update calls. We have received monthly snapshots of the composition of the fund portfolio loan-by-loan and we have benefited from witnessing the operator successfully manage through several work-out situations in which they had to actively go through a court process to be made whole on their loan. In no instances to date do we believe that the team has either erred in their underwriting of the real estate collateral value or failed to proactively enforce their rights as a lender. Overall, the performance of the investment has been within the base case of our underwriting assumptions.

One thing that is not uncommon with our work in relatively small/niche strategies, however, is that other investors searching for opportunity have also subsequently found this operator and invested in their fund. One of the primary risks that our team identified at the outset of our diligence was that many of the "best" loans this team was making were in relatively off-the-run lending situations on smaller assets where more institutional-scale operators wouldn't waste their time. As this operator has looked to get more capital to work, we have seen some key shifts in portfolio metrics:

	January 2018	January 2020
Outstanding Loan Balance	$30.3MM	$268MM
Weighted Average LTV	63%	64%
Weighted Average Coupon	10.40%	8.80%
Weighted Average Term	14 Months	16.3 Months

As the fund has grown in size we have seen the average duration on these bridge loans extend, the average rate compress, and the average LTV inch higher. In fairness to this team, who we hold a great deal of respect for, the nature of the underlying collateral on the most recent loans has also improved. Fewer are the situations where the borrower may have material credit issues, or where the asset has serious imperfections that must be addressed. More common today are loans on cleaner, higher-quality commercial real estate assets, that are also larger. It makes sense to us that those loans would garner a tighter interest rate in a more competitive opportunity set with more lenders willing to advance cash on those assets.

Herein lies the hardest part of our active oversight process, in determining what has really happened and what, if any, action we should take. Has the manager moved to these higher-quality loans because the more complex situations aren't as attractive amidst a competitive lending landscape, or have they moved up that quality spectrum because they need to get more capital to work per deal and these larger loans are naturally going to be on "cleaner" assets? Are they avoiding smaller stressed situations because their larger portfolio with more line-items doesn't allow them the time to do the heavy lift work-outs that often come with those situations, or are they being prudent stewards of capital by increasing the credit quality of their underlying loan portfolio during a benign credit environment? At what point are we no longer being appropriately compensated for the illiquidity risk we are taking on in this investment vis a vis more liquid credit alternatives or other private credit options?

For the moment the jury is still out. For starters, we would certainly rather see a manager accept rate compression and "stick to their knitting" as opposed to stretching out the risk spectrum or add leverage to preserve nominal returns at the cost of a notably riskier portfolio composition. We also do believe that some compression in rate is natural as the fund grows and participates in fewer truly one-off niche situations that lack any lending competition. Ultimately, where we settle out as an investor will depend on how these metrics evolve in the near-term and how we feel about the team/firm's growth with respect to still being able to capitalize on higher return, more complex situations when they find them. Our research team will be doing our deep-dive annual onsite meeting with the team in the coming weeks and we will look to come back with a clearer view of what our next action with respect to this investment should be.

Organizational Update

As Vivaldi has continued to grow as a firm, we pride ourselves in our commitment to investing in our people, technology, and infrastructure to ensure that we are well-positioned to continue to competently work on behalf of our clients. In this section of our letter, we have highlighted the additions of new team members.

In the fourth quarter, Vivaldi made several hires to increase the value we can provide to clients.

William Proper, CFA is a Wealth Adviser based in Cleveland. Vivaldi recently acquired The Proper Analysis Corporation, the registered investment adviser founded by Bill in 1993. Bill's experience in the investment industry, and previously as a CPA, position him well to serve his high net worth clients. Bill is also the chairman of his synagogue's investment committee and, working as a volunteer, provides financial consultation to the Palliative Medicine Foundation.

Greg Goldfeder, CFA joined Vivaldi as part of the Proper Analysis acquisition and serves as a Wealth Adviser in our Cleveland office. Greg graduated from the University of Michigan with a Bachelor of Arts. He also holds a Master's in Business Administration (MBA) in Finance from Villanova University and is a Chartered Financial Analyst (CFA) charter holder.

Shannon Woodthorpe will be serving as a Client Service Associate from the firm's Cleveland office. Shannon has over 22 years of administrative experience. In her current position, Shannon has worked providing administrative assistance to the Proper Analysis investment advisory firm for the past 10 years.

