FRAZIS
• CAPITAL PARTNERS •

Dear investors,

Performance

This month we returned +0.84% net of all fees. This compares favourably to the S&P500, which was down -0.1%, and the ASX 200, which posted a -2.3% fall.

Key drivers were Alibaba (+0.8%), Whitehaven Coal (+0.5%), Persimmon (+0.4%) and Tata Motors (+0.39%). Our hedges were the main detractor from performance, costing (-1.26%). This was due to our volatility positions rather than the S&P 500 market hedge.

Portfolio

This was a period of low volatility in markets and low activity in the Fund. We made small increases to our hedges and closed our only short position in JD.com. This was fortunate as it has risen more than 10% since. Our loss here was mitigated by call options we purchased well above our entry price. We currently hold no other outright equity shorts.

We identified two excellent short candidates (the first with a busted business model, the second a likely fraud) but there were no shares available to borrow. We took profits on our long positions in German and Brazilian equity ETFs, but left a modest exposure exposure.

We initiated a position in CVRR, an independent petroleum refiner and marketer, operating full coking medium-sour crude oil refinery facilities in Kansas, as well as extensive pipelines and storage facilities. Refining margins have compressed in the US, but we expect inventories to continue to fall and crack spreads to normalise. CVRR is well-capitalised, extremely cheap, and pays out the bulk of its earnings above capital expenditure as dividends. It has one bond on issue due in 2022. While US crude and gasoline stocks are elevated, we have faith in the market's capacity to absorb the excess and revert to mean, which would be bullish for refining spreads and push CVRR from our $7 entry price to above $20. This is a modest position at 1.8%, and we may increase this to 2.5%-3%.

Valuation Multiples based on Current Capitalization

For the Fiscal Period Ending	12 months Dec-31-2015A	LTM 12 months Jun-30-2016A	12 months Dec-31-2016E	12 months Dec-31-2017E	12 months Dec-31-2018E
TEV/Total Revenue	0.3x	0.3x	0.35x	0.30x	0.31x
TEV/EBITDA	3.3x	7.7x	5.86x	5.35x	4.50x
TEV/EBIT	4.8x	22.0x	15.88x	9.34x	7.50x
P/Diluted EPS Before Extra	3.6x	40.0x	15.46x	9.90x	6.76x
P/BV	0.8x	0.8x	0.79x	0.78x	0.76x
Price/Tang BV	0.8x	0.8x	-	-	-

The Cash Dilemma

Our large short positions pose a dilemma. When you sell a stock short you receive the proceeds in cash. As a rough model of the portfolio, we are100% long equities, hedged by around 40-50% 'risk-off' positions. This means we have a large amount of cash that we would prefer to utilise. In a dramatic risk-off environment we intend to close our short positions at a profit, and this would require closing the cash investment as well, so we want as little volatility in this part of the portfolio as possible.

Our first instinct was to put it in Government bonds, but this brings questions of duration, i.e. sensitivity to interest rate risk. Bonds are currently yield so little that you need to extend far out in maturity to get any kind of return. An ETF holding short term US Treasuries yields about 0.11% - hardly enough to cover trading costs. TLT, an ETF consisting of Treasuries maturing in 20+ years (average duration of around 16), yields 2.2%, but has a duration of around 16, and thus may (temporarily) decline in capital value should rates rise.

There are good reasons to be long the back end of the Treasury curve, namely that it tends to rally when equities, real estate and other beta assets decline. 2% is a historic low, and frankly doesn't sound like much, but some other developed markets are at 0% or below. This kind of (parallel) movement in the US would result in a dramatic uplift in TLT. But 18% swings with 1% movements in rates are clearly inappropriate for the cash proceeds of short sales.

Corporate credit is another option. LQD is an ETF comprising of investment grade US corporate credits with a yield of around 3%. This is more interesting, but adds corporate default risk on top of duration risk. Interestingly it has zero correlation with the market, but this would almost certainly change in a risk-off environment. This has a place, but offers no complete solution.

We looked at high yield bonds, which have recovered somewhat after selling off over 20% earlier in the year. Interesting, at a 5% yield, but again a poor substitute for. This is a historically low yield but quite a typical spread.

We then took a close look at AGG, which is an aggregate of all bonds in the US, including Treasuries of all maturities, all investment grade corporate credit, as well as more exotic species like the bonds of various municipalities. There are over 4000 names in the index, but crucially some are risk on performers (treasuries) and some are risk-off performers (corporate credit). AGG offers over 2% with a fraction of the volatility of corporate or treasuries alone, and offers the maximum diversification.

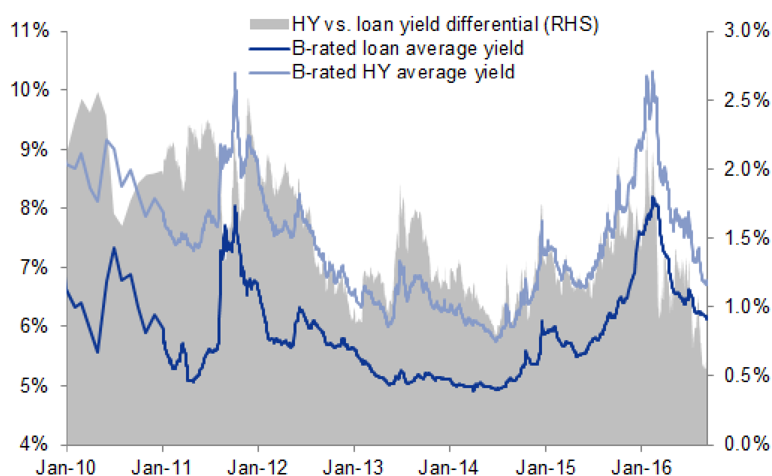
We thus ended up with the positions outlined below (which may change month to month). The vast majority is in AGG, with a decent position in treasuries to add some duration to the portfolio, as well as some positive-yielding negative beta.

