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Investor Letter

Second Quarter 2020

By: Vivaldi Investment Research

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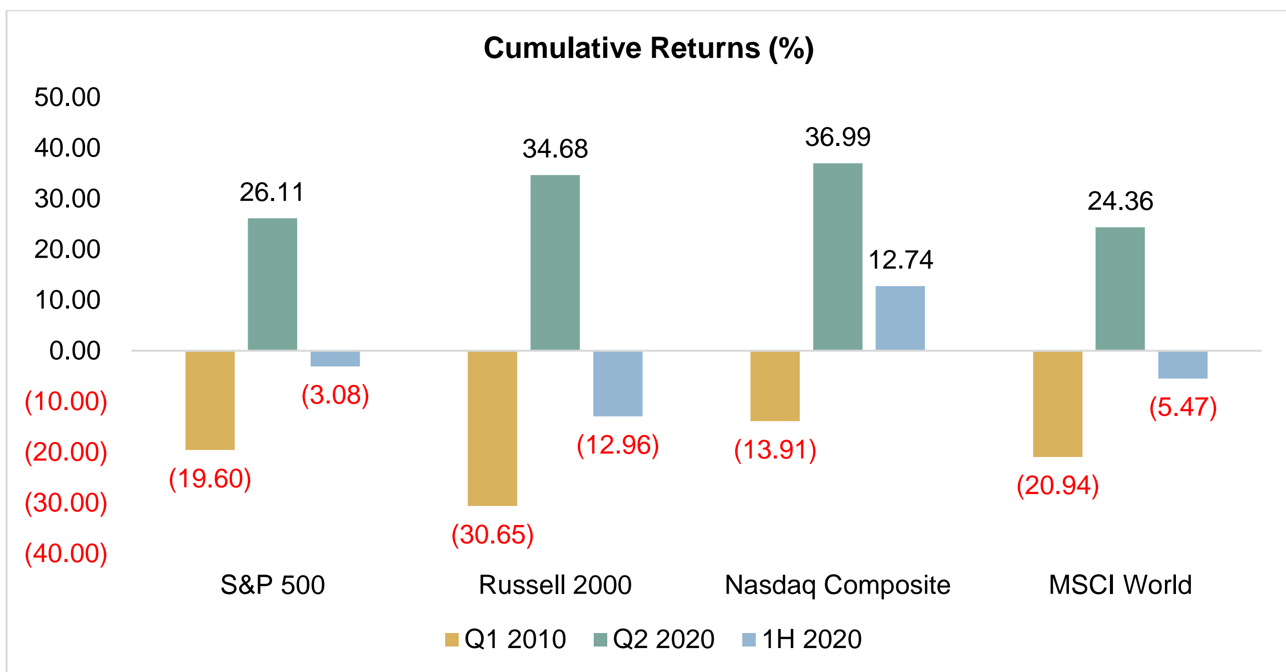
Market Perspective

As we continue to navigate this global health crisis as a firm and team, we want to send wishes of good health to all of our clients and their families. We are proud of the work our broader Vivaldi team has done to adapt to these challenging times and the extra effort that many of them are now putting in from home as they balance any number of competing responsibilities. While this letter will focus on market commentary and outlook, we continue to prioritize the health, safety, and stability of our firm and team so that we can continue to advocate for our clients and their investment portfolios.

What a difference a quarter makes. With the staggering market correction and dislocation that occurred at the tail-end of the first quarter, the equally as impressive rally in many asset classes in the second quarter represents yet another environment over the last decade where very large market moves have been nearly erased in what feels like the blink of an eye. This narrative does not stand up to scrutiny if one really digs beneath the surface of broad-based domestic equity indexes (which is certainly where we spend most of our time), but the simple fact that equities saw a snap-back rally of this magnitude in the midst of a global pandemic is truly impressive. Below is a snapshot of a collection of widely quoted equity indices.



Something we highlighted in our first quarter letter that we believe is worth revisiting is how disparate was the dislocation across credit and equity markets. In many different sub-sectors we saw credit securities trade worse than their related equity securities. The snap-back in markets in the second quarter proved consistent with this dichotomy as equity markets recovered first and most significantly, while many related credit markets have rallied but not by the same magnitude. We understand the nature of market liquidity differences that drive these types of dislocations over short timeframes, but eventually these imbalances will normalize based on the fundamental order of priority within a capital structure. Below is a snapshot of a collection of broad credit benchmarks to put these comments into context.

