# REFLECTION

## 1st QUARTER 2023 REVIEW

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*Our arbitrage strategies thrive on a bit of volatility. But the sudden collapse of Silicon Valley Bank left little time to adjust to the effects of this volatility.*

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## AMETHYST ARBITRAGE FUND

### *In the midst of a banking crisis*

It is not uncommon that something out of the ordinary will occur and suddenly change the trend in markets. Such abrupt changes are usually accompanied by high volatility. The first quarter of 2023 certainly provided a good example, when a run by depositors on a regional bank in California, the Silicon Valley Bank (SVB), triggered a sharp reversal in the upward trend in bond yields and a precipitous drop in stock prices over just a few trading sessions.

Our year began well enough, with our fixed income arbitrage strategies performing very well. Our other strategies were generally performing as expected, apart from a few developments in M&A transactions, which are discussed below.

Markets had adjusted well to the high inflation environment, especially since there were growing signs that prices were stabilizing. This led us to conclude that the cycle of rising interest rates could soon turn a corner. Of course, there was talk of recession and market participants seemed to believe that the central banks could now afford to begin slowly reversing some of their recent monetary tightening, to cushion the blow. But everything was suddenly thrown into question, as the events at SVB raised the spectre of a banking crisis.

Our arbitrage strategies thrive on a bit of volatility. But the sudden collapse of Silicon Valley Bank left little time to adjust to the effects of this volatility. The quarter looked promising, but in the end it delivered a negative return. The portfolio's diversification nevertheless cushioned the impact, and we think that the portfolio is well positioned for the coming quarters. Let's take a closer look.

### *MARKET EVENTS*

Throughout 2022, the conditions were generally favourable for M&A arbitrage. The strategy's results exceeded objectives, in contrast with our other strategies, which at times suffered in the face of sometimes extreme market conditions. Once again, our cause was well served by the diversity of our investment strategies which are executed across many different arbitrage situations.

### *Some Surprises*

The first quarter of 2023 proved to be more difficult for M&A arbitrage. A series of unpleasant surprises would take place. First, in the oil transportation sector, the U.S. company Frontline unexpectedly withdrew its offer to merge with Euronav. Then a shareholder of Ritchie Brothers, a heavy equipment auctioneer based in Vancouver, launched a campaign to block its takeover bid for U.S. based IAA – a merger worth US$7.3 billion. Thinking that clamouring by the outlying shareholder was just noise, we added to our position. But then the proxy advisory agencies ISS and Glass Lewis surprised the market by recommending that shareholders vote against the deal. Although we felt that that the deal had merit, this nevertheless posed a real danger to the transaction. Since ***we had never seen a deal go through after two proxy voting agencies recommended voting against it and no major shareholder speaking in favour of it***, our prudent management rules dictated that we had

| FROM Jul. 1998 to Mar. 2023 | ANNUALIZED RETURNS (%) *Net of all fees* | | | | | | | Volatil. | Correl. | % Mths > 0 | Sharpe Ratio |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | YTD | 1 yr | 3 yr | 5 yr | 10 yr | 20 yr | Incep. | | | | |
| **Amethyst Arbitrage Fund - Cl. F** | **-1.1%** | **-2.4%** | **7.5%** | **2.2%** | **4.7%** | **6.7%** | **7.7%** | **7.9%** | **-** | **73%** | **0.70** |
| HFRI - Global Fund Weighted | 1.0% | -1.9% | 10.3% | 4.7% | 4.5% | 5.7% | 6.0% | 6.9% | 0.48 | 65% | 0.57 |
| S&P 500 (TR) | 7.5% | -7.7% | 18.6% | 11.2% | 12.2% | 10.4% | 7.3% | 16.0% | 0.43 | 64% | 0.32 |
| S&P/TSX Composite (TR) | 4.6% | -5.2% | 18.0% | 8.8% | 7.9% | 8.9% | 6.8% | 14.8% | 0.49 | 63% | 0.32 |
| EAFE World Equity (TR) | 7.6% | -4.1% | 10.3% | 0.9% | 2.3% | 4.5% | 1.7% | 16.9% | 0.43 | 56% | -0.02 |
| FTSE CAN Long Term Bond | 4.7% | -7.2% | -4.4% | -0.2% | 2.2% | 5.3% | 5.4% | 7.9% | 0.14 | 59% | 0.41 |

**S&P 500 Index**

liquidate our position to limit potential losses. Surprisingly, the deal went through anyway, but it could have failed just as easily. In the face of such uncertainty, we felt it better not to take the risk.

### Overdue TD Bank Acquisition

The failure of Silicon Valley Bank (SVB) in California also had some repercussions. Last year, TD Bank agreed to buy First Horizon Bank (FHN), a regional bank in the southern U.S., for US$13.4 billion, and we took a position on the deal, which was expected to close in the first quarter of 2023. The deal makes strategic sense for both parties; however, regulators have been very slow and have yet to announce their approval or rejection of the acquisition. The market value of most regional banks in the U.S. fell immediately following the troubles at SVB, and FHN was not spared. Most banks have somewhat rebounded, but FHN is still trading at a 30-35% discount to the current deal price. Although it's possible that TD could walk away from the transaction, given their significant investment of time and money, coupled with FHN's strategic value, we think that a more likely outcome is that TD will renegotiate the closing price by 10-20%. If we are correct, there is significant upside from the current price. In the meantime, we are tactically trading our position to lower our cost while we patiently wait for a conclusion to this saga – which may eventually turn in our favour.

