REFLECTION

3rd QUARTER 2023 REVIEW

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SUMMARY

This is why our expertise and diversification across multiple sub-strategies and sectors is so important: it allows us to seek out and find good opportunities.

CRYSTALLINE

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years of passion and performance

CANADIAN MANAGER OF ALTERNATIVE FUNDS, SINCE 1998

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AMETHYST ARBITRAGE FUND

Financial markets are generally expected to be quieter during the summer months, providing just the right level of volatility for us to profitably manage our various arbitrage strategies. This period prepares us for the fall, when market volatility is at its highest, with all the risks that this entails.

The third quarter of 2023, however, proved to be the exception to the rule. Equity markets initially performed well in July, but just when many market participants might have been tempted to let their guard down, the markets turned around and logged a quick correction in the first three weeks of August. And September would prove to be even more volatile.

Highly Volatile Bond Markets

There was no respite for the bond markets either, with daily fluctuations in U.S. Treasury prices that stunned investors and observers alike. Of course, today's economic trends are not easy to establish: are we in a recession or just a slowdown, and will it be a soft or hard landing? In the background, the central banks are proving particularly tenacious about maintaining restrictive monetary policies.

Our various arbitrage strategies are not directional, so we have the freedom to adapt to a range of market conditions. The conditions in the last quarter prompted us to exercise a great deal of caution. In other words, we avoided, as much as possible, situations where the outcome was relatively unpredictable and concentrated on those where we could better see where things were heading.

None of this prevented us from launching the Canadian Sovereign Bond Absolute Return (SBAR) Fund on September 1, as planned. See below for more information.

MARKET EVENTS

There was no shortage of activity in the markets: we participated in 32 new transactions during the quarter. But, as a sign of the times and current market conditions, the majority of them involved small companies, much like in the previous quarter. Those transactions are now the most attractive, as they are usually simple and they close relatively quickly. In addition, they are generally inexpensive and require less financing for the buyer, which means that the transactions that fail are few and far between.

Two Disturbing Cases

Two other cases served as a reminder of how large transactions can be far more complex and end in truly unpredictable ways. The first is Microsoft's efforts to acquire Activision Blizzard, an American video game developer and publisher, for US$69 billion. For a long time, everyone was left guessing about the outcome, with U.S. regulators once again hesitating to give their stamp of approval. We were involved in the transaction only at the very end, when they finally came to a decision. The result was that we recorded a small profit, but this was not the case for everyone involved. ***This transaction stands as another good example of how a regulator's attitude can sometimes leave the whole M&A arbitration industry looking bad.***

FROM Jul. 1998 to Sep. 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	**-1.8%**	**0.9%**	**1.8%**	**1.8%**	**4.7%**	**6.3%**	**7.5%**	**7.9%**	**-**	**73%**	**0.67**
HFRI - Global Fund Weighted	4.2%	6.7%	6.7%	5.1%	4.6%	5.2%	6.1%	6.8%	0.47	65%	0.56
S&P 500 (TR)	13.1%	26.6%	10.2%	9.9%	11.9%	9.7%	7.4%	15.9%	0.43	64%	0.30
S&P/TSX Composite (TR)	3.4%	9.5%	9.9%	7.3%	7.5%	7.9%	6.6%	14.8%	0.49	62%	0.30
EAFE World Equity (TR)	4.5%	22.3%	3.1%	0.6%	1.1%	3.1%	1.6%	16.8%	0.43	56%	-0.04
FTSE CAN Long Term Bond	-4.6%	-5.6%	-10.4%	-1.8%	1.9%	4.3%	4.9%	8.0%	0.14	58%	0.34

S&P 500 Index

The other very special case was that of MaxLinear, which was trying to buy Silicon Motion, an American-Taiwanese company in the semiconductor industry. Receiving an approval from the Chinese authorities looked difficult, and even unlikely. But to everyone's surprise, the deal received a green light at the very end of the process. We then took a small stake in the transaction, only to see the buyer suddenly pull out (something quite rare), provoking extreme volatility in a single trading session. In this case, we fared less well.

CONVERTIBLE SECURITIES

It has to be said that this summer's speech by the Chair of the U.S. Federal Reserve (the Fed) took many observers by surprise, and its impact on both the bond and stock markets has significantly shifted the outlook in the convertible bond market. As a result of the equity market downturn, which accelerated in September, the conversion options on some convertible bonds lost their effectiveness. Without the hedge provided by such options, convertible bonds look more like straight bonds that fluctuate with changes in interest rates. And the weak bond market has effectively pushed some of our positions into negative territory. But this is not a catastrophe; far from it. Most of the bonds we hold have relatively short maturities of two to five years, so the impact on their prices are much smaller than those on long-term securities.

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Still Well-Positioned

In the absence of a major credit event that could affect one of our positions (something we consider highly unlikely), our situation is quite comfortable. For a start, we find ourselves with a bond portfolio that should provide an excellent return. In addition, the downside, or value that these bonds could lose is now much lower due to the convexity phenomenon. Rising rates have less of an impact on the prices of bonds with higher yields. For example, an increase in yield from 1% to 3% will cause the price of the bond to fall more sharply than if the yield were to rise from 5% to 7% conversely, this convexity works to the bondholder's advantage, sending prices higher faster should rates decline again

Although it is quite difficult to predict when the volatility in bond markets will subside, interest rate futures suggest that North American central banks are approaching that time when they will stop raising rates. This is also suggested by the current political rhetoric around the issue. And any recovery in the bond markets will have a beneficial effect on our portfolio.

In the meanwhile, we continue to enhance the quality of our portfolio, focusing mainly on new issues. We are targeting bonds with good high coupons and looking for situations where we can secure a good carry.

