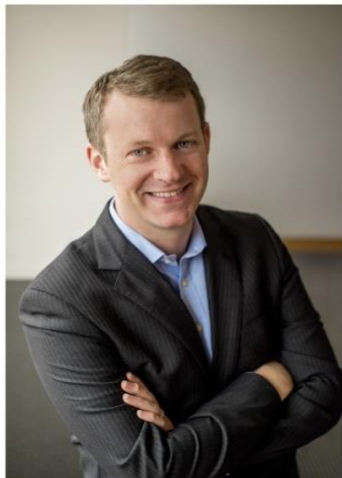
A3 FINANCIAL
INVESTMENTS

*Q1 2020 Commentary*

By Gregg Bell, Portfolio Manager of the A3 Alternative Credit Fund (AAACX)



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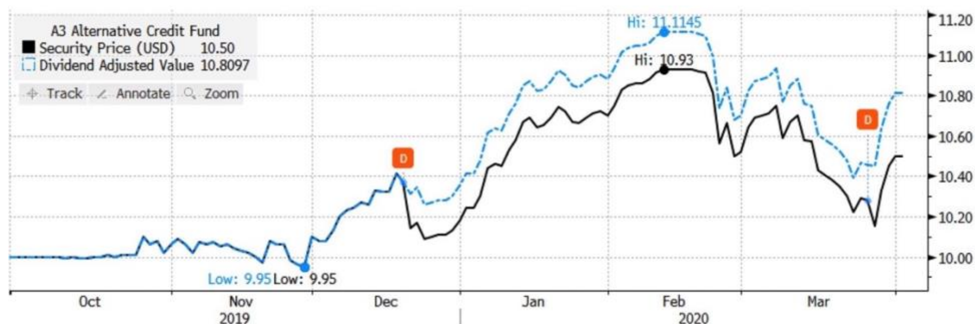
This has certainly been an extraordinary start to the year for the credit and equity markets. As the realities of the tragic, global spread of COVID-19 unfolded on investors, we saw some violent downdrafts and exceptional volatility. As you know, our focus at A3 Financial is on the credit markets and we believe we are moving towards a de leveraged environment with a premium placed on credit quality and cash flows.

## I. Performance

The A3 Alternative Credit Fund (AAACX) had a net return of 1.05% in March and returned 4.42% net for the quarter[1], outperforming the Bloomberg Barclays Global Aggregate Bond Index[2] which was down (0.33%) over the same 3-month period. The Fund had a 30-Day SEC yield of 9.10% subsidized[3] and 3.39% unsubsidized[4]. Since inception (10/1/19), the fund has a total net return of 8.10%[1]. We continue to operate without any leverage. Shown below in blue is the net total return for the AAACX fund with dividend events, as of March 31, 2020.