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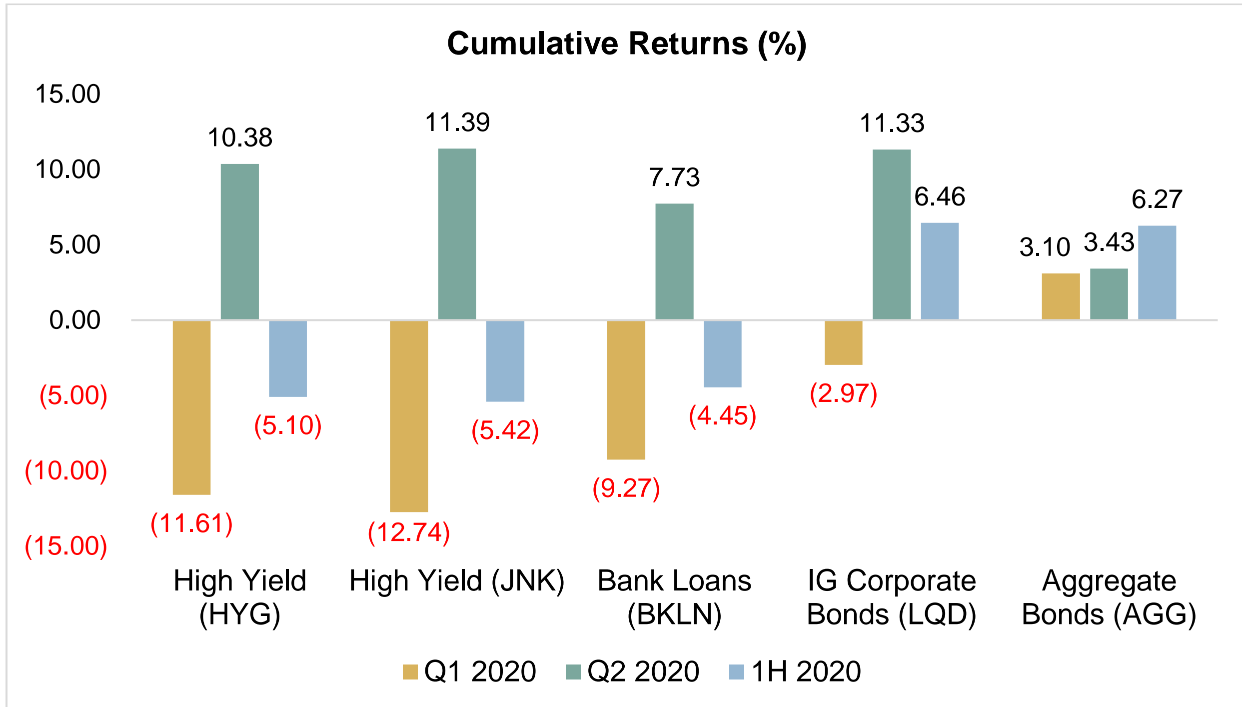