FIXED INCOME

The unprecedented volatility in the bond markets intensified in the third quarter, such that the DEX Canadian Universe Bond index recorded a 3.97% loss and is now in negative territory year to date. In the United States, 10-year federal government bonds rose by 75 basis points, provoking substantial losses in many passively managed portfolios.

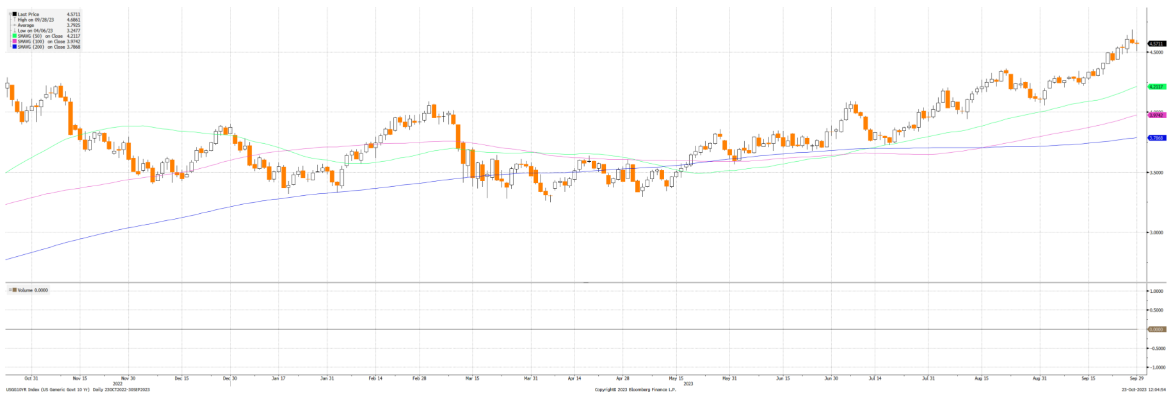
For our part, we have maintained a cautious approach to our arbitrage strategies on the yield curve and duration. This, combined with our focus on the gains provided from our defensive carry, enabled us to once again achieve a good return for the quarter, adding to our gains since the start of the year.

A Steep Credit Curve

As for credit spreads, the picture is mixed. There has been a slight compression in spreads on federal agency and provincial government securities, which were at approximately the same level as they were at the end of the first quarter. The credit curve, meanwhile, remains very steep and continues to offer very high returns on capital, in the order of over 20% for 5- and 6-year government agency bonds. This dislocation still offers a rare opportunity, and we intend to take full advantage of it.

At the end of the quarter, we were using 100% of our risk envelope in this strategy, similar to our position at the end of the previous quarter. This figure varied between 95% and 100% throughout the quarter. Strategically, we are maintaining an average duration of 2.8 years in our portfolio's spreads, and we favour agency spreads with maturities of 3 years and 5 to 6 years. We are also maintaining a slight bias toward a steeper yield curve. As for duration arbitrage, the high volatility has prompted us to remain neutral, at least for the time being.

US Government Bonds - 10 Year Yield



Launch of a New Fund

With interest rate hikes hammering bond portfolios, and knowing that investors seek the most stable and secure returns possible from their fixed income investments, we launched the Canadian Sovereign Bond Absolute Return (SBAR) Fund on September 1. The creation of this fund has given us a vehicle that offers interested investors this highly promising niche strategy where the performance to date has clearly outpaced that of the Canadian bond indices.

The SBAR Fund is based on an absolute return investment strategy that focuses on spreads between very safe and liquid Canadian government (and government backed bonds) and does not require calls on the direction of either markets or interest rates to generate returns. Since the start of the year, this strategy has generated a positive return of 5.8%, despite a significant drop in Canadian bond prices for all maturities over the same period.

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For investors in the Amethyst Arbitrage Fund, there is no change and they still maintain the same exposure to this strategy, but investors looking for a "pure play" can now invest directly via our fixed income SBAR Fund.

THE ECONOMY AND FINANCIAL MARKETS

Opinion is now divided on the effect of interest rate hikes on the global economy. More people now seem to think that rising rates will eventually curb inflation without causing too much damage to economies. This is based on the theory of the "soft-landing," i.e., that a central bank can control inflation without plunging the country into recession, as is usually the case. Surprisingly, the Fed seems to be nurturing this hope. But how can we ignore the fact that medium- and long-term bond yields, which continue to rise, will inevitably have a devastating impact on the global economy? Of course, some American indicators seem to be reassuring, suggesting that the U.S. economy will continue to grow. But for how long? ***In the current economic environment, it is difficult to predict the decisions of central bankers, and this will do nothing to tame the volatility in financial markets.***

Limited Appetite for Risk

The lackluster performance of the financial markets clearly indicates that investors shied away from risk during the third quarter. Although the S&P 500 and Nasdaq indices are still positive for the year to date, they have nonetheless in the last quarter fallen 4% and 5%, respectively. The S&P/TSX slipped 3% during the quarter, wiping out all the index's gains for the year. Equity markets often recover in the fall quarter, once past October. Can we still hope for such an outcome this year, now that the geopolitical environment is becoming more and more complex by the day?

OUTLOOK

While the explosion of violence in Israel and the Gaza Strip threatens to ignite the entire Middle East, the total absence of leadership in the House of Representatives is causing the legislative apparatus in the United States to seize up, threatening to disrupt both the U.S. economy and the financial markets. ***The inability of elected Republicans to choose a Speaker of the House of Representatives shows the many destabilizing effects of the current schism in the Republican Party, just one year ahead of the presidential election.*** The financial markets may not escape this fate, either. Thankfully, the managers of the Amethyst Arbitrage Fund can draw on a number of completely different, non-directional strategies, and this agility makes our fund well suited to this potentially turbulent period.

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