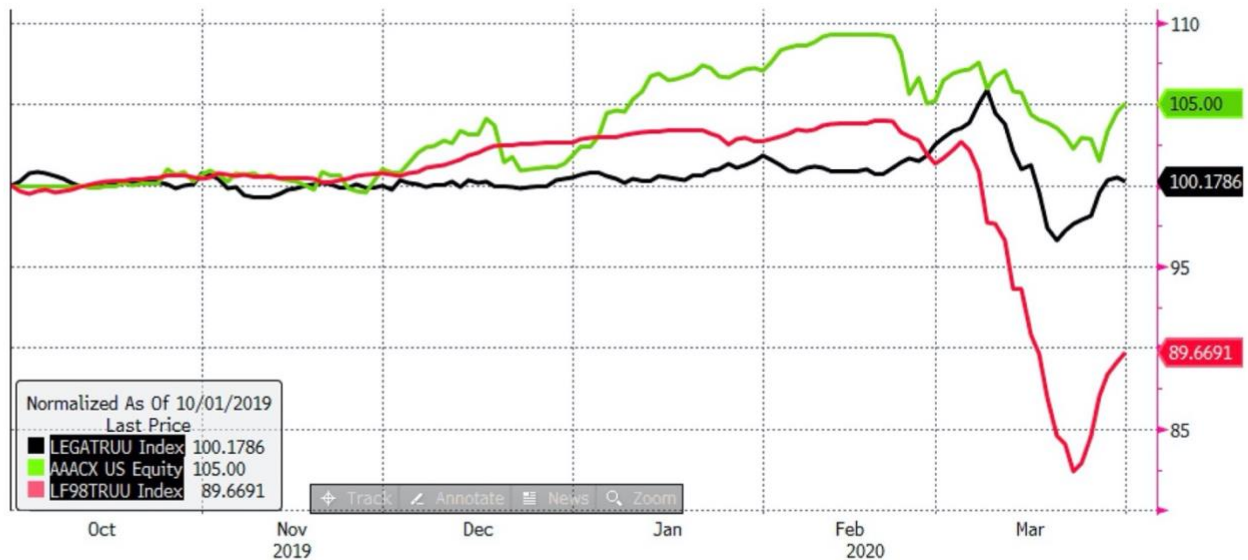

Source: Bloomberg, as of 3/31/2020

Returns for the quarter were led by the high-income characteristics of the portfolio, accompanied by outperformance in US Government insured reverse mortgages and the January rally in loans. During the quarter, we sought to reduce exposure to public markets and moved up in credit quality, having benefited from the early January risk-on rally. We increased our defensive core positions primarily in reverse mortgages and continue to see short duration, high income opportunities in loans to essential business models within the small-to-medium enterprise private sector. In times of uncertainty, we look for business's that benefit from government support of their cash flows. As of March 31st, 2020 the portfolio consisted of approximately 92.8% AAA rated government guaranteed securities[6]. The remaining non-rated securities do not necessarily indicate low credit quality, but are private in nature. The fund distributed its second quarterly dividend of $0.1259 per share on March 26th, representing a current distribution rate of 4.80%[8].

The longest bull market in history came to an abrupt end in late February, and drove a stampede into safe haven assets. The global collapse of cash flows resulting from COVID-19 has subsequently changed many of the fundamentals of credit investing. Our view is that we are experiencing a global cash flow shock, driven by combined negative consumer-based demand and just-in-time supply chain deterioration. The macro backdrop is largely negative and resembles a depression economy with global rolling shutdowns. We fear this cash flow shock will drive an unprecedented worldwide debt default wave in the coming months and is likely to stress the foreign dollar denominated debt markets which are negatively impacted by safe heaven dollar strength.

II. Portfolio Review

We took a variety of strategic steps in the fund throughout the quarter to reduce risk in an attempt to insulate the fund from deteriorating consumer and corporate cash flows. Concerns related to mounting job losses and business closures led us to exit nearly all investments that lacked cash flow support from a government source. Furthermore, we shortened the weighted average tenure of our direct loan portfolio to less than 4 months. Shown below is the price performance, excluding dividends, of the AAACX fund (Green), the Bloomberg Barclays Global Fixed Income Aggregate Index (Black) and the Bloomberg Barclays US High Yield Index (Red).




Source: Bloomberg, as of 3/31/2020, composed of A3 Alternative Credit Fund (Green), Bloomberg Barclays Global Fixed Income Aggregate (Black), & Bloomberg Barclays High Yield Index (Red).

As a core defensive position, we remain invested in U.S. Government guaranteed AAA rated home equity reverse mortgage positions, which now represent a healthy portion of our book. Our confidence in these notes is based on a long history of research and ownership of a niche asset class that is not dependent on cash flow and is fully insured against home value loss and default. The asset class has been historically challenging to lever, due to its small market capitalization and coupon accrual, an attribute which we believe insulated it from the forced sales seen in this recent deleveraging.

Unlike traditional mortgages and most credit products, which are dependent on borrower payments, home equity reverse mortgages are uniquely suited to withstand this period of cash flow shock because they are not reliant on a borrower's ability to repay the debt on a monthly basis. With a reverse mortgage, the homeowner does not make monthly payments, but instead capitalizes the accrued interest resulting in a single debt repayment of all of the borrowed principal and interest at maturity which is typically accompanied by a home sale. This payment is guaranteed by the U.S. Government against home value loss at sale and default.

CLO debt and equity exposures, which consist of high cash flowing structured corporate loan securities, contributed materially to January's positive 5.11% net return. The S&P Leveraged Loan Index, a benchmark for collateralized loan obligation ("CLO") collateral, ended 2019 at 96.72% of par, up from a November low of 95.35% of par. The October/November decline in loan prices seeped into US CLO debt tranche pricing, as lower loan prices caused a decrease in equity NAV as well as market value coverage ratios, which are both important valuation metrics used to determine CLO pricing. As a result, we saw an increase in secondary supply of junior debt into Q4 2019, furthering a supply/demand imbalance and creating what we viewed as an asymmetric risk reward market entry point. As a result of the loan selloff and subsequent recovery in January, the median CLO equity NAV increased from approximately 35% of par as of Nov 4th 2019 to 51% of par as of January 2nd 2020 according to Wells Fargo Research.

