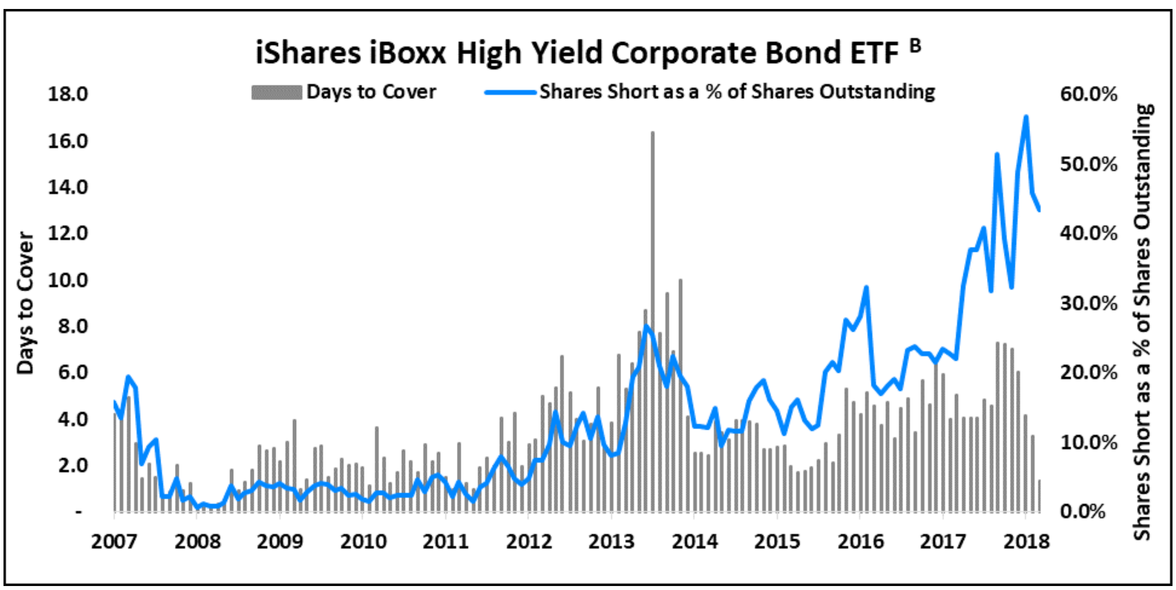
CrossingBridge Low Duration HY Fund (CBLDX)

Quarterly Fund Update: 4Q 2018

Trump-ed

In card games, “trump”[1] describes the suit that outranks all others; as a fund manager, I prefer diamonds, but as a hopeless romantic, hearts are fine too. A primary principal we embrace is “return of capital is more important than return on capital.”[2] In 2018, practically all major asset classes suffered declines. In 4Q18, the high yield bond market experienced the seventh worst quarterly drawdown in 25 years. During this period, we played a "trump card" in protecting investors’ capital.

