

Current Investment Thesis

Welcome to our second Quarterly Investor Letter. The fund finished its first 6 months period since its July 1st launch on a positive and strong note. In many respects we saw a bifurcated world, whereby in the second half of Q2 stricter measures were put in place with respect to the COVID-19 pandemic resulting in further hardship for individuals and smaller businesses in particular. On the other hand with the additional support being provided by central banks and governments the stock markets were performing strongly with (near) record highs being achieved.

Central banks and governments globally have remained committed to supporting the ongoing effort to reinforce economic recovery through expanding monetary and fiscal stimulus measures. These efforts have had an immediate impact on credit spreads and market price levels.

Commodity prices are showing signs of upward pressure over the past year, while labor market slack and the slowdown in economic activity continues to be an offsetting factor. General expectations remain for a subdued rate of inflation for the near-term, but the longer-term impact of significant global stimulus spending resulting in higher inflation rates remains a concern.

Overwhelmingly, the fund is allocated to structured credit, primarily backed by US housing assets. Given the sharp sell-off we observed in March, we felt that this offered the best risk reward. U.S. home prices have continued to rise at an above average rate as increased new household formations and low mortgage rates have pushed a higher level of demand outpacing a constrained level of existing single-family home supply.

The legacy Non-Agency RMBS sector remains one of the best performing asset classes within the structured credit universe. Stable fundamental collateral performance, idiosyncratic structural deal benefits associated with excess interest, and market demand for relatively higher yielding securities have continued to drive strong returns.

In this letter we aim to explain, why we have selected the managers we have and what the opportunity set is for those managers. We want to reiterate the positioning of the fund that we highlighted in our last letter as we think it is key for investors to understand the potential this fund offers:

- i) We still see opportunities in dislocated parts of the credit markets, especially structured credit. In the RMBS space the underlying assets (US housing) are stable, but the prices of the securities have not come back to their original levels. Whole loans in the same sector also offer significantly more interesting pricing at this moment. In general, the long only part of these strategies can deliver high teen returns.
- ii) There are still opportunities in shorting credit in the corporate space as well as commercial real estate. In corporate credit overall, we face a significantly different economic environment today. The issues of commercial real estate are clear to anybody and holding protection on some of the subordinated tranches of CMBS makes us think back to the short subprime trade in 2006 and 2007. The immediately pulled bazooka of Central bank liquidity has kept capital markets wide open and is maintaining these spreads artificially tight; however, we think it is a matter of time before they could widen again. Liquidity does not solve for solvency!
- iii) The core portfolio strategy today can be summarized as being long the fundamentally strong, but relatively cheap consumer credit structures, while applying hedges in the fundamentally weak and relatively expensive corporate credit and commercial real estate space. Both sides offer an attractive absolute return prospective. It puts us in a position to shift the allocation to pure corporate distressed opportunities whenever defaults increase and corporate credit markets sell off, whilst not being dependent on the timing of it.

In summary, we are well positioned to take advantage of mispriced dislocations as well as highly complex, process driven situations.

Returns

TDCOP gained +4.69% (Class A shares) during its second quarter of operation. On an annual basis this translates into a net return of 15.18% which is above its target return of 10%-12%. Also, the quarter displayed some of the resilience we think the portfolio should demonstrate against deteriorating market conditions. In October, the portfolio gained 0.60% while equity markets and HF indices were sharply lower.

Returns were driven by the solid performance of the core long books, predominantly mortgage backed securities. Emerging markets contributed especially in November & December, in particular as Argentinian assets recovered following the technical sell off in September.

In terms of strategy we remain comfortable with the five managers currently in the portfolio, with a focus on structured consumer credit and a cautious stance on corporate credit markets. As capital markets have remained wide open, it remains too early to allocate to the more "pure distressed" corporate debt specialists. We expect this will change in the future, but we are happy to stick with the current portfolio as long as this does not materialize. We suggest reading the individual manager reports which you can find via the links provided, which provide more insight to the managers as the top level has not fundamentally changed. Two of the managers presented at the Legends4Legends online webinar. We encourage you to listen to the [recording by clicking here](#).

Funds

Fund I - Emerging Markets Distressed Debt – Quarterly Return 7.31%

The manager of Fund I, invests mainly in distressed debt situations with a focus on emerging markets since 1998. This is an area with very few players, especially with the experience of this Manager. Theta has been invested in his fund since 2003. His style is contrarian, stepping into the markets when risk aversion is at its highest. Investments are highly idiosyncratic and often driven by active involvement of the Fund team. The regions they invest in are spread out, with current concentrations in Argentina and Ukraine. The fund is hard closed at a size of \$4.5bln, not allowing any additional inflows, showing the commitment of the manager to focus on returns rather than asset gathering.

Q4 summary

Unlike their developed markets counterparts, sovereigns, provinces and corporates in emerging markets are not able to borrow as easily to fund large fiscal deficits in order to combat the corona crisis. This leads to emerging markets already providing interesting distressed debt opportunities for experienced players. The Fund has been slowly building positions in these new situations while the main p&l driver remains its existing positions in provincial and corporate debt in Argentina. These positions contributed strongly in November & December. With hardly any repayment obligations for the coming 5 years and bond yield that are several percentage points above those of the world's weakest sovereign creditors, these are very attractive positions to hold.

