REFLECTION

4th QUARTER 2019 REVIEW

www.cristallin.ca

SUMMARY

The search for yield carries on in an environment where the rates on government bonds are often negative in real terms, and sometimes even in absolute terms.

CRYSTALLINE

ans de passion et de rendement
years of passion and performance

CANADIAN MANAGER OF ALTERNATIVE FUNDS, SINCE 1998

1002 Sherbrooke Street West
Suite 1525
Montreal (Quebec)
Canada H3A 3L6

TEL. +1 514 284 0248
info@cristallin.ca

AMETHYST ARBITRAGE FUND

While we would have liked to add a few percentage points to the fund's return for 2019, but for that we would have had to relax our risk management criteria, and that was not something we were willing to do. In a period of very low interest rates, the search for yield continued to drive a growing number of investors toward equity markets. These markets had a spectacular year, despite fears of an economic slowdown due to trade wars and the ongoing chaos in political and economic management in the United States.

Capital protection

We did not want to relax our risk management, because our role includes protecting capital. And we will continue in that direction. A single common factor is emerging among our three main strategies: high asset prices. This has been behind the need for rigorous risk management. Sooner or later, asset values will reach the point where a sharp downturn becomes inevitable. No one can predict exactly when that will occur, but we will be ready.

MARKET EVENTS

There was no shortage of opportunities in the last quarter, and we took part in 23 M&A transactions, bringing the total for the year to 95. Surprisingly, we posted a 5% "mortality" rate, compared to our historical average of 3%. The problem stemmed from Canadian deals, which had a failure rate of 12% - the highest in 25 years.

In terms of surprising turns of events, one of the most striking was certainly the rejection by minority shareholders of the privatization of Canfor. Two of the three governance consultants had nevertheless recommended the transaction. We had taken only a very small position on the transaction, which we quickly liquidated. After the rejection of the MEG Energy project, this was the second transaction refused by shareholders. Should we see this as the start of a trend? That would be surprising, since the losses incurred by shareholders in these two cases should only encourage others to think twice before shooting down a strategically advantageous proposed transaction.

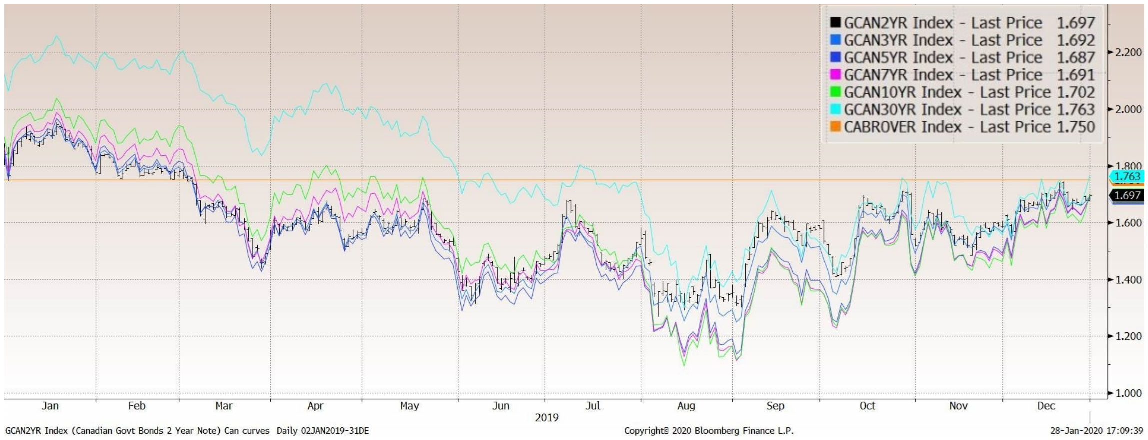
Market cycle now mature, interest rates negative

Admittedly, we would not describe our results for the quarter as excellent, but they were modest and prudently motivated. One thing is certain: we remained focused on our capital preservation objective, given the maturity of the stock market cycle and, above all, the very low interest rates. The search for yield carries on in an environment where the rates on government bonds are often negative in real terms, and sometimes even in absolute terms. So investors are driven to narrow their credit spreads, and they overbuy the stock market since it is valued on the basis of interest rates.

We refuse to give in to such temptation, and continue to invest only in positions where the expected return justifies the risk. We participated in fewer transactions in 2019, and we reduced our leverage. Going into 2020 we still have our guard up, now more than ever.