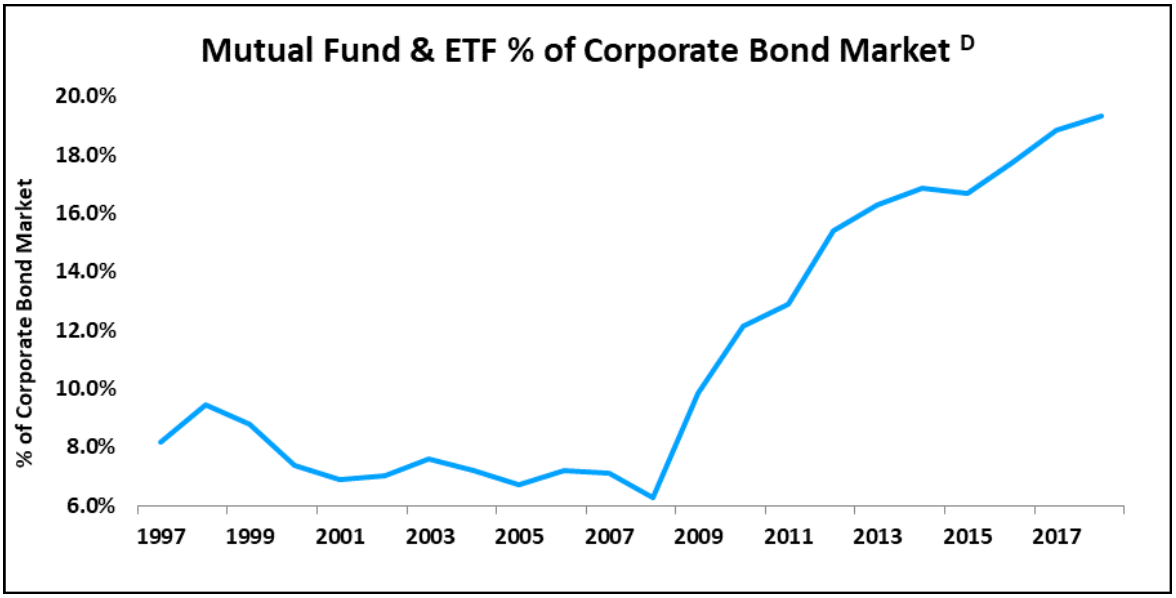
Timing was uncertain, but the dramatic widening of corporate credit spreads[A] was not particularly surprising to us. Throughout the year, we have warned of the deterioration in credit quality and covenants for leveraged loans, the looming risk in BBB credits, and aggressive corporate financial engineering in the face of investor complacency. Of course, the consistent pattern of tightening monetary policy or President Trump’s unconventional methods were unsettling to the markets.



[1] Derived from the Latin triumphus defined as “triumph, victory procession”

[2] www.cohanzick.com

In 4Q18, some investors expressed similar concerns by selling short over 50% of the outstanding shares of HYG[3]. Although bearish speculation and hedging was foreseeable, the magnitude of the shares shorted along with the trading volume to support this activity was surprising. While short interest rose to historically high levels, the days to cover[4] actually went down instead of up, to less than 2 days, as trading volume rose dramatically. Bringing this matter to the attention of Grant's Interest Rate Observer, we were quoted: "What if the volume dries up? It's going to increase volatility, and potentially drive a wider disparity between the underlying cash market and the ETF…I have more questions than answers."[C]

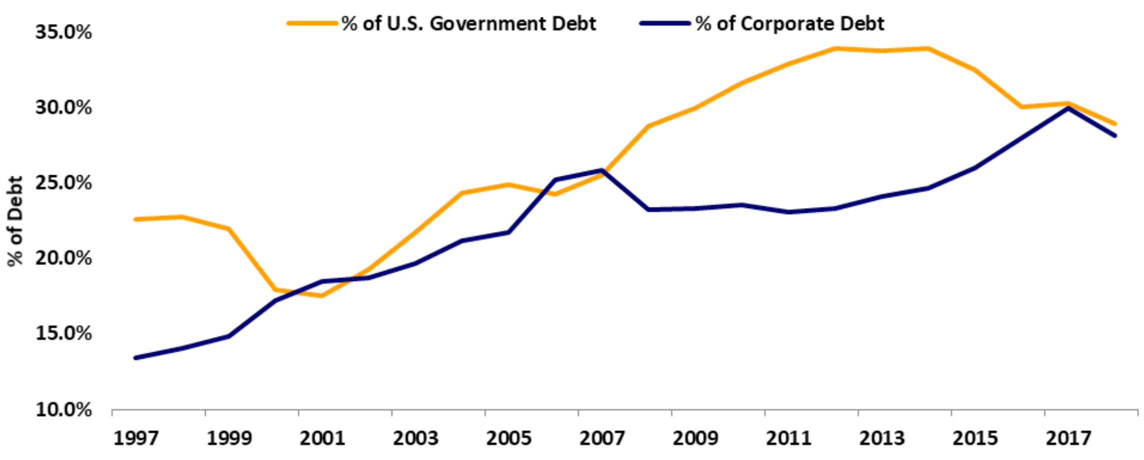


Concerns about the impact of a decline in trading volume become even more acute when one considers the dramatic growth of mutual funds and ETFs as holders of corporate bonds. Historically, insurance companies, pension funds and other financial institutions have been the largest holders of these securities. These institutional buyers have usually been willing to ride out fluctuations in interest rates and economic cycles because their portfolios were diversified and, typically, assets were matched against liabilities. Mutual fund and ETF investors generally have no such asset/liability matching strategy and these instruments provide daily liquidity. Thus, a negative turn in sentiment may cause these investors to reduce exposure rapidly, which may lead to disruption as supply exceeds demand.