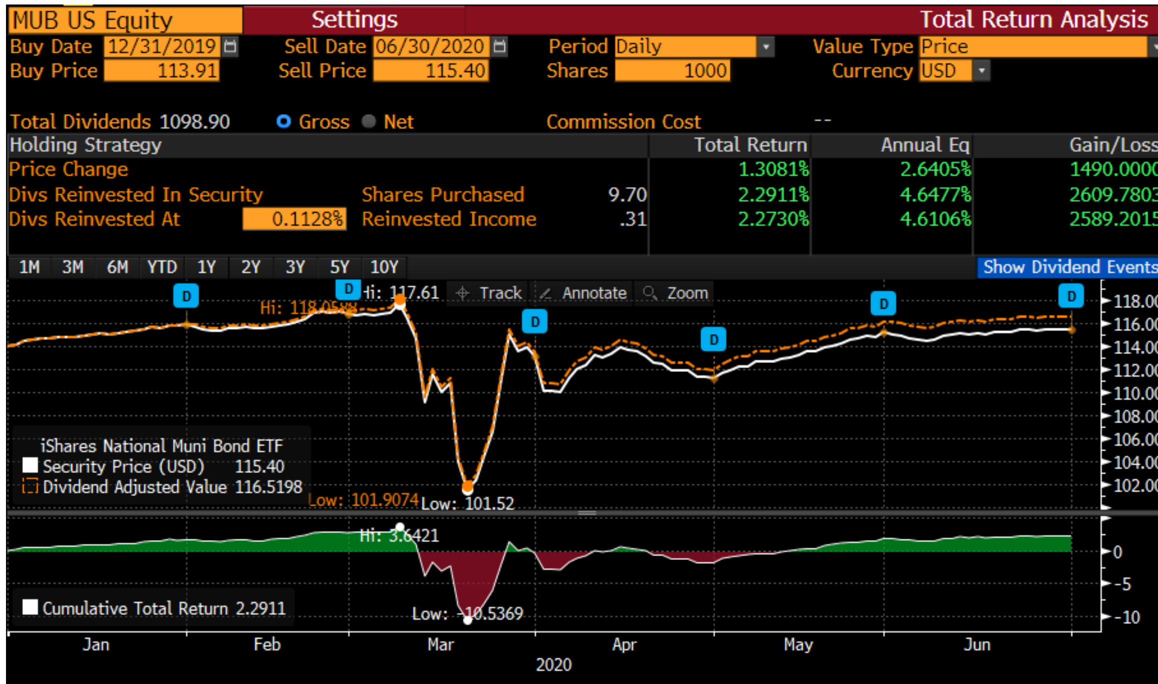
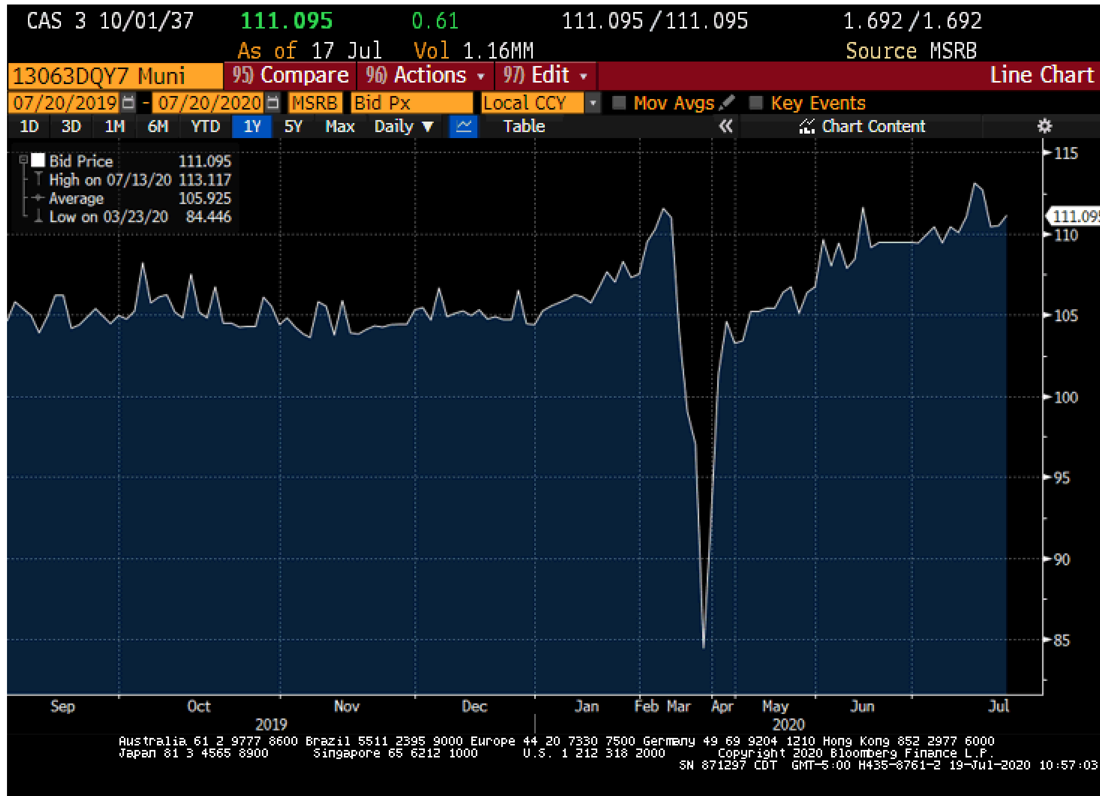


