REFLECTION

4th QUARTER 2022 REVIEW

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SUMMARY

AMETHYST ARBITRAGE FUND

What a Year It's Been!

No doubt most investors will be pleased to finally have 2022 behind them. Throughout the year, much was made of the downturn in equity markets – and rightly so, with the S&P 500 ending the period down almost 20%. But we can't forget the bond markets, which were ravaged by rate hikes during the year. The Canadian Universe Bond Index, which includes over 900 different bonds and had posted positive returns almost every year for decades, slumped 11.7% in 2022. As a result, there is no safe haven for investors looking to count on a balanced portfolio. Fans of portfolios built on an asset allocation of 60% in equities and 40% in bonds – the traditional portfolio – suffered major, almost unprecedented losses.

"Multi-Strategy" Approach

The events of the past year have illustrated the relevance of multi-strategy hedge funds like ours. Our use of several non-directional strategies diversified across a wide range of positions served us well. Despite the rout in the financial markets, we managed to generate a slightly positive return for the year. ***The Amethyst Arbitrage Fund has once again demonstrated an ability to cope with periods of intense volatility and protect investors' capital. Mission accomplished.***

Encouraging Outlook

We expect 2023 to be a good year, as we see a trend of investors moving more and more into hedge funds. Hedge funds have not necessarily been popular over the last few years, but the recent underperformance of traditional markets may be about to move the needle somewhat. The sometimes excessive market volatility has certainly reminded us of the importance of liquidity. Our portfolio is composed entirely of liquid assets, and with good reason. Market volatility could fade over the next year and provide a more stable landscape, after years in which the pandemic, inflation and monetary and fiscal policies have seen markets careen from one extreme to another. We expect to deliver positive returns, possibly well above those of the last three or four years, even though we are well aware of the risks of recession.

MARKET EVENTS

Our M&A arbitrage strategy yielded good returns during the year on a relatively small amount of deployed capital. This strategy enabled the Amethyst Arbitrage Fund to post a positive, albeit modest, result for the year as a whole, even though conditions were very difficult and certainly highly volatile. The high volatility throughout the year gave us some headaches, but once again, our approach of cutting our losses when necessary served us well.

Caution Is Still the Order of the Day

Caution was essential throughout the year, and we stayed the course through the fourth quarter. We continued to limit our involvement to those transactions that we felt were the safest, that had relatively short maturities, and that offered a return we considered acceptable. This limited our participation in new transactions in October and November to 14.

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FROM Jul. 1998 to Dec. 2022	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	**0.9%**	**0.9%**	**2.0%**	**1.8%**	**4.7%**	**7.0%**	**7.8%**	**8.0%**	**-**	**74%**	**0.71**
HFRI - Global Fund Weighted	-3.9%	-3.9%	5.8%	4.5%	4.7%	5.7%	6.1%	6.9%	0.48	65%	0.57
S&P 500 (TR)	-18.1%	-18.1%	7.7%	9.4%	12.6%	9.8%	7.1%	16.0%	0.43	64%	0.31
S&P/TSX Composite (TR)	-5.8%	-5.8%	7.5%	6.8%	7.7%	8.5%	6.7%	14.8%	0.49	63%	0.31
EAFE World Equity (TR)	-16.8%	-16.8%	-1.5%	-1.1%	1.9%	3.6%	1.4%	16.9%	0.43	56%	-0.04
FTSE CAN Long Term Bond	-21.8%	-21.8%	-5.8%	-1.1%	1.7%	5.0%	5.2%	7.8%	0.13	59%	0.40

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S&P 500 Index

However, given the extreme volatility of the spreads we saw in December, we decided to add 12 more deals. Most of them were transactions that had been announced previously, but in which we had chosen not to participate at that time. We nevertheless bought in when price declines made them much more attractive and, therefore, considerably less risky.

CONVERTIBLE SECURITIES

As it is often said, if we could just predict the unpredictable, life would be so much easier. And that would certainly have been the case in 2022 for convertible bond managers. In the extremely volatile markets of the past year, in a couple of cases, what seemed like good ideas, supported by strong credit ratings and very rewarding carries were spoiled by unpredictable situations. Among other things, we suffered some losses on good credits that suddenly went south in very unexpected ways. But, we hold a diversified portfolio that is actively hedged which of course, largely, but not entirely, offset these losses, resulting in a slightly negative return in 2022.