FROM July 1998 TO December 2019	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	**4.5%**	**2.0%**	**6.5%**	**5.6%**	**6.5%**	**7.7%**	**7.5%**	**-**	**73%**	**0.75**
HFRI - Global Fund Weighted	10.4%	4.5%	3.5%	4.0%	4.6%	6.1%	6.6%	0.42	67%	0.58
S&P/TSX Composite (TR)	22.9%	6.9%	6.3%	6.9%	7.2%	6.6%	14.3%	0.44	63%	0.30
EAFE World Equity (TR)	18.4%	6.5%	2.8%	2.6%	2.0%	1.9%	16.4%	0.40	56%	-0.03
FTSE CAN Long Term Bond	12.7%	6.6%	21.8%	10.9%	6.7%	6.9%	6.8%	0.03	61%	0.67

Canadian 2 Year Govt Bonds



CONVERTIBLE SECURITIES

Over the past quarter we consistently sought to adjust our hedges and risk levels to position ourselves for 2020. We enter the New Year with the belief that the economic expansion will carry on for some time, and that market volatility will continue to rise. Once again, we are keeping our distance from companies that are so popular that they quickly become very expensive and continue to appreciate. A fall becomes inevitable, much like it did for Icarus, the figure from Greek mythology who lost his wings by flying too close to the sun. We will continue to seek liquidity and flexibility in convertible securities, which offer, above all, a carry trade return and downside protection.

We will continue to seek liquidity and flexibility in convertible securities, which offer, above all, a carry trade return and downside protection.

Energy proved to be the best-performing sector, and we continued to add modestly to our positions. The worst sector was health: cannabis stocks have fallen out of favour, and we are keeping our distance. We added 14 market event stocks, 3 U.S. convertible securities that act as put options, and 1 Canadian convertible security. Our selection criteria were primarily the coupon, credit and valuation, with limited downside risk, as well as the potential for appreciation in the underlying equity in the case of the Canadian convertible securities.

Time to realize some profits

We disposed of 10 event driven positions and 7 convertible securities during the quarter. We decided to take our profits on these securities in order to meet our objectives and due to deteriorating credit or valuations that had become too high.

At Crystalline, our priorities are unchanged: capital protection, improving the quality of our investments by reducing risk and, lastly, a solid portfolio structure. We need to achieve these objectives in an environment where markets continue to appreciate and the consensus remains strongly positive, despite geopolitical risks and huge government budget deficits. We believe that asset prices are reaching levels where the markets no longer have a margin of error.

FIXED INCOME

The sharp drop in interest rates that began in early 2019 finally reversed in the fourth quarter. Interest rates for maturities of two years or more rose in most industrialized countries, up by 10 to 30 basis points depending on the maturity.

As for longer-term rates, the German market remains our barometer. As you may remember, last summer 10-year rates plummeted to -0.80%. They now stand at -0.20%.

We believe that U.S. and Canadian bond rates are unlikely to rise much at all until German rates turn positive.

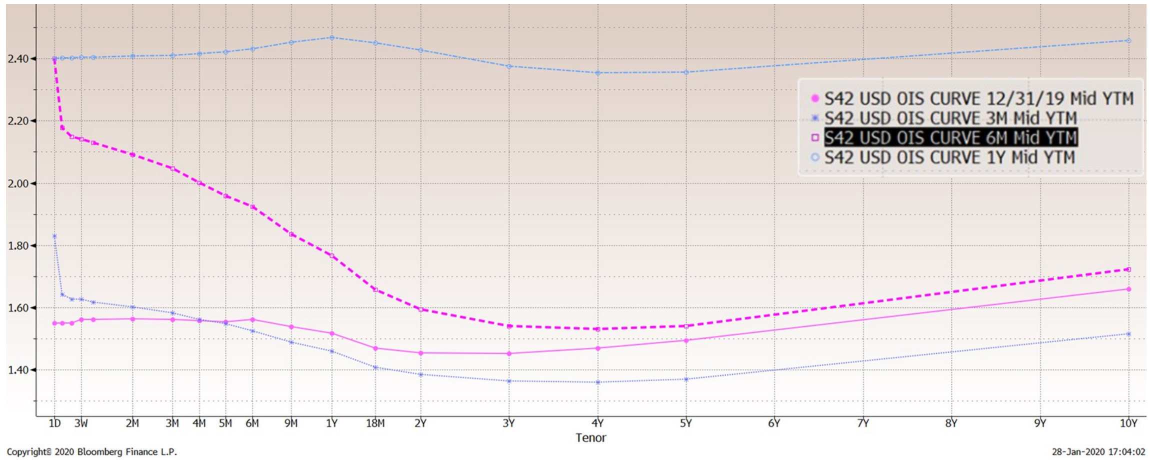
Despite the hikes in bond rates last quarter, the monetary policies of the main central banks remain relatively accommodating. For example, the European Central Bank (ECB) has announced new quantitative easing measures. The U.S. Federal Reserve (the Fed) lowered the federal funds rate in October, for the third such cut in four months. Rate cuts are still expected in 2020, but they will surely be fewer in number. Market participants appear to believe that there may be just one, in both Canada and the United States. With this being an election year south of the border, the Fed can be expected to maintain the status quo.