[3] "HYG" is the symbol for the iShares iBoxx High Yield Corporate Bond ETF which is commonly accepted as a passive proxy for the high yield market. We believe that using HYG is a more applicable comparrison than a non-investible index as it is both investible and charges fees.

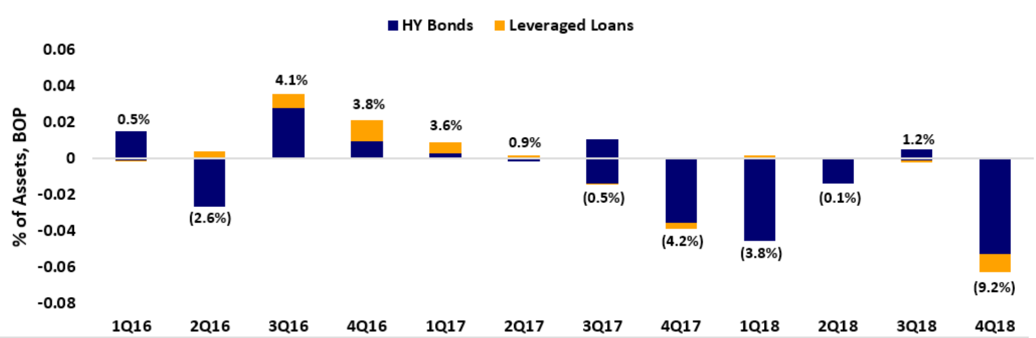
[4] Days to cover is the number of days it would take to close a short position based on average daily trading volume.

% of Corporate and U.S. Government Debt held by Foreigners [E]



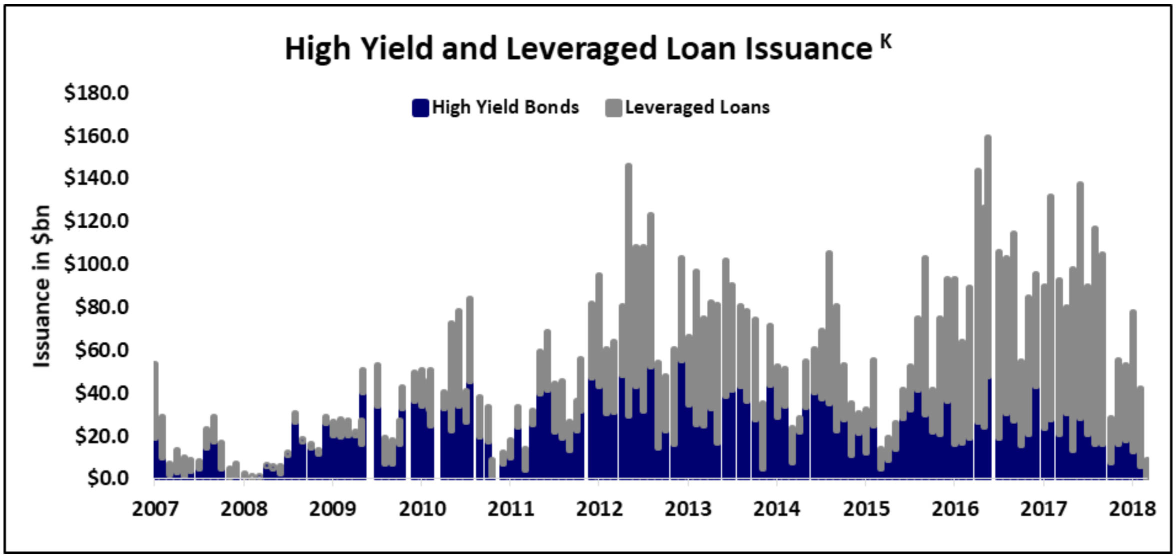
Similarly, foreign investors have increasing influence in the U.S. corporate and government bond markets. Today, foreign ownership of U.S. government and corporate debt is above 28% of each asset class.[F] Furthermore, China is the largest holder of U.S. government debt with approximately $1.14 trillion.[G] Tough talk on trade by President Trump may lead foreign investors to reduce their holdings of U.S. debt, which could cause future disruption to the markets.