One credit market that we were particularly focused on and active in during the market dislocation was the municipal bond market. Municipal bonds are the poster child for understanding how liquidity rather than credit risk can sometimes drive price movements in bond markets. The municipal bond space is highly fragmented compared to similar credit markets, replete with millions of different bond issuances, all with their own specific indentures and nuances. That market is also highly opaque, dominated by retail-to-broker and broker-to-broker trading. Finally, the ownership base of municipal bonds is itself highly fragmented and often relatively passive, with many more investors looking to invest simply by adhering to specific credit ratings and durations rather than by any fundamental bottom-up work on a specific credit. This ownership dynamic is important because it means that when municipal markets dislocate, there are few investors who are well positioned to be aggressive buyers of specific credits based on an informed view of the credit risk of a specific name. All of these factors were further compounded by the fact that the uncertainties of a global pandemic and the implications on cash flow and business performance raised questions around even seemingly bulletproof cash flow streams. For instance, there are not many economically-driven environments where toll road revenues would be down 80% in a month; however, we saw just that in certain municipalities in March and April. To put the municipal market behavior into context, below is a price chart of the largest municipal bond ETF (MUB):



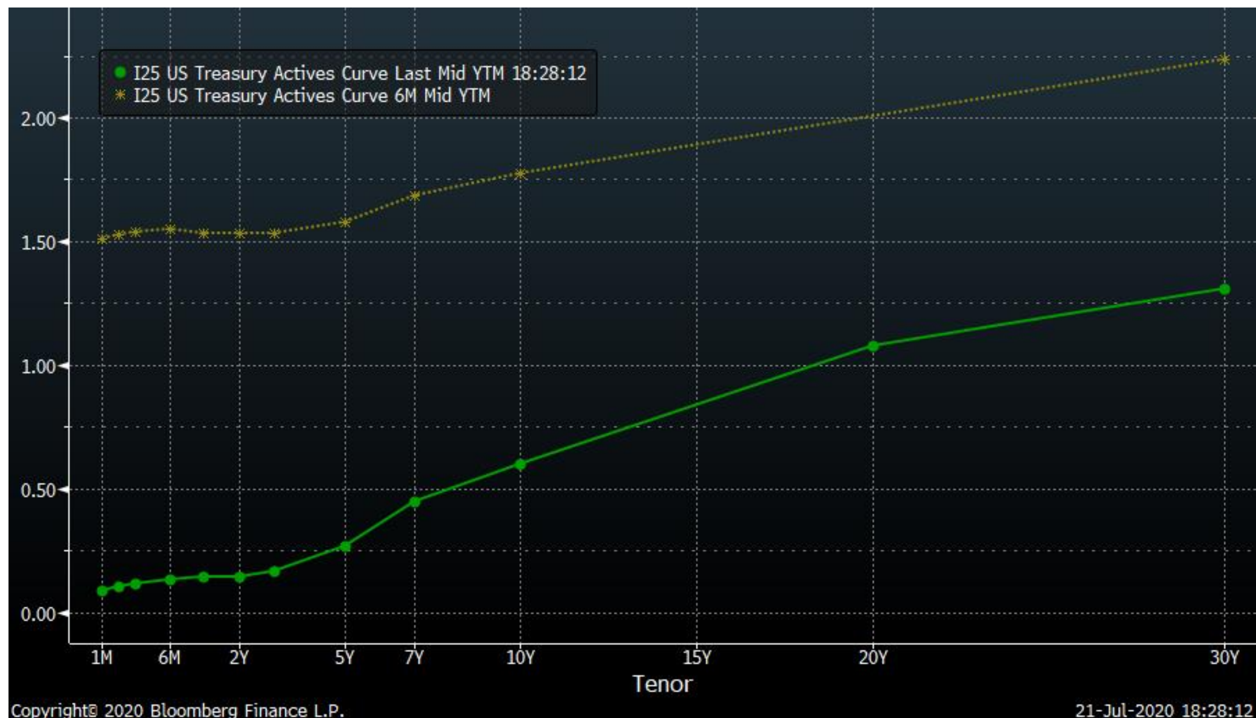
The combined fundamental and technical/structural aspects of the municipal bond market left it particularly poorly positioned to weather a liquidity crunch in capital markets where bond traders were working from home offices that quickly turned into unsupervised daycare centers. Conversely, a view that our team held in mid-March was that interest rates had rallied incredibly and that the highly interest rate duration-sensitive municipal bond market should probably rally as well. While the headline risk of falling municipal revenues is an easy one to ascribe to, the actual underlying credit picture of such a fragmented market is much more nuanced. By way of example, California has been plagued with a bad headline reputation when it comes to municipal finance dating back several decades. The reality is, however, that the state has been operating with a balanced budget ever since the last financial crisis. Paired with a new constitutional requirement that mandates contributions to a “rainy day fund”, California enjoys one of the most robust state municipal balance sheets in the country. That, however, did not stop California revenue bonds from trading down over 25 points within a two week window, depicted in the chart below.