Fund II – Structured Credit – Quarterly Return 7.59%

We consider this Manager to be one of the best RMBS investors which suffered a deep drawdown from the technical dislocations in March but was able to maintain their portfolio. As a result, almost all of March's drawdown was unrealised, creating a very attractive setup for a strong recovery. They are now in a good position to achieve significantly higher yields on assets that have a low risk of impairment. Given the rally in general markets they spend part of the yield on S&P puts while still expecting to achieve attractive double-digit returns.

Q4 summary

The overall positive tone for risk assets in the RMBS and ABS markets continued throughout the final month of 2020 as investors remain optimistic with COVID-19 vaccinations having begun in several countries. The Fund's performance for the month reflects the continuation of asset price recovery in conjunction with the rally in broader markets. Trading activity in the secondary markets was strong in both RMBS and ABS. Investor appetite for exposure to Residential and Consumer credit has been notable and we have seen an uptick in primary issuance preparing to come to market during the start of 2021. Trading in Credit Risk Transfer securities and prices both continued to edge higher, especially lower in the capital structure. The pipeline of prospective investment opportunities has begun to build materially, and we expect this to continue throughout the first half of the year

Fund III – Structured Credit – Quarterly Return 1.15%

Similar to Fund II, but more niche focused on legacy non-agency RMBS where they have a real edge. Those legacy assets have very low LTVs with homeowners that have been in their houses for approximately 15 years. Even in draconian economic scenarios, they expect these assets to be money good. The Fund was hedged going into this crisis and made a lot of money on their HY and CMBS shorts, part of which they still maintain. It allowed them to be one of the few liquidity providers to REITs and mutual funds selling these assets at fire sale prices in March.

Q4 summary

The strength of the housing market has continued to be a fundamental driver of performance of the Legacy Non-Agency RMBS sector. Throughout the past year, the portfolio's "cash-flow upside bonds" have performed extremely well, while longer duration bonds have shown some sensitivity to the potential for a steepening yield curve. Ultimately, the backdrop of increasing home prices is expected to continue for the next several quarters given the current supply/demand dynamics and will lend support to the performance of its core long positions. Meanwhile, the ongoing economic stimulus policies, both fiscal and monetary, remain a key support mechanism for the broader market. The impact of these measures has been clearly observed in market price/spreads, as yields have reverted to pre-crisis levels for most segments of corporate credit.

Given the elevated valuations across certain credit sectors, coupled with an almost universally sanguine expectation for a rapid economic recovery, the manager anticipates any deviation of fundamental performance will likely translate to increased volatility. While they expect a favorable outlook for continued performance within the legacy Non-Agency RMBS sector, excess risk remains a concern in other areas of credit markets (e.g. CMBS, Corporate Credit). Looking ahead, they expect to see periods of market dislocation that will likely provide additional trading opportunities to monetize hedge positions and re-allocate to attractive discounted new purchases. This strategy has been extremely effective throughout this past year and they see potential for generating long-term returns over the year(s) ahead.

Fund IV – Structured Credit – Quarterly Return 2.20%

The Fund invests into multi-sector high yield loans, with an emphasis on real estate secured loans. The Fund seeks the best relative value in primary or secondary (often distressed) markets. The Fund's return comprises cash flow from capital gains on the resolution of distressed loans and net-interest income from performing loans. In particular, the manager buys portfolios of loans from banks and originators, reworks them with their internal service providers to then repackage and securitise the loans. The sharp rally in the most senior liabilities offers them very cheap non-recourse financing. The fund historically has returned a very stable 9-11% net, which going forward is expected to be higher as their existing portfolio recovers from a largely technical sell-off in March and as they deploy new funds at significantly higher rates than pre-covid.

Q4 summary

The manager is expecting approximately 17% yield (with approximately 1 turn of leverage) on its existing portfolio with a 15+% yield on its expected pipeline, which is currently very strong and exceeds its current cash available to invest. 68% Of its pipeline is in high conviction sectors that have incurred COVID related credit dislocations where the manager believes there is alpha from asset management and securitisation. The following presentation gives a good overview of the areas it invests in with the potential returns.

Fund V – Distressed Debt– Quarterly Return 5.95%

This Manager is an integrated distressed debt manager that dynamically captures the fundamental and technical opportunities across liquid and illiquid markets. The Manager has a trading platform which provides a lot of value in this current phase, while also having the expertise to do middle market restructurings as they will present themselves. On the liquid trading side, there is currently a lot for them to do. We think there is some significant embedded value in some of their longs like MGM Studios which is a big position. It is also one of the most active funds on individual credit shorts and they have focused on names that would be in trouble in any slight downturn, let alone what's hitting them now. We see embedded value in these shorts as they hardly trade and make a big jump on a credit event. Their book is impossible to duplicate. They expect there will be more to do in restructurings in 6 months or so from now.

Q4 summary

For the quarter the Fund generated a positive return. This was a combination of trading opportunities, its short book, as well as post re-org equity positions. The manager believes there is significant default risk given an economic environment that remains both highly challenged and uncertain, which it is looking to take advantage of. The continuation of leveraging activity among corporations with deeply challenged fundamentals has not changed the view that a segment of the High Yield market is facing a high probability of default.