Net Flow of Leveraged Loans and HY Bonds [H]



	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18
BAML US HY Index	3.2%	5.9%	5.5%	1.9%	2.7%	2.1%	2.0%	0.4%	(0.9%)	1.0%	2.4%	(4.7%)
CS Lev Loan TR	1.3%	2.9%	3.1%	2.3%	1.2%	0.8%	1.1%	1.2%	1.6%	0.8%	1.9%	(3.1%)

Regardless of the cause, the impact of capital flows on investment returns was particularly apparent in 4Q18. As shown above, the quarter saw -9.2% net outflows of leveraged loans and high yield bond mutual funds and ETFs. This resulted in the second worst quarterly performance for leveraged loans[I] and third worst quarterly return for the high yield bond[J] market since the Credit Crisis.



The sharp decline in net fund flows in the high yield and leveraged loan market also negatively impacted the ability of corporations to access the capital markets. As shown above, in December, new issuance of leverage loans fell to the lowest monthly level since January 2015. More astoundingly, the month also marked the first time since November 2008 when no new high yield bonds were issued. The decline in new issuance of high yield bonds in December coincided with a near absence of bonds that were called or tendered for by their issuers. Despite the dearth of such short-term investment opportunities, we were able to take positions in bonds of Gibraltar Industries[L] and Spectrum Brands[M], the only high yield bond issuers that, to our knowledge, announced calls during December.

HY Bond Spread Movement after Sharp Widening[N]

Option Adjusted Spread Movement (in basis points)

Widening Period			Next 3 Months	
Peak Date	Peak Level	Prior 3 Mos Δ in Spread	To Tights	To Wides
Aug-07	445 bp	+212 bp	-176 bp	-1 bp
Dec-07	564 bp	+195 bp	-22 bp	+58 bp
Jun-10	711 bp	+180 bp	-167 bp	-12 bp
Aug-11	714 bp	+245 bp	-210 bp	+51 bp
Oct-15	653 bp	+179 bp	-155 bp	-52 bp
Jan-16	755 bp	+203 bp	-221 bp	+17 bp
Average Spread Movement (OAS)			-159 bp	+10 bp
Dec-18	531 bp	211 bp	?	?

Previous market sell-offs similar to 4Q18 are often precursors to a reversal in the corporate credit market may provide a near-term opportunity. As shown above, the last six times the high yield bond market experienced a widening of credit spreads of approximately 200 bp, the following three months saw a narrowing of credit spreads to nearly the same degree. Thus, while some bemoaned the disruption, the market retreat also provided opportunity. Some investors felt compelled to sell at lower prices and corporations were forced to pay higher rates and provide better terms to prospective lenders.

Below are several examples of new positions established in 4Q18 where we took advantage of the market turmoil (with an emphasis on event-driven opportunities).

Gibraltar Industries – Gibraltar is a producer and distributor of building products that has debt equal to 2x EBITDA but has been holding enough cash to enable it to repay its debt fully. We had previously purchased Gibraltar's 6.25% Senior Subordinated Notes due 2021 for the Fund in early 2018 and continued buying throughout the year. As a result of the company's strong balance sheet, it came as no surprise on December 20th, when the company announced that it had decided to use the cash for debt repayment setting a redemption date for early February 2019. Even during a period with little or no new HY bond issuance, Gibraltar was one of the few HY bonds that were called during December.

