Market Commentary

Third Quarter 2021

Introduction

The early months of the third quarter were characterized by slower trading volumes after nearly 18 months of frenzied activity post-March 2020. However, trading activity picked up as summer came to a close and volatility returned to the markets. The yield on the 10-year U.S. Treasury note closed nearly 18 basis points (bps) higher month-over-month in September, high yield corporate credit spreads widened approximately 25 bps, and the S&P 500 was down 4.8%. Despite these market moves, the Fund posted a strong month to close out the quarter as structured product spreads remained relatively stable and the Fund's low duration positioning provided shelter from the rate selloff.

Market Environment

Within residential assets, fundamental performance in US residential mortgage-backed securities (RMBS) continues to be a tailwind for Fund returns. The combination of strong home price appreciation, declining delinquencies from COVID-19 payment deferral programs, and faster prepayment speeds have all served to benefit realized returns from pre-crisis RMBS.

Commercial Real Estate (CRE) CLOs have shown continued price resiliency despite an unusually heavy new issuance pipeline.

Within the corporate space, strength in the leveraged loan market has been helpful for the Fund's collateralized loan obligation (CLO) holdings. Trailing 12-month leveraged loan default rates remained low at just 0.47% with only 4.7% of the market currently trading below a 95 dollar price. While a healthy loan market has benefitted the fundamentals of our CLOs, high new issuance volumes in US CLOs weighed slightly on spreads this quarter, particularly at the top of the capital structure. Many CLO managers appeared to be rushing to issue and refinance deals before year end, when the transition away from Libor is expected to occur, in order to avoid any temporary disruptions that may occur as a result of the change.

In asset-backed investments, senior aircraft-backed securities contributed marginally as they were held back on COVID delta variant-related news. We will continue to monetize aircraft EETC seniors as they tighten. Mortgage REIT preferred equity was driven by carry as more general performance in the space was mixed on the quarter.

Fund Outlook

Despite broader market volatility, structured product spreads remained remarkably flat through quarter-end. As we head into the year's final quarter, there are looming macroeconomic issues on the horizon, such as the potential breach of the US debt ceiling, which could generate significant market volatility. This potential for volatility could coincide with year-end, when balance sheet constraints typically drive forced selling from dealers and accounts, potentially leading to attractive entry points for the Fund. We see the Fund as positioned with a number of higher-quality assets that should not only prove defensive on a relative basis in a market pullback, but which could also be sold and replaced with more distressed assets should such a move occur.

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For Carry Assets / Distressed Resolution Strategies:
Unlevered Carry: This represents the model-based, loss-adjusted yield of the relevant assets before giving effect to leverage. This includes, without limitation, the effects of interest income and return of principal for assets at a premium or discount to par, as well as amortization of the premium or discount to par. The figure does not necessarily represent current period cashflow of the assets. For example, a zero coupon Treasury bill would contribute based on its yield to maturity despite making no interest or principal payments before maturity. The figure does not include any assumption of total return due to trading the relevant assets.

Unlevered Resolution Run Rate: This applies to strategies that generally do not derive the majority of their income from regularly scheduled payments but where the assets are purchased at a discount to fair value due to non-performance or reperformance of the credit. The Unlevered Resolution Run Rate represents the model-based rate of discount capture expressed as a percentage of dollar investment amount for the resolution of the asset. For example, for a non-performing residential mortgage loan, this would represent the modeled rate of return on assets invested from foreclosure sales, short sales, discounted pay-offs, and similar asset resolutions; this figure would not, however, include any assumption of total return due to trading the loans themselves.

Net Run Rate = Unlevered Carry + Unlevered Resolution Run Rate + Financing Cost (all represented as a percentage of investment amount)

Levered Run Rate (% Capital) = Net Run Rate x (Investment Amount / Capital Deployed)

Levered Run Rate (% NAV) = Net Run Rate x (Investment Amount / Fund NAV)

For Relative Value Strategies:
Run Rate (% Capital): Represents an expected rate of return based on historical performance for strategies for which relevant historical information is available or in other cases based on backtest or models. Performance is based on deployed risk capital. In contrast to Carry Assets / Distressed Resolution Strategies, this includes assumptions about total return due to mark-to-market and trading of the relevant instruments.

Run Rate (% NAV) = Run Rate as % of Capital x (Capital Deployed / Fund NAV)

For Shorts:
Short Notional Equivalents: Amount of credit hedges expressed in on-the-run HY CDX equivalent notional computed using model-based hedge ratios for each hedging instrument.

Run Rate (% Notional Equivalents): This figure represents the model-based, loss-adjusted hedging cost, including the effect of ongoing interest expense, expected credit losses, and amortization of the premium or discount to par. The figure does not include any assumption of spread widening or tightening (such as the effect of spread roll-down).