Price appreciation was captured throughout late December and January. Capitalizing on the rally, we repositioned up in credit during January only to soon thereafter fully exist all exposure to CLOs. This decision was based on observed volatility in the underlying leveraged loan market in late February. Our decade long experience with the CLO market, has taught us that in stressed markets, the asset class sells off indiscriminately followed by a repricing of risk and leverage as the dust settles and security differentiation based on fundamentals returns. A repricing of credit in the repo market was the first sign which was followed by margin calls. These things then feed upon themselves driving rapid deleveraging, risk aversion, spread widening and ultimately defaults, which are still to come.

III. Where We Go From Here

As we look ahead, we remain wary of increasingly present "false yield", found where cosmetically high stated yields are unsupported after taking into consideration default assumptions. The depth of the economic contraction is still yet to be seen, but our view is that this market correction is likely to be the most rapid economic slowdown of our lifetime and we will look to remain defensively positioned until default risk materializes.

Unique opportunities nonetheless exist today in niche markets, as market participants delever, shedding income producing assets. We seek to increase our defensive core positions and continue to see short duration, income opportunities in reverse mortgages and private loans where unique credit fundamentals can support returns during extremely turbulent market environments.

Many investors have been searching and often stretching for yield over the last decade; the last month has shown just how volatile and negative certain fixed income holdings can be. I am sure very few investors in some of the largest credit funds out there understood that their value could plummet 20% in a very brief period. As we move through the next phase of the credit cycle, we believe that we have the experience and strategy to continue to protect capital and provide quality yield to our investors. Thanks to our current investors for your investments. For those of you new to A3 Financial, please look at our track record and consider AAACX to help you in your search for income. We would welcome the opportunity to discuss our approach with you.

Sincerely,
The A3 Financial Team

**Come Meet Us Online:**
Join our Webinar: Tuesday April 14th, 1pm EST. Email us at IR@A3.Financial for an invitation.

**Reading Recommendations:**
- *The Fourth Turning: An American Prophecy*, by William Strauss, Neil Howe - on demographics and social change
- *The Tipping Point*, by Malcolm Gladwell - on exponential spread and epidemics
- *Debt*, by David Graeber - on history of credit collapse

1 Inception date is October 1, 2019. Returns are net total returns. Results are unaudited.
2 "Rating Exposure" reflects the underlying securities nationally recognized statistical ratings organization's credit rating.
3 "30-Day SEC Yield (subsidized)" is an annualization of the Fund's total net investment income per share for the 30 day period ended on the last day of the month and reflects any net fees waivers and reimbursements in effect during the yield calculations period.
4 "30-Day SEC Yield (unsubsidized)" reflects the 30-day yield if the investment adviser were not reimbursing the fund for part of its expenses or waiving all or part of its fee.

The returns quoted present past performance. The performance shown is net of all fees (including a monthly advisory fee of 1.50% per annum) and expenses and reflects the reinvestment of dividends and investment income. Depending on an investor's investment date, holding period and other factors, an investor may have an overall performance that underperforms or outperforms the data shown.

Inception date for AAACX is 10/01/2019. Returns greater than one year are annualized. Current performance may be lower or higher than the performance data quoted. Investment return and principal value will fluctuate so that shared, when redeemed, may be worth more of less than their original cost.

Management fee: 1.50%
*Net Expense Ratio/ **Gross Expense Ratio: 3.30%/3.40%
***Expense limitation: 1.95%

*The Net expense ratio reflects the reduction of expenses from fee waivers and reimbursements. Elimination of these reductions will result in higher expenses and lower performance. These reductions are contractual and will continue until at least 9/12/2020.
**The Gross Expense Ratio reflects additional expenses embedded in the Fund's performance, such as the indirect costs of investing in other investment companies.
***The Adviser has entered into an expenses limitation agreement to pay the ordinary operating expenses of the Fund that exceed 1.95% per annum.

The AAACX prospectus is available here.
The A3 Alternative Credit Fund is a continuously-offered, non-diversified, registered closed-end fund with limited liquidity.
Distributor – Foreside Fund Partners LLC

Past performance is no guarantee of future results.

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