DJO Finance[O] – On November 19, 2018, DJO, a producer of orthopedic products and medical devices, announced that it had agreed to be acquired for $3.15 bn by Colfax Corp, a provider of fluid and gas handling equipment and specialty valves. In the companies' joint presentation outlining the transaction, the companies indicated that all DJO debt would be repaid at the closing. Although we considered purchasing DJO's public bonds in anticipation of their retirement, we chose, instead, to buy the company's term loan due in 2020. With committed bridge financing in place, and, apparently, low regulatory approval risk given the different business lines of the two companies, the transaction appeared to have fairly low deal risk. Positioned at the top of the capital structure, the investment in the loan afforded us an attractive rate of return and the added safety of a secured loan, an investment we wouldn't mind holding even if the proposed acquisition failed to close. We began buying the loan for the Fund in November at yields around 5% but took advantage of December's weakness in the leveraged loan market to add to the position at annualized yields as high as 8%.

Momentive Performance Materials[P] – Momentive, a leading producer of silicone-based chemicals for use in a wide array of end markets, filed for bankruptcy in April 2014 and emerged in October 2014 having reduced total debt from $3.0 bn to $1.2 bn. Through strong operating performance and repayment of debt, leverage has been reduced from 4.1x when it left Chapter 11 to 3.2x in mid-2018. As part of the Plan of Reorganization, holders of Momentive's pre-petition secured notes exchanged their bonds into new 3.88% 1st lien bonds due 2021. Despite arguments by the secured note holders that the coupon on the new bonds was below market, investors that were providing $600 mm of new equity to the reorganized company convinced the court that the rate was the best possible estimate of the "market", forcing the 1st lien bondholders to take the new bonds in satisfaction of their claim. Although the company emerged from Chapter 11, holders of the 3.88% bonds continued to litigate based on their view that the coupon was too low. In October 2017, the Second Circuit Court of Appeals reversed the bankruptcy court's decision regarding the interest rate and remanded it back to the bankruptcy court to determine an appropriate rate of interest. The bankruptcy court heard oral arguments in August and September 2018 and its decision is still pending. Reportedly, however, the bankruptcy court judge has already tipped his hand that he is likely to revise the rate upward. It is our belief that the judge will increase the rate to reflect, at the very least, the rate at which J.P. Morgan initially indicated it could complete a financing. If the bankruptcy court rules in favor of a higher rate, the interest rate would be re-set and the incremental interest is expected to be "caught up". In September 2018, a Korean chemical company agreed to purchase Momentive for $3.1 bn. Due to change of control provisions of the company's debt, all outstanding debt will be repaid at par plus accrued interest when the sale closes, likely in 2Q19. Based on our view that the rate is likely to be increased and that the bonds are likely to be repaid when the sale of the company is completed, we began to purchase the bonds for the Fund at a calculated yield to redemption in the 5.0-7.5% range. We had been considering taking a position in these bonds for several months, but the market downdraft during the quarter brought out some sellers willing to take a lower price, making the potential return even more attractive to us.

In Conclusion

Card players are sometimes accused of having “a tell”, a gesture or voice inflection that gives other players insight into the strength or weakness of their hands. President Trump relishes his own unpredictability. Yet, as an outspoken public figure over many decades, he has provided an extensive record of his pronouncements on business, politics, culture, etc. As such, Trump’s “tell” is neither hidden nor unpredictable. For example, 30 years ago, Trump was quoted as saying, “I'm not big on compromise. I understand compromise. Sometimes compromise is the right answer, but oftentimes compromise is the equivalent of defeat, and I don't like being defeated.”[Q] So, it should come as no big surprise that at the time of this writing, we are in the midst of the longest government shutdown in U.S. history.

Investors are accustomed to the uncertainty of the economic cycle, the Federal Reserve’s constantly evolving monetary policy, and corporate earnings. However, the President’s actions have introduced new factors which may be positive in their intention, but also may be fraught with the potential for near-term pain and unintended consequences.

David Sherman and the CrossingBridge Team

POSTCSRIPT

In our 2Q18 investor letter, **"Float Like a Butterfly, Sting Like a (Triple) B,"** we warned that an influx of “fallen angels” might swamp the high-yield market. Within the first two weeks of January, Pacific Gas & Electric (“PCG”[R]), was downgraded to “junk”. PCG’s $17.5 billion of outstanding bonds would have represented approximately 1.24% of the ICE Bank of America Merrill Lynch U.S. High Yield Bond Index and would have become one of the top 5 issuers in the index. However, PCG announced that it would be filing for Chapter 11 at month-end, by-passing the high yield market index entirely.

