REFLECTION

2nd QUARTER 2021 REVIEW

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SUMMARY

AMETHYST ARBITRAGE FUND

Even though we faced some adversity in implementing our yield curve arbitrage strategy, the fund performed well overall in the second quarter. And we are confident that, going forward, we can build on this momentum, despite a striking dichotomy between the state of the economy and financial asset valuations, the impact of having a new Democratic administration in the U.S., and the uncertainties surrounding the timing of changes to the Federal Reserve's (the Fed's) monetary policy. Let's see how all of this relates to our key strategies.

MARKET EVENTS

Conditions Are Still Favourable

In the first quarter, we noted that the environment was highly favourable for strong returns on M&A arbitrage activities, and this continues to be true. Activities have continued apace over the past three months such that we participated in 41 new transactions, and most of them have been profitable. As a result, the M&A segment posted excellent performance in the second quarter.

This success is due in part to our well-advised decision to avoid transactions in the tech sector. Just as we had feared, China continues to delay approvals of these deals for a variety of reasons, many of which appear to be political. The inflamed rhetoric between China and the United States is clearly escalating, and it is difficult to predict where all this will lead. Nothing suggests that such disputes will be resolved any time soon.

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Transfer of Power That Is Anything but Smooth

In the United States, the transfer of power from the Republicans to the Democrats is unfortunately hampering – at least for now – the effectiveness of the Federal Trade Commission (FTC). Delays in the appointment of new commissioners have impeded the Commission's analysis and approval of cases. In addition, since Democratic administrations are, by nature, more pro-consumer than pro-business, more deals are likely to be refused.

For example, on Wednesday, June 16 the U.S. Attorney General Merrick Garland filed a civil lawsuit to block Aon's proposed acquisition of Willis Towers Watson on the grounds that it would violate the country's antitrust laws. The deal is valued at US$30 billion, and observers believed that the negotiations were almost complete. Our loss was minimal, since we had only a small position in this transaction that we decided to liquidate rather than wait for the court to reach a decision.

CONVERTIBLE SECURITIES

The second quarter began as the previous one had ended, with convertible bond prices weakening and credit spreads widening. May brought some stability to the market; however, by June, investors began to completely disregard risk again, and prices rose substantially. We had expanded our holdings in March and April, but the current market, in which investors are engaged in excessive risk-taking, allows us to continue rebalancing the portfolio and adjusting our delta to the desired level, thereby reducing risk.

FROM July 1998 to June 2021	ANNUALIZED RETURNS (%) *Net of all fees*						Volatility	Correl.	% Mths > 0	Sharpe Ratio
	1 yr	3 yr	5 yr	10 yr	15 yr	Incep.				
Amethyst Arbitrage Fund	**13.0%**	**2.2%**	**3.4%**	**4.1%**	**5.4%**	**7.5%**	**8.1%**	**-**	**74%**	**0.66**
HFRI - Global Fund Weighted	29.2%	8.5%	7.8%	5.1%	5.0%	6.6%	7.0%	0.48	66%	0.64
S&P/TSX Composite (TR)	33.9%	10.8%	10.8%	7.4%	6.8%	7.1%	14.9%	0.49	63%	0.33
EAFE World Equity (TR)	29.4%	5.6%	7.5%	3.0%	1.6%	2.3%	16.8%	0.44	56%	0.01
FTSE CAN Long Term Bond	-6.9%	5.1%	3.5%	6.0%	6.3%	6.6%	7.2%	0.13	61%	0.61

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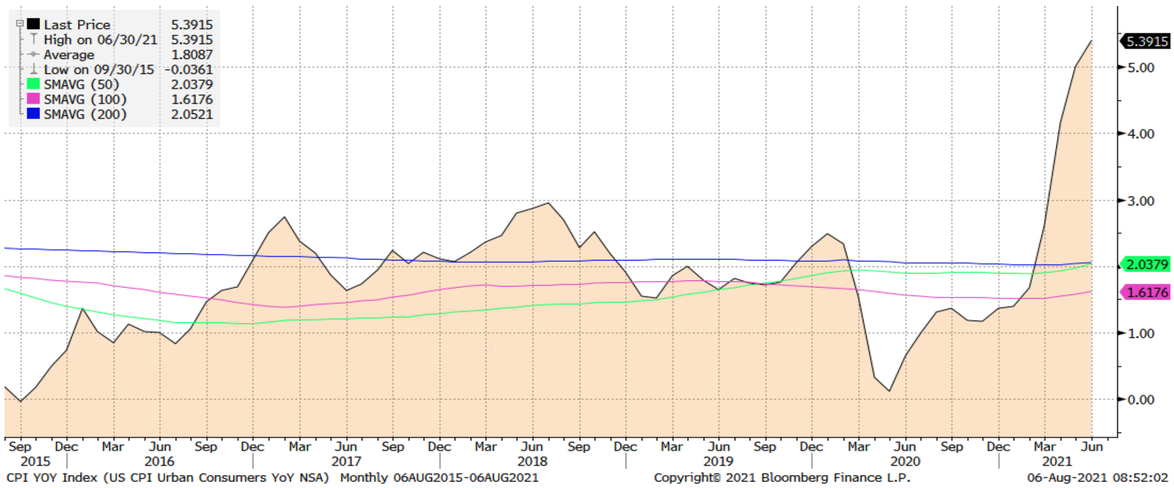
US CPI (Consumer Price Index - YoY)



...we are not convinced by those who see the current jump in inflation as only temporary

In addition, we are actively seeking opportunities to invest in convertible securities priced near the pivot point where they are fully hedged by the short position in the company's equity and where, in the event of a rapid market decline, the price of the convertible bond will not fall as fast as the stock price, thereby generating a gain for the combined position. We also favour longer-dated bonds when such opportunities arise in order to mitigate the impact of time decay as the security approaches maturity.