As seen above, this particular bond had traded at a premium to par for its entire life, largely due to the AA- credit rating, which historically means there is little to no fundamental credit risk in the bond. The price decline from 110 to 85 in March was not reflective of any actual deterioration in the fundamental credit risk of this bond. Rather, this was purely a liquidity driven dislocation in which either municipal-focused mutual funds being forced to sell bonds to meet redemptions, or retail investors looking to flock to cash at any cost, were willing to sell a bond at 85 that, given the underlying credit strength of the issuer, should never pay back anything less than par. While the market anomoly in this particular bond was arbitraged away in short order, we continue to see dislocations like the above that have yet to fully recover from their March lows.

While we generally would not dedicate this much of our letter to a single sub-sector of the fixed income space, we think it is worthwhile as we all attempt to find our footing on the back of a dramatic spike in market volatility, even as that environment has abated despite the fact that we remain in a highly uncertain time. We may never again see a move like we did in March within the high grade municipal bond space, but it is yet another datapoint demonstrating the importance of understanding mark-to-market risk versus fundamental risk, particularly when liquidity is scarce.

The last market metric we would note is the continued compression in interest rates across most points in the yield curve. The importance of the level and shape of the U.S. Treasury curve cannot be overstated, as it has implications for just about every sector and asset class in which we invest. Whether it is fixed income, credit, equities, real estate, or venture capital, all of these sectors are tied to and affected by the broader interest rate environment to differing degrees. Below is a chart of U.S. Treasury rates as of July 21 compared to six months prior. Note that the United States has remained the one large developed capital market where sovereign rates have not yet gone negative, at least at the front-end of the interest rate curve. We think focusing on where the front-end of the curve moves as the country makes its way through this recession is going to be critical.



**All Chart Sources: Bloomberg*

Highlighted Research Process & Investment Opportunity

We spend much of the space in these letters discussing the trends and developments that we think may be of interest in understanding investment performance and the opportunity landscape. Most often, those observations happen at the asset class, sector, or potentially at the strategy level. The reality, however, is that the Investment Research team spends the vast majority of our time focused even one layer deeper at the investment manager level. Most of our efforts are not expended trying to make a macro-level call or tactically allocate to an asset class or sector based on a top down view, but instead are focused on identifying talented teams that we believe can outperform, within their respective peer group, over a full market cycle. Our own research process is geared toward attempting to find those teams, underwriting their investment process, portfolio construction, and risk management frameworks, and holding those managers accountable to that underwriting. Over the long-run, our team believes that we will add more consistent value at that micro level, and that one of the most important steps in building an investment portfolio is aligning yourself with the right team. Picking the right organization and team should help in environments that are rife with opportunity as well as those that are more fraught. We actually tend to think more about that alignment specifically in times of stress. In that vein, given the truly historic dislocation we witnessed in the credit markets in the first half of the year, we thought we would provide some insight into how one of the teams in one of the most impacted credit sectors fared.

As many of our clients have likely seen, there has been no shortage of headlines calling for major trouble ahead in the leveraged loan market. After the last global financial crisis, the leveraged loan market became one of the preferred ways for companies to finance themselves, pushing that sector to consecutive years of all-time record issuance. As is the case with most credit sector booms, as more dollars move into the space, the balance of negotiating power between creditor and borrower tends to shift in the borrower's favor. This paradigm was certainly true of the leveraged loan space, with deals in recent years becoming much more “covenant-lite” (to borrow

a term favored by financial journalists). One feature of the leveraged loan space that made it particularly attractive for borrowers is that the loans originated are generally floating rate in nature, disproportionately benefitting borrowers as global interest rates continued to march lower. The large acceleration in issuance coupled with the stripping away of covenants prompted many concerns about what would happen to the leveraged loan market once we hit our next recession and the financial performance of borrowers is negatively impacted. We are about to find out.