For simplicities sake we are likely to exit LQD at an opportunistic time in the future and invest the proceeds in AGG. True to our aim to minimise unnecessary trading, we will do this at an opportunistically favourable time.

Ticker	Description	Yield net of costs	Volatility	Duration	Size	Volatility	Beta	Percentage of credit portfolio
SHV	The iShares Short Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities between one month and one year.	0.4%	0.1%	0.5	$3.3 billion	0.1%	0	0%
TLT	The iShares 20+ Year Treasury Bond ETF seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years.	2.1%	11%	18.2	$7.5 billion	11%	-0.5	19%
LQD	The iShares iBoxx $ Investment Grade Corporate Bond ETF seeks to track the investment results of an index composed of 1,624 U.S. dollar-denominated, investment grade corporate bonds.	3.1%	5%	8.6	$32.7 billion	5%	0	7%
HYG	The iShares iBoxx $ High Yield Corporate Bond ETF seeks to track the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds.	5.1%	6%	3.8	$16.9 billion	6%	0.5	10%
AGG	The iShares Core U.S. Aggregate Bond ETF seeks to track the investment results of an index composed of the total U.S. investment-grade bond market.	2.2%	3%	5.3	$41.1 billion	3%	-0.03	64%

Summary

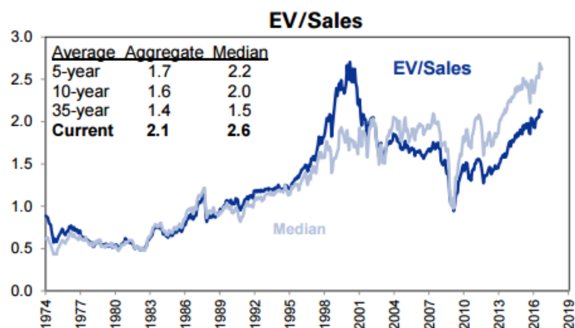
Today seems a poor time to be investing in bonds: credit spreads have compressed and the Fed is raising rates, with a 50% chance of a hike by the end of the year baked into markets. This suggests caution.

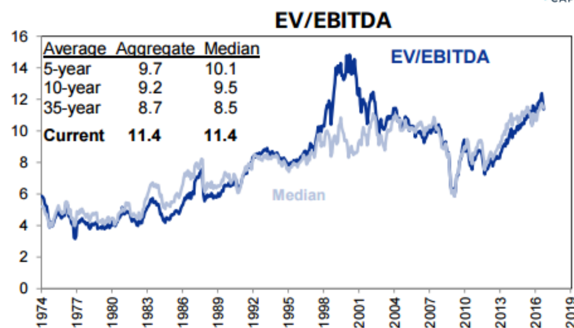


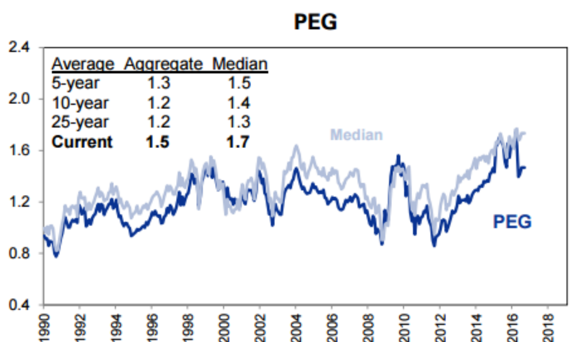
Source: Goldman Sachs Research

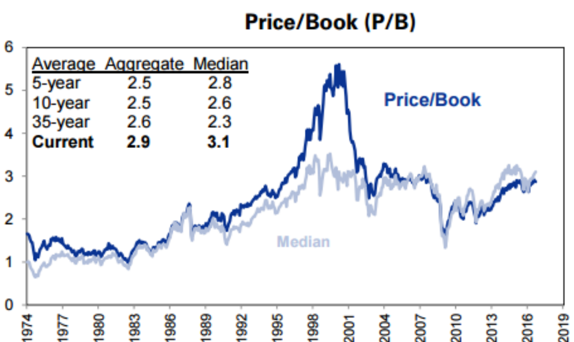
So why are we comfortable with this?

Quite simply the bonds make an important contribution to our portfolio exposure. Our most closely tracked metric is the portfolio's performance vs the US market, and despite being hedged aggressively we are still outperforming the market during rallies. This gives us comfort that we can risk and afford small losses in the bond portfolio in return for improved returns in the defining market scenario: a severe risk sell-off.









Source: Goldman Sachs Research

We maintain constant awareness of our place in the market cycle. We are at extreme valuations by any metric yet this is no time to be on the sidelines. We see incredible investment opportunities in a number of areas. This is an excellent environment for our strategic mix of hedges and long term investments.

Michael Frazis