Opportunities Abound

There is no doubt that the market is now rife with attractive opportunities, given the large number of new issues last year. This allows us to select credits, coupons, maturities and premiums that meet both our quality objectives and our risk management criteria. But despite these attractive market conditions, we intend to continue exercising caution due to the exceedingly high valuations in the equity market, especially among the very large-cap stocks.

FIXED INCOME

Two of our three "alpha drivers" suffered losses in the second quarter. Despite this more difficult period, we believe that the factors that caused such losses will reverse in the near future, allowing our current positioning to deliver significant rewards.

As is often the case when an unexpected event occurs, we incurred a mark-to-market loss after the Fed's meeting when word came out that several members expect the central bank to begin raising interest rates sooner than market participants had anticipated. The impact of this news was immediate, with a considerable flattening of the yield curve.

Temporary Flattening

Since the first quarter our strategy has been to hold the opposite position: i.e., one that favours a steeper curve rather than a flatter curve. The impact of such murmurs from the Fed came as quite a surprise, given that such a rapid and deep contraction of the curve has only occurred two other times in the last 20 years: in 2009 and in March 2020. History teaches us, however, that the impact of such a surprise on the curve usually resolves in under three months, or sometimes even very quickly, as in 2020 when it took only 15 days.

We have maintained our position, since this loss was not in breach of our risk management rules and because we believe that our arbitrage strategy based on a steepening of the yield curve is still fundamentally sound. First, the Fed's quantitative easing program, under which it buys large amounts of securities every month, will probably need to end before we see any interest rate hikes. And nothing to that effect has been announced so far. The Fed's officials have merely indicated that this is under discussion. Furthermore, we are not convinced by those who see the current jump in inflation as only temporary. While some of it may indeed be transitory, the rest will be more permanent. We believe that, in the months ahead, inflation will be higher than the average inflation recorded since 2008.

Tempting Spreads on Agency Securities

Credit spread arbitrage is another segment of our business where the dynamics have strayed somewhat from what we usually see. For the past several months, the most attractive spreads have been on the securities of federal bodies (agency securities). In fact, since the fall these securities have been priced at very attractive levels. But this situation has carried on to the point where they can now be purchased at a premium to provincial securities. Given the higher credit quality and liquidity of federal agencies, this situation is unsustainable over the medium term, so it provides some attractive arbitrage opportunities. To reap the benefits we will need to be patient and hold on to our current positions.

THE ECONOMY AND FINANCIAL MARKETS

The scope of the economic recovery that will follow the pandemic cannot easily be predicted with any accuracy. The sharp slowdown in the trade

U.S. Treasuries - 10 Year Yield

and production of goods and services during the pandemic has created a considerable imbalance in the data that defies easy comparisons of one period to the next. However, the difficulties faced in several sectors by supply chains trying to meet demand are a clear demonstration of very strong economic activity. At its June 16 meeting, the Fed raised its forecast for real GDP growth in 2021 from 6.5% to 7.0%. At the same time, it indicated that consumer demand will likely push the inflation rate to 3.4% by the end of the year, compared to the previous forecast of 2.4%. As a result, the Chair of the Fed, Jerome Powell, said that its leaders have begun talking about reducing the institution's monthly bond purchases.

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North American equity markets have continued trending upward, to new all-time highs in the second quarter. Both the U.S. S&P 500 Index and the Canadian S&P/TSX Index are up over 15% since the beginning of the year. As for bonds, the yield on U.S. 10-year Treasuries dropped sharply during the quarter, from 1.72% to 1.44%. And this trend looks set to continue into the third quarter, as recent comments by the Chair of the Fed indicated the possibility of an earlier-than-expected rate hike, provoking a notable flattening of the yield curve.

The price increases in the commodities markets have been remarkable. The price of oil, in particular, has continued to climb and is up more than 50% since the beginning of the year. The cost of a basket of major commodities rose 15% in the second quarter and was up 31% since January. Prices for most agricultural products have also risen sharply.

OUTLOOK

All Eyes Are on Inflation

The main topic of discussion in the third quarter is likely to be inflation. The U.S. Consumer Price Index (CPI) continued to rise in June, up 0.9%. ***The annual change in the CPI is now 5.4%, the highest it has been since July 2008.*** Some comfort may be taken in the fact that the component posting the largest price increase was used cars. Meanwhile core inflation, which excludes food and energy and generally guides decision-making on monetary policy, has reached 4.5%, its highest level since November 1991. Inflation in June turned out to be hotter than economists expected, and no doubt the experts will be paying close attention when the next figures are released.

The inflation rate is likely to have major implications for monetary policy. So far, Fed and U.S. Treasury Department officials have been saying that the increase will be temporary, as it reflects the strength of the economic recovery, and that inflation will soon return to somewhat more normal levels. The June figure may have cast some doubt on this belief, and the figures to be released in the coming months will be more conclusive. But one thing is certain: the Fed may well begin normalizing monetary policy sooner than expected.

Bank of Canada and the Next Federal Election

It appears increasingly likely that Canadians will be heading to the polls in a general election this fall. The Trudeau government has often been attacked for dithering on some high-profile issues, but its image has clearly been burnished by how it managed the pandemic. Since this was the most important issue the government has faced in the past year and a half, its impact on public opinion will most likely be positive.

On the other hand, an election could hamper the Bank of Canada in its work. Our central bank has been more willing than the Fed to begin normalizing monetary policy. The Bank has already begun tapering its monthly bond purchases, and ***it is becoming increasingly clear that interest rate hikes are coming to Canada before the U.S. makes the same move.*** But it is rare for a central bank to make any significant policy moves during an election.