Just over three years ago we began to invest with a credit specialist firm based out of Kansas City named Palmer Square. The firm is focused on all forms of credit securities but has a particularly deep experience and expertise in the leveraged loan market and the related collateral loan obligation ("CLO") market. Palmer Square is an asset manager that operates different investment funds trading in primary and secondary credit markets, but is also a CLO issuer that manages underlying loan pools as an asset manager. We have known and worked with Palmer Square for some time and have come to regard their credit team as a conservative and rigorous underwriter of credit risk. We also believe that their relatively boutique size has allowed them to be more nimble and opportunistic in an effort to generate better risk-adjusted returns as opposed to simply gathering assets alongside some of the much larger credit managers they compete with. Vivaldi began working with Palmer Square by investing in one of their registered funds where they look to trade the loan, high yield, and structured credit markets broadly. With that said, we also developed a deeper relationship with the firm that allowed us to begin to co-invest alongside Palmer Square in one of their CLO programs. We consider those co-investment opportunities to be the purest exposure one could obtain to the raw credit work being done by Palmer Square's research team and the structuring work being done by their capital markets team, both of which we feel are of the highest quality. While there was some stress in early 2016 in the loan market, namely around energy-related credit, the first half of this year marks the first real extended credit cycle since we underwrote the firm and the opportunity.

To put this discussion in some context, the second quarter saw 41 companies file for bankruptcy. Those defaults accounted for $70 billion in aggregate loans and bonds outstanding. There have now been $106 billion in defaulted loans and bonds thus far in 2020. That already puts 2020 on pace to surpass 2009 as the worst year for defaults (measured by outstanding volume) as there were $205 billion in defaults in all of 2009. That data just pertains to companies that have already missed payments or formally entered Chapter 11. In a similar tone, the volume of investment grade debt that has been downgraded to junk by the rating agencies has already surpassed the 2009 total at $190 billion. All this is to say that Palmer Square is now operating in a very difficult environment for credit. Within our co-investment program where we own equity tranches alongside Palmer Square's General Partner, we have participated in six independent CLO transactions. Those six CLOs have exposure to 1,985 individual loans. Of these, exactly two issuers have defaulted as of the end of the second quarter, with only one of those loans defaulting in the second quarter (of the 41 total companies noted above).Those two defaulting companies represented less than 0.50% position sizes in their respective CLO pools. For additional context, Palmer Square's base case assumption to generate their targeted returns for these pools assumes 3% in *annual* defaults. In addition, on the credit rating side of the equation, the CLO pools we are exposed to all began with 0% allocations to CCC+ or lower rated credits. As it stands as of the end of the second quarter, across our six deals, the CCC+ or lower rated bucket ranges from 2-4%, less than half that of the average CLO pool. While we remain in the early innings of this economic contraction, the realized credit performance metrics are indeed supportive of Palmer Square's conservative nature when it comes to underwriting credit risk.

We highlight this not as a victory lap as if we had seen the global pandemic coming, because there are certainly areas that we could have allocated capital to that were less economically

sensitive than leveraged loans. We just do not believe that we would have a very high hit rate in making those top-down macro calls, specifically as it relates to environments like a global health crisis which are nearly impossible to foresee or predict with any reasonable confidence on timing and severity. Instead, we attempt to align ourselves with the best teams we can find across sectors to give ourselves a better probability of weathering the storm whenever it comes and however disruptive it is. We will almost certainly see more defaults in loans and bonds moving forward and, undoubtedly, some of those companies will be in Palmer Square's CLOs. To date, however, we have been encouraged with our share of credit events relative to that fundamental backdrop and we think that bodes well for where we end up after this credit cycle has run its course.

Organizational Update

Amidst these unprecedented times, our primary focus is to deliver our clients the same wealth management experience they have come to expect. Since March, our entire organization has worked remotely, and we are grateful for the energy they have committed to maintaining our strong corporate culture. As we continue to operate with an uncertain road ahead both in route and duration, we are focused on investing in our human capital and technology as we not only adapt but ideally take advantage of a highly unusual environment to think critically about areas in which we can improve our team processes and structure not just to survive this period but to come out of it better on the other side. As a firm, we continue to have several new hires in the pipeline across the functional units of our business and we are committed to continuing to invest in those resources that will be beneficial to us in the intermediate and long-term despite the near-term uncertainty. We look forward to sharing the backgrounds of the professionals that are joining us as they come on board later this summer.

Below is a quick update:

- Our Advisory Team is well equipped for video conferencing and screen sharing so you can continue to have productive and interactive one-on-one discussions about your personal situations – just ask and we will set something up!

- The Client Service Team is fully operational to handle the day-to-day operations of servicing your accounts as well as those "above-and-beyond" requests. We encourage you to reach out to ClientService@vivaldicap.com or call 312.248.8300.

- We understand that this was a highly unusual tax filing season for a myriad of different reasons. We would just remind you that we have a dedicated e-mail for clients for all tax-related inquiries Tax@vivaldicap.com.

Kind Regards,

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