FULCRA
ASSET MANAGEMENT INC.

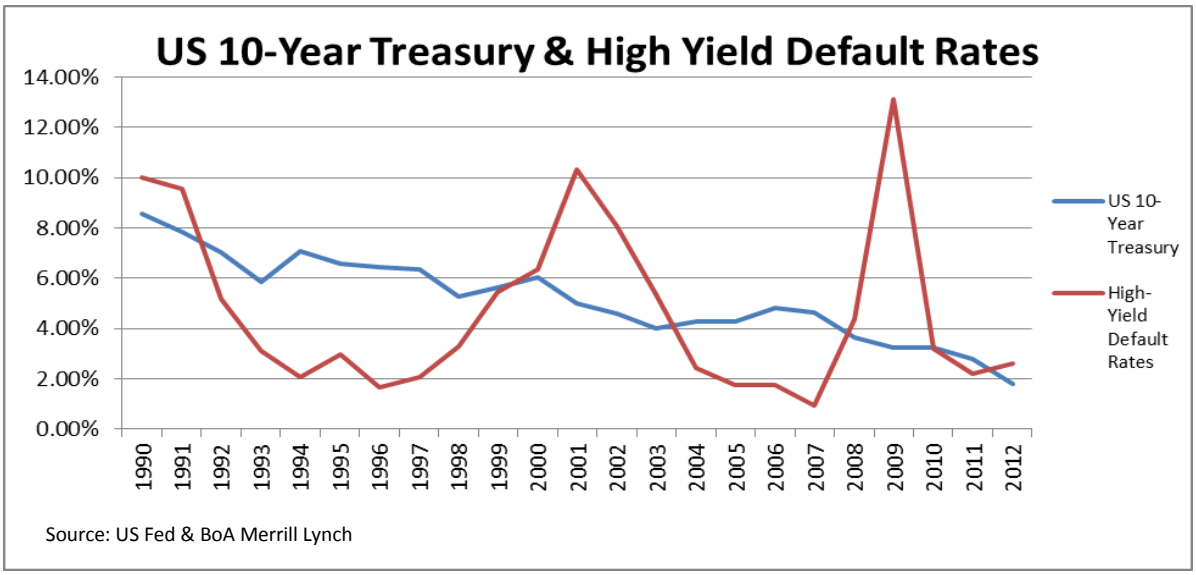
Fulcra Focused Yield Fund – Q4 2012 commentary

With 2012 behind us it would seem appropriate to reflect on the year that has passed and provide our crystal ball view (sic) for 2013. Unlike US politicians, which according to Bloomberg Businessweek "…spent upwards of an entire year and $5 billion on elections that achieved approximately nothing"; the Fulcra Focused Yield Fund generated a net return of 7.35%[1] in 2012.

As an opportunistic credit fund, we are agnostic to credit ratings and also invest in different parts of a company's capital structure – whether it is a loan or a convertible bond that we create ourselves. Of the bonds/loans the fund is invested; 45 percent are investment grade and 55 percent are non-investment grade. The overall duration of the fund is 2.5 years and the cash balance averaged a little over 20 percent throughout the year.

Looking out over the horizon, your typical investment grade corporate bond funds, which are benchmarked against the 6.9 year duration DEX Universe Index, are very exposed to a spike in government bond yields; more so than any time in history given the all-time low yields they currently sit. Specifically, the DEX Universe Index yields approximately 2.4 percent to maturity. Furthermore, the 3.8 trillion dollar Bank of America/Merrill Lynch investment grade index in the US has a yield to maturity of 2.75 percent and a duration of 6.8 years. These low yields, and the certainty that this is the best return you will receive over the next 7 years is far too dependent on the assumption that interest rates will continue to stay low.

While much debate ensued over the US's fiscal cliff, we think an ascent of one or more of the following: interest rates, default rates, and taxes pose a real risk to the economy and market. As you can see in the graphs below these are all close to if not at their all-time lows. Eventually, something will give and the re-pricing of securities may be abrupt.



[1] Fulcra Focused Yield Fund class B

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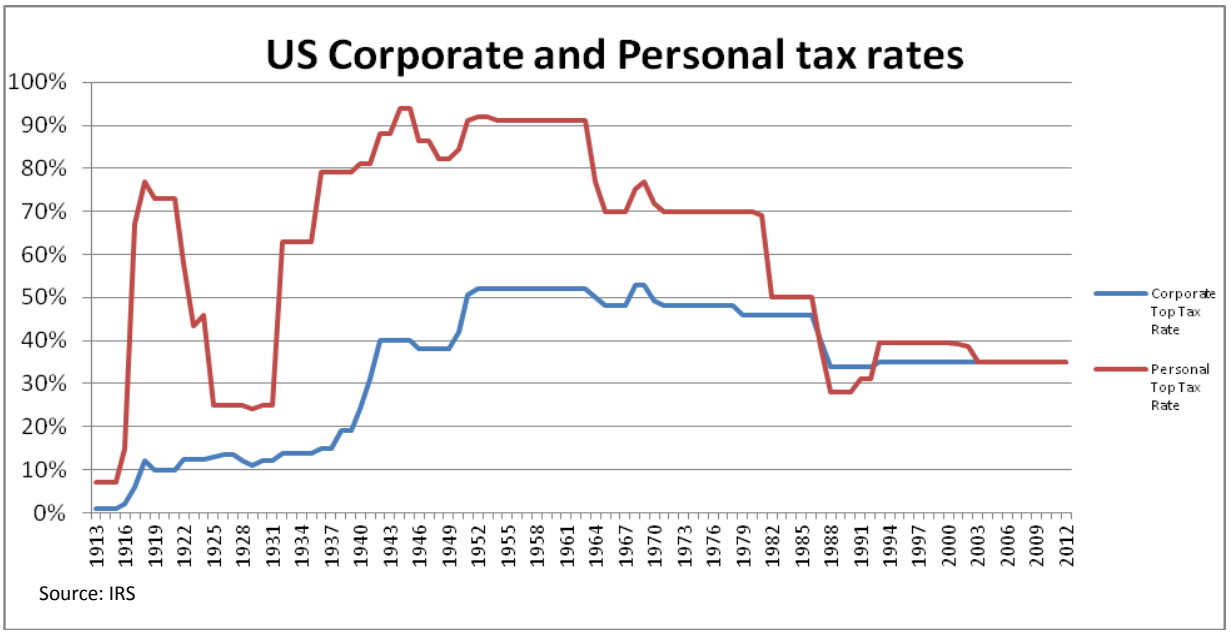

Don't ask us when any one or more of these variables may increase. What is clear, however, is that preserving capital from these potential head winds takes precedence above everything else.

We believe we can still earn adequate returns of 5 to 7 percent by continuing to utilize a broad mandate of ratings and security selection flexibility. One such example was the purchase, in September 2012, of an investment grade utility bond with a maturity in April 2013. The yield to maturity, for 7months, at the time of purchase was 3.4 percent. However, the company decided to tender for these bonds before maturity and our return got bumped to 5.25 percent ... while also getting our money back sooner.

In the past we have commented on the attractiveness of investing in floating rate loans due to their position in the capital structure (at the top) and lack of interest rate sensitivity (coupon increases with interest rates). We continued to add to loans in the fourth quarter and by year end they represented 12 percent of the fund. While loans have seen a recent increase in popularity we are still finding select opportunities that meet our return requirements.

Best Regards,

Matt Shandro
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