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"Everything is fine today, that is our illusion." – Voltaire

Voltaire, the 18th Century French philosopher couldn't have said it better. While he wasn't referring to the monetary and fiscal induced sugar high that the Western world has been experiencing over the last year, it does, in our opinion, summarize it well. The illusion, of course, is what the next few years have to offer in terms of economic growth. We don't think economic growth will be able to attain the pace it did prior to the beginning of the financial crisis in late 2007.

Similarly, the default rate of corporate bonds which reached a record 13.7% in 2009 is now on pace, according to Fitch Ratings, to reach just 1% in 2010. Without the monetary stimulus, through low interest rates and quantitative easing, many companies would not have been able to refinance debt to a longer maturity date. This low default rate highlights how sensitive the high yield bond market is to macroeconomic and capital market developments. For many corporate entities this monetary stimulus has provided an "illusion" that everything is fine.

While a forecasted default rate of 1% might suggest a narrowing in spreads, recent volatility of some sovereign credits (i.e. Greece and Spain in particular) has increased the risk premium of many asset classes, including corporate bonds which have increased 60 and 150 basis points over the last 2 months for investment grade and high yield respectively. The fund was able to offset these negative macro forces by owning US and CAN government bonds and S&P 500 puts. However, we were able to take advantage of lower prices during this period and added to our positions in National Money Mart 10.375% bonds due 2016 and Capital Source 12.75% bonds due 2014, which we'll speak to in greater detail below.

Capital Source is a commercial lender in the US that focuses on lending to middle market companies. The bonds the fund owns were issued in the 2nd quarter of 2009 to refinance maturing debt. Unfortunately for the company but fortunately for investors, Capital Source had to provide a lot of collateral and a high coupon to get the deal done. As you may recall, the 2nd quarter of 2009 was not exactly the best time for companies to be tapping capital markets. We are, however, quite happy that Capital Source issued this $300 million bond as it is secured against a pool of loans that is 13 times the size of the bond issue. The company also owns an exceptionally well reserved bank so that it can fund its loans through deposits opposed to the securitization market. The level of reserves it holds against its loans is double that of bigger banks and the loans that the company has been underwriting recently are to borrowers with above average credit metrics and at higher than historic interest rates as many competitors, including big banks like Chase and Bank of America, keep lending volumes low.

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Capital Source may also, if loan growth picks up, look to refinance the bonds the fund owns in order to spread the collateral over a larger bond issue. If management decides to refinance these bonds, which aren't callable, they could be tendered for 20 points higher than where they are trading today. While the bond is currently yielding 9% to maturity we are getting paid very well to own a secured bond where we do not have to pay (i.e. give up yield) for the refinance option.

The fund has completed its first year and we would like to thank the funds' investors for their support. If you have any questions or comments, please do not hesitate to contact me.

Regards,

Matt Shandro

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