Across the rest of the M&A portfolio, all of our transactions are progressing well with good expected returns on their closing. Some recently announced transactions are trading at prices that don't adequately compensate investors for their risk, but we continue to exercise caution and are still finding attractive opportunities to add new positions with attractive yields.

## CONVERTIBLE SECURITIES

The year began well in January for our convertible bond strategy as credit spreads narrowed, volatility remained sufficiently high, and new issues came out at attractive prices. However, the situation deteriorated somewhat in February when equity markets entered a correction, following the strong rally in January. In the end, the banking crisis in March generated extreme volatility in the bond markets, and this had an impact on some of our positions.

### Room to Be Tactical

***Despite this volatility, we did not see any real panic among investors, as central bank interventions provided liquidity in the markets.*** Of course, convertible bond prices have fallen, reflecting concerns over widening credit spreads and a market in search of a clearer direction. Despite the old saying that, when in doubt, it is better to sell, we preferred holding onto most of our positions. In fact, the best way to take advantage of a skittish market with no apparent direction was to tactically add to solid positions when prices temporarily dipped, and this is what we did. We expect to sell many of these opportunistic positions at a profit during the second quarter.

### Returning to Normal

We expect conditions in the convertible securities market to return to normal over the next quarter, as central bank interventions stabilize the financial markets. This will allow us to both liquidate tactical positions that have played their role and establish new positions with good prospects for the rest of the year.

## FIXED INCOME

In the last few quarters of 2022, we had positioned ourselves to take advantage of the eventual narrowing of credit spreads between government agency bonds and Government of Canada bonds, primarily in 5- to 7-year maturities. We felt that this situation offered the most attractive potential return on capital. The market proved us right early in the year when these credit spreads began to narrow appreciably, generating a significant gain on our positions. But this trend ended abruptly in early March as the news spread of the problems at Californian SVB. Within the space of a few days, this would lead to the liquidation of the bank and would force the U.S. Federal Reserve (the Fed) to take measures to prevent contagion across the country's entire banking sector. Credit spreads widened dramatically, and a sizeable portion of our gains evaporated. A move of this scale was last since in March 2020, at the start of the COVID-19 pandemic. With investors fleeing to the

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**US Government Bonds - 10 Year Yield**

safety of government bonds, two days was enough to erase much of our gains from the compression spreads over the previous two months. So we find ourselves back at the starting line, but we are holding onto these positions, as we believe that spreads will almost certainly narrow and normalize from these unusually wide levels, and when then do, that we can generate very attractive returns.

### *Positive Performance and Outlook*

Despite this unexpected and sudden widening of spreads, our fixed income portfolio posted positive performance for the quarter as a whole, thanks to careful risk management and diversification. In the current environment, we find ourselves well placed to generate good returns in the coming months. Our positioning provides us with approximately 8.3% of annualized positive carry. In addition, the steep positive slope of the credit curve means that, as time passes, our positions will increase in value as their maturities shorten. Lastly, the recent volatility has driven credit spreads to unusually wide levels, and we intend to once again take advantage of this situation through our strategic positioning in Canadian government agency bonds with maturities of 5 to 7 years.

*There will be a strong temptation to lower interest rates when any signs of a recession appear.*

## THE ECONOMY AND FINANCIAL MARKETS

### *Central banks: between a rock and a hard place*

Inflation or recession, which should be fought first? Central bankers now find themselves on the horns of this dilemma more than ever before, and what they decide is likely to have a significant impact on where financial markets will head next. The Bank of Canada has just announced that it is maintaining its key interest rate at 4.50%, which is what it had done at its previous meeting. Governor Tiff Macklem says that this is possible due to the inflationary outlook. But he is quick to warn that there may still be further rate hikes, suggesting that the Bank will not start cutting rates any time soon.

In the United States, we learned from the minutes of the March meeting of the Fed's Open Market Committee that the banking crisis triggered by the collapse of Silicon Valley Bank will probably push the U.S. economy into recession. So, despite a banking system that is in good condition and resilient, Fed officials believe that the economy will take a hit. There will be a strong temptation to lower interest rates when any signs of a recession appear. All the more so since the ISM Manufacturing Index has been below 50 since December.

## OUTLOOK

### *Paradigm change*

One of the highlights of the last quarter was certainly watching the yield on U.S. 10-year bonds fluctuate by more than 50 basis points per month throughout the first quarter – down in January, up in February, and down again in March. Inflation and the risk of recession were central to the debate in the first quarter, and may well be again in the second quarter.

In 2022, the traditional 60/40 portfolio gave its worst performance in decades, but the opposite was true in the first quarter of 2023, as this asset allocation gave its best quarterly results in three years. Investors will be sorely tempted to believe that we are experiencing a paradigm shift, and to let their guard down about risk. We believe that it is best to remain somewhat cautious in the face of this outlook. Nevertheless, our arbitrage strategies will remain a good way to profit from volatility, which may continue to stalk the markets over the coming months.