Tina Cappelli will also be serving as a Client Service Associate from the firm's Cleveland office. Tina has worked the past 32 years providing customer service for CPA, retirement plans, human resources, and investment advisory firms.

Jordan Kelman, CIPM joined Vivaldi as a Senior Associate on the Wealth Advisory team. Jordan will serve to further enhance the firm's trading abilities and efficiencies. He has 10 years of industry experience and has earned the Certificate in Investment Performance Measurement (CIPM) designation.

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

Kind Regards,

Michael Peck, CFA
President, Co-Chief Investment Officer
mpeck@vivaldicap.com

Brian R. Murphy
Portfolio Manager
bmurphy@vivaldicap.com

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INVESTING IN ALTERNATIVE INVESTMENT STRATEGIES, SUCH AS HEDGE FUNDS AND PRIVATE EQUITY FUNDS, MAY ENTAIL SUBSTANTIAL RISK AND MAY NOT BE SUITABLE FOR ALL INVESTORS. MANY ALTERNATIVE INVESTMENT MANAGERS AND THEIR RELATED PRODUCTS ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MORE TRADITIONAL INVESTMENTS, SUCH AS MUTUAL FUNDS. ALTERNATIVE INVESTMENTS MAY INCLUDE SPECIFIC RISKS ASSOCIATED WITH LIMITED LIQUIDITY THE USE OF LEVERAGE, ARBITRAGE, SHORT SALES, OPTIONS, FUTURES, AND DERIVATIVE INSTRUMENTS. THERE CAN BE NO ASSURANCES THAT A MANAGER'S STRATEGY (HEDGED OR OTHERWISE) WILL BE SUCCESSFUL OR THAT A MANAGER WILL EMPLOY SUCH STRATEGIES WITH RESPECT TO ALL OR ANY PORTION OF A PORTFOLIO.

UNLESS OTHERWISE INDICATED, ANY PERFORMANCE SHOWN IS UNAUDITED, NET OF APPLICABLE OPERATING, MANAGEMENT, PERFORMANCE, AND OTHER FEES AND EXPENSES, PRESUMES REINVESTMENT OF EARNINGS AND EXCLUDES INVESTOR SPECIFIC SALES AND OTHER CHARGES. PLEASE REFER TO A FUND'S MEMORANDUM FOR MORE INFORMATION REGARDING THE FUND'S FEES, CHARGES, AND EXPENSES, WHICH WILL REDUCE THE FUND'S GAINS. PERFORMANCE MAY VARY SUBSTANTIALLY FROM YEAR TO YEAR OR EVEN FROM MONTH TO MONTH. AN INVESTOR'S ACTUAL PERFORMANCE AND ACTUAL FEES MAY DIFFER FROM THE PERFORMANCE INFORMATION SHOWN DUE TO, AMONG OTHER FACTORS, CAPITAL CONTRIBUTIONS, AND WITHDRAWALS/REDEMPTIONS. INVESTMENT RESULTS MAY VARY SUBSTANTIALLY OVER ANY GIVEN TIME PERIOD AND THE VALUE OF INVESTMENTS CAN GO DOWN AS WELL AS UP. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

ANY OPINIONS, ASSUMPTIONS, ASSESSMENTS, STATEMENTS OR THE LIKE (COLLECTIVELY, "STATEMENTS") REGARDING FUTURE EVENTS OR WHICH ARE FORWARD-LOOKING, INCLUDING REGARDING PORTFOLIO CHARACTERISTICS AND LIMITS, CONSTITUTE ONLY SUBJECTIVE VIEWS, BELIEFS, OUTLOOKS, ESTIMATIONS OR INTENTIONS OF VIVALDI, SHOULD NOT BE RELIED ON, ARE SUBJECT TO CHANGE DUE TO A VARIETY OF FACTORS, INCLUDING FLUCTUATING MARKET CONDITIONS AND ECONOMIC FACTORS, AND INVOLVE INHERENT RISKS AND UNCERTAINTIES, BOTH GENERAL AND SPECIFIC, MANY OF WHICH CANNOT BE PREDICTED OR QUANTIFIED AND ARE BEYOND VIVALDI'S CONTROL. VIVALDI UNDERTAKES NO RESPONSIBILITY OR OBLIGATION TO REVISE OR UPDATE SUCH STATEMENTS.

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