In the fixed income markets, the highlight of the quarter was undoubtedly demand for credit securities, primarily corporate bonds. The race for yield among U.S. investors is becoming increasingly heated. Although credit spreads continue to narrow, demand is growing unabated. And the phenomenon is spreading to Canada. One cannot help but note the number of new issues by companies with low credit ratings. They are attracting record numbers of investors, who are buying these securities despite very low risk premiums on a historical basis.

Yield curve below the key policy rate

The yield curve finally steepened towards the end of the year in both Canada and the United States, after a marked flattening since the beginning of 2019. Are we to understand that the Fed's three

Overnight US Fed Rate Expectations



key rate cuts have reduced the risk of recession that everyone was talking about in the first half of the year? Somewhat surprisingly, in Canada the entire yield curve is now inverted relative to the key interest rate. Bond rates for all maturities are now below the policy rate, which is currently 1.75%.

How will this all end? It is difficult to avoid the conclusion that, by keeping interest rates so low, the central banks are indirectly driving investors to take on more risk. In the United States, bond funds are ballooning, and the ever-growing demand for corporate bonds is markedly higher than it was in 2008 in the months leading up to the financial crisis. Should credit spreads widen and force some bondholders to suddenly sell, the supply-demand balance could shatter, and risk-adjusted spreads could widen very quickly. For now, the outlook for the credit market remains slightly favourable, even though it is expensive, at around 0.50 to 2.00 standard deviations on a historical basis. We will try to take advantage of this situation early in the quarter, while remaining alert to any shifts in economic conditions.

Bond rates for all maturities are now below the policy rate, which is currently 1.75%.

As the New Year begins, no one, absolutely no one, is talking about a rate hike. Should we be concerned? History is certainly full of cases where trend reversals caught everyone by surprise...

THE ECONOMY AND FINANCIAL MARKETS

The world economy grew by only 2.9% in 2019, its worst performance in the last ten years. Nevertheless, the MSCI World Index rose a spectacular 24% over the period. If the stock market, as many believe, is forward-looking, then we should expect a rebound in the global economy in 2020. A successful outcome to trade disputes could lend support to this prediction, but it will not be enough. Central banks will probably still need to maintain their monetary easing policies. Many observers believe that central banks will hold the line, given the absence of inflation.

The U.S. economy seems to have found a cruising speed of around 2%, but some uncertainties remain. The sharp tax cuts of 2018 may now begin to affect fiscal policy, as the debt burden leaves little room for economic stimulus.

In Canada, the year began on a cautious note from Bank of Canada (BoC) Governor Stephen Poloz. Once again the BoC maintained the status quo on interest rates at its first meeting of the year. However, the Governor underscored some disappointing statistics on consumer confidence, retail sales and employment. From the outset, he stated that the BoC has not closed the door to interest rate cuts.

OUTLOOK

Rarely have the experts on the outlook for equity markets been so unanimous, expecting the S&P 500 Index to rise 5% to 7%. None of them are talking about a decline. However, the leading index of U.S. markets is already trading at 18.5 times forward earnings. This represents a cyclical peak that, in the last thirty years, was only surpassed in 1997-99, during the tech boom.

Most market participants are aware that the very low interest rate environment is one of the reasons, if not the main reason, for current stock market valuations. As we have mentioned, few of them expect rate hikes in 2020.

The absence of inflation reinforces managers' belief that central banks would be ill-advised to raise interest rates in such an environment.

The New Year promises spectacular twists and turns on the American political scene. President Trump will most likely be acquitted of the impeachment charges against him, but the process will leave its mark. The partisan rift in the U.S. Congress, highlighted as never before by the impeachment trial, does not bode well for the coming year. The divided electorate is hunkering down in their positions and turning a deaf ear to arguments, stoking fears that no holds will be barred between now and the November election. It will be difficult for economic and financial circles to ignore such a climate, yet market observers unanimously believe that stock markets will rise and interest rates will fall. Only time will tell.

CRYSTALLINE
ans de passion et de rendement
years of passion and performance