Endnotes

[A] Bank of America Merrill Lynch 7-10 Year US Investment Grade Corporate Index option adjusted spread based on yield-to-worst at 9/30/18 was 129 bp, widening to 180 bp at 12/31/18. The Bank of America Merrill Lynch High Yield Master Index option adjusted spread based on yield-to-worst at 9/30/18 was 328 bp, widening to 533 bp at 12/31/18.
[B] Source: Bloomberg, analyst estimates
[C] Almost Daily Grant's, November 16, 2018
[D] Source: Morgan Stanley, Federal Reserve
[E] Source: Morgan Stanley, Federal Reserve
[F] Source: Morgan Stanley, Federal Reserve
[G] US Treasury Securities Foreign Holders China <HOLDCH>, Bloomberg
[H] Source: EPFR, Jefferies, analyst estimates
[I] The Credit Suisse Leveraged Loan Total Return Index
[J] The ICE Bank of America Merrill Lynch High Yield Index
[K] Source: J.P. Morgan
[L] As of 9/30/2018 our position in Gibraltar represented 2.26% of the Fund. As of 12/31/2018 our position in Gibraltar represented 1.84% of the Fund.
[M] As of 9/30/2018 our position in Spectrum represented 1.47% of the Fund. As of 12/31/2018 our position in Spectrum represented 2.79% of the Fund.
[N] Source: Bank of America Merrill Lynch Global Research
[O] As of 9/30/2018 our position in DJO represented 0.00% of the Fund. As of 12/31/2018 our position in DJO represented 1.42% of the Fund.
[P] As of 9/30/2018 our position in Momentive represented 0.00% of the Fund. As of 12/31/2018 our position in Momentive represented 1.56% of the Fund.
[Q] Life, Vol. 12 (January 1989), p. iii
[R] As of 9/30/2018 our position in PCG represented 0.00% of the Fund. As of 12/31/2018 our position in PCG represented 0.00% of the Fund.

Disclosures

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus contain this and other important information about the investment company, and it may be obtained by calling 1-888-898-2780 or visiting our website at: https://www.crossingbridgefunds.com/literature. Read it carefully before investing.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice. Fund Holdings and sector allocations are subject to change and should not be considered a recommendation to buy or sell any security.

*__Definitions:__ The **ICE BofAML 0-3 Year US Treasury Index** is tracks the performance of US dollar denominated sovereign debt publicly issued by the US government in its domestic market with maturities less than three years. The **ICE BofAML 1-3 Year US Corporate Index** is a subset of the ICE BofAML US Corporate Index including all securities with a remaining term to final maturity less than three years. The **ICE BofAML US Corporate Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. The **ICE BofAML 0-3 Year US High Yield Excluding Financials Index** tracks the performance of short maturity US dollar denominated below investment grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one month but less than three years remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and minimum amount outstanding of $250 million. It is not possible to invest directly in an index. The Chicago Board Options Exchange (CBOE) **Volatility Index, or VIX**, shows the market's expectation of 30-day volatility, and is a commonly used measure of market risk.

Mutual fund investing involves risk. Principal loss is possible. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. Because the Fund may invest in ETFs and ETNs, they are subject to additional risks that do not apply to conventional mutual funds, including the risks that the market price of an ETF's and ETN's shares may trade at a discount to its net asset value ("NAV"), an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact a Fund's ability to sell its shares. The value of ETN's may be influenced by the level of supply and demand for the ETN, volatility and lack of liquidity. The Fund may invest in derivative securities, which derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate. Derivatives can be volatile and involve various types and degrees of risks, and, depending upon the characteristics of a particular derivative, suddenly can become illiquid. Investments in Asset Backed, Mortgage Backed, and Collateralized Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments.

Diversification does not assure a profit nor protect against loss in a declining market.Diversification does not assure a profit nor protect against loss in a declining market. It is not possible to invest directly in an index.

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