REFLECTION

4th QUARTER 2020 REVIEW

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SUMMARY

AMETHYST ARBITRAGE FUND

What a Turnaround!

Following the desperate situation in March, by the last quarter of 2020 we found ourselves almost in a state of exuberance. The year will be remembered for the markets' quick and spectacular turnaround. Once it was confirmed that the COVID-19 pandemic was spreading with virulence in Europe and America, the financial markets were left ravaged at the beginning of the year and many managers lost their bearings. The rout continued until it became clear that governments and central banks could organize a rescue that would at least be temporary, and that science, with stunning efficiency, could provide the glimmer of hope we so desperately needed.

The Amethyst Arbitrage Fund had the necessary tools to get through this period: experience, ingenuity and caution. The widespread downturn in March wiped out our performance in the first quarter. But the measures we took immediately in its wake to mitigate the risk by focusing the portfolio on higher conviction opportunities, as well as the caution exercised as we executed our arbitrage strategies, put us in an enviable position to take advantage of a year-end full of solid opportunities. After we had recovered from the shock of the pandemic, in the spring we set ourselves an objective of making up for the losses incurred in the first quarter and ending the year with a positive return. Today, we can say that this mission was accomplished.

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MARKET EVENTS

In the fourth quarter the mergers and acquisitions market, much like the stock market as a whole, benefited from a strong rebound in investor confidence. The proven efficacy of the COVID-19 vaccines, which made it possible to begin vaccinating on a mass scale as early as January, provided renewed hope that the pandemic would end sooner rather than later. The elections in the United States also removed considerable political uncertainty, allowing equity markets to post unprecedented gains over the last two months of the year, with returns of up to 10%. That was all it took for business leaders to resume deploying long-term capital through acquisitions. The recovery ushered in stock deals in the sectors hardest hit by the pandemic, such as oil and mining, as well as mostly cash transactions in other sectors. ***In the course of the last quarter we added 27 new positions, as transactions of sufficient quality to meet our criteria finally emerged. Since we had exited all of our M&A positions announced pre-pandemic, none of our positions were compromised during the quarter.***

Reluctant Chinese Authorities

A shadow has been cast over this picture by the attitude of the Chinese government, which is looking to limit the growth of certain Chinese companies such as Alibaba, Ant Group and Tencent, to name but a few. These companies have dominant market shares and have continued to acquire local competitors, and this seems to irritate President Xi Jinping to no end. While this has not yet resulted in any cancelled deals, it has nevertheless slowed the M&A market somewhat, with spillover effects on any transaction with a Chinese buyer.

FROM July 1998 TO Dec. 2020	ANNUALIZED RETURNS (%) *Net of all fees*						Volatil.	Correl.	% Mths > 0	Sharpe Ratio
	1 yr	3 yr	5 yr	10 yr	15 yr	Incep.				
Amethyst Arbitrage Fund	**1.5%**	**1.2%**	**5.4%**	**4.3%**	**6.1%**	**7.6%**	**8.2%**	**-**	**74%**	**0.66**
HFRI - Global Fund Weighted	11.6%	5.5%	6.1%	4.2%	4.7%	6.3%	7.0%	0.50	66%	0.59
S&P/TSX Composite (TR)	5.6%	5.7%	9.3%	5.8%	6.0%	6.5%	15.0%	0.50	63%	0.29
EAFE World Equity (TR)	5.4%	1.5%	4.6%	2.6%	1.6%	2.0%	16.9%	0.45	56%	-0.01
FTSE CAN Long Term Bond	11.9%	8.2%	6.8%	7.0%	6.5%	7.1%	7.1%	0.13	61%	0.69

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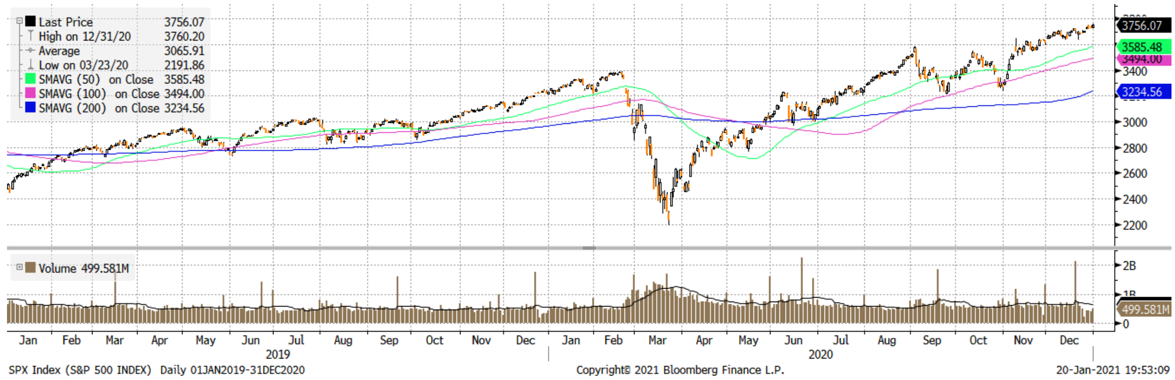
S&P 500 Index



CONVERTIBLE SECURITIES

The fourth quarter was good overall. While many investors were distracted by new issues and political events, we mostly took advantage of the secondary market to add several convertible securities of good quality, bearing sizeable interest coupons and well protected by short positions in the underlying stocks. These positions are spread across several industries, providing good diversification. In addition, the abundant liquidity in the markets allowed us to liquidate, at a good prices, certain positions whose risk we felt was too high.