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More Positive Tone

The year 2023 is clearly beginning on a more positive note. A new reality has set in. ***Risk and high interest rates are now largely factored into current asset prices.*** Bonds are being issued to finance new projects and make new investments, rather than just to buy back older bonds or bail out companies in dire need of refinancing. And this new paradigm seems to be here to stay. It will be easier to invest in companies with prudent debt levels and avoid nasty surprises, those with good projects and whose management provides reliable information. This is everything that we need to be enthusiastic right now.

FIXED INCOME

In the fixed income market, the fourth quarter was marked by volatility that is comparable to what we saw in March 2020, when the pandemic hit, and during the great recession of 2008-2009. The difference is that, this time, the situation has lasted longer. The yield curve and duration have again moved unexpectedly, quickly and sharply. The result was negative performance in the fourth quarter, effectively wiping out some of the gains we realized in the previous quarter and producing a slightly negative performance for the strategy over the year as a whole, but setting the fund up for a very interesting 2023.

The Stage Is Set

Canada's sharply inverted yield curve has strongly influenced the widening of credit spreads since September. Even if nothing else changes during the next year in terms of credit spreads and the slope of the yield curve, the extremely steep credit curve for the 4-7 year maturity bonds has now driven up the potential return on capital to levels rarely seen: around 20% in some cases. Any narrowing of spreads, coupled with the yield curve returning to a more normal slope, could generate very attractive returns. On this basis alone, the stage may be set for this segment of the fund to deliver very good results over the next year. There is much to suggest that many fundamentals of the bond market are highly "stretched," including the credit spreads in Candian federal agency bonds at the 3 to 8-year maturity range, which currently offer a very attractive potential return compared to the spreads on provincial bonds. In this higher interest rate environment, in which Canadian rates are probably no longer rising and credit spreads are very wide, we may well see the pendulum begin to swing back. This will create some very attractive opportunities.

THE ECONOMY AND FINANCIAL MARKETS

Interest Rates and Recession

In the U.S., there is no guarantee that the Federal Reserve (the Fed) has completed its current cycle of interest rate hikes. The Chair of the Fed has not ruled out further increases in the first quarter of 2023. There can be no doubt that these hikes are weakening the U.S. economic outlook, and a recession will be difficult to avoid in 2023. In Canada, the central bank raised rates seven times in 2022, to 4.25%. As of the time of writing, many observers believe that the December 7 hike could be the last in the current cycle, as Canada's economic data have been somewhat better than that of our neighbours to the south. But this will probably

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Canadian Government Bonds - 10 Year Yield

not be enough to avoid a recession here, too, which could last a few quarters. However, the contraction may be less intense. In the eurozone, the energy situation is becoming a major issue as the conflict in Ukraine continues to escalate and threaten the region's energy supplies.

Business Leaders Are Very Concerned

Globally, the tone in discussions of the economic outlook is decidedly negative. A survey of 4,410 CEOs from 105 countries, conducted by PwC in preparation for the Davos World Economic Forum summit, found that 73% of them expect global growth to be negative over the next year. This is the survey's bleakest result in 12 years.

OUTLOOK

A Year in Two Acts

Volatility will continue to be the focus of discussions among market participants.

There is a consensus among economists and policymakers that 2023 will play out in two phases. In the first half of the year, the economy will be in recession due to the impacts of the war in Ukraine, supply chain failures and the battle to tame inflation. These will remain the key issues that governments and the major players in the private sector will be trying to address. Volatility will continue to be the focus of discussions among market participants. The year seems to be off to a good start, as prices have risen appreciably in both the equity markets and the bond markets. Although investors seem to be letting down their guard somewhat, we still feel that there is still good cause to remain cautious.

As for the second half of the year, the consensus is for a return to more favourable conditions. There will be more talk of the recession ending, lower inflation, and possibly of a resolution to the conflict between Russia and Ukraine. This will set a much more positive tone for the financial markets, and investors will be able to regain a level of confidence that is lacking right now. However, it should always be noted that most forecasts usually fall victim, sometimes dramatically, to unforeseen events and revisions.

Relative Calm in Politics

In Canada, barring a change in the NDP's attitude (which is unlikely), financial markets will not be obliged to deal with elections in North America in 2023. But politics will still be in the news, as the major U.S. political parties quickly begin races in the second half of the year to field candidates for the 2024 presidential election. However, this is unlikely to have any effect on the markets until next year. The political risk lies more in a dysfunctional U.S. Congress. In the wake of the saga surrounding the election of Kevin McCarthy as speaker, weak leadership in the U.S. Congress's House of Representatives is likely to impede the passing of any measures vital to the smooth functioning of the economy and financial markets. Raising the debt ceiling could again become a headache for the U.S. administration. Let's hope that reason will prevail.