Given the persistent volatility over much of the past year, it is interesting to note that there were few major credit events in 2020. We were nevertheless very cautious, reducing portfolio risk throughout the year as the economy faltered and the uncertainties around the U.S. election continued to grow. However, following the good environment in the last quarter, we are entering 2021 with a solid portfolio of convertible securities.

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We nevertheless expect to trim some of these positions in the first quarter due to concerns that the new President's fiscal stimulation may result in excessive valuations for certain financial assets. Investors will likely become less exuberant as it becomes clear that some companies will not be able to survive, even as the economy reopens. ***Companies unable to find their way back to profitability will have difficulty obtaining financing.*** We believe it is imperative to avoid the dangers inherent in relaxing our credit quality criteria in order to chase a higher return.

We believe that good opportunities will be plentiful once the post-pandemic economy has once again found its footing. Well established companies will be looking to finance new acquisitions and new projects and to refinance overly expensive debt. While these companies will probably achieve even higher valuations, the markets will also experience temporary setbacks, and we will be able to capitalize on them. Our core strategy continues to be the cautious arbitrage of such situations.

FIXED INCOME

During the last quarter we had begun to liquidate positions in agency and corporate securities that were less liquid in order to make the portfolio more flexible. With these transactions complete, and given that the generally narrow spreads made the outlook for risk-adjusted returns less attractive, ***we kept our use of the risk envelope at 40%, on average, in the fourth quarter.*** It should be recalled that we used up to 60% of the risk envelope in the previous quarter.

Of course, although the return generated in the fourth quarter was positive, it fell short of the two previous quarters. Nevertheless, it still enabled our fixed-income arbitrage segment to post its best annual overall performance since 2012, despite a first quarter marked by unprecedented turbulence. This performance could have been even better, except that when the recovery began in the spring we did not want to deviate from our disciplined and prudent approach. As a result, the weight of our transactions fell somewhat short. The year's performance mainly resulted from our strategic credit arbitrage positions and, to a lesser extent, our tactical and long-term credit strategy.

Disturbing Concentration

We begin 2021 with much the same positioning as we have had since the end of October, i.e. approximately 40% of the risk envelope. As core positions, we hold spreads on the 6-year agency bonds that we initiated in the previous quarter. They still offer a return on capital of close to 12% And we continue to maintain a slightly long bias on duration. ***We are particularly concerned that most market participants now share extremely similar views.*** Everyone has a very positive outlook on risky assets. Long positions in equities and commodities are in favour, along with short positions in bonds and the U.S. dollar. As often happens, such a concentration could lead to a positioning problem at some point during the first quarter. We could therefore see a rapid and pronounced correction, such as in the first quarter of 2018. Investors have a high degree of confidence in the role played by central banks and governments – to date and in the future – to safeguard markets, but these authorities are powerless when markets become seized by a sudden panic, exacerbated by poor positioning. Moreover, these phenomena are often transitory and generally offer good buying opportunities. Should this sce-

U.S. Treasuries - 10 Year Yield

nario arise, we will be ready.

THE ECONOMY AND FINANCIAL MARKETS

The second wave of the pandemic had adverse effects on economies in the last quarter. Governments had to tighten their health measures again, which inevitably had a negative impact on economic growth. The consensus among economists is that world real GDP contracted 4.5% in 2020. But the start of vaccination efforts suggests a healthy rebound in 2021, with the currently consensus estimate at 5.3%. If these forecasts prove correct, by the end of 2021 global economic output is expected to have returned to the same level as at the end of 2019. Overall, this would be as if world economic growth had just tread water for two years.

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Not surprisingly, corporate profits were hard hit in 2020. Companies in the S&P 500 Index reported a 14% drop in earnings for the year just ended. But due to the fresh start afforded by the vaccines, the analysts' consensus is for 22% earnings growth in 2021. However, it should be noted that such earnings forecasts at the start of the year are often coloured by excessive optimism. For example, just as with global economic growth, at the end of 2021 U.S. corporate earnings may only be at the level achieved two years earlier.

Moreover, despite the sharp decline last March, the stock market has performed exceptionally well over the past two years. Since January 2019, the S&P 500 Index is up by approximately 45%. Not surprisingly, the price-to-earnings ratio, which has historically averaged around 15, is now 23. This is a good illustration of just how expensive the stock market has become. The gulf between the economy and the stock market has rarely been greater.

OUTLOOK

Major Change in Political Leadership

An important political transition has just taken place south of the border: the Democratic Party is regaining control of both the White House and the Senate. This is certainly good news for the stability of American politics, but the new leadership faces major challenges, and there is no guarantee of success. The traditional U.S. economy is faltering, while both the Treasury Department and the Federal Reserve have probably exhausted most of their fiscal and monetary ammunition over the past year. President Trump's attitude, behaviour and all too often rash decisions over the past four years will leave their mark in many areas. ***Joe Biden certainly has the skills needed for the Oval Office, but will he have the energy?***

Volatility and Discipline

With the help of vaccines, we begin the New Year with hope. The overwhelming majority of economists and financial strategists are optimistic about economic growth, corporate profits and stock market returns. It should be recalled that this was also the case one year ago. Experience has shown that a strong consensus forecast does not always bode well. There is every reason to believe that the financial markets will experience relatively high volatility over the next year. But we will be ready. Volatility is our sandbox, after all. ***And rest assured that we will continue to apply the same rigour to our operations in 2021, because it is part of our DNA.***