

Annual letter to the co-investors of SIH BrightGate Global Income Fund

15th January 2021, Madrid

“All of humanity’s problems stem from man’s inability to sit quietly in a room alone”

Blaise Pascal, Pensées, B139.

Dear co-investors,

First of all, we hope that you and your families are well. BrightGate Capital sends a warm hug to all of you during these difficult times, and we hope that you, your family, and your friends have not been affected.

We would like to start with a quick summary of the fund. The fund closed on 31st December 2020 with a NAV of 118.93, which represents a net annual return of 4.5%. The fund was launched on 14th October 2013, and the annualized return since its inception has been 2.5%. The ISIN codes for the different classes of the fund are LU0942882589 (class A) and LU1984948874 (class F).

The philosophy of the fund is Buy & Hold, with an investment mandate in global credit with low durations, generally below 3. The portfolio is currently relatively concentrated, between 40 and 45 positions, and gathers our best ideas, which we believe offer a more attractive risk-adjusted return than the average credit found in today’s High Yield (HY) markets. Although we like to hold the positions for as long as we can, our fund in this respect is not a traditional Buy & Hold fund, where positions are bought and held until maturity, but rather we constantly assess our positions against the price at which they are quoted and the performance of their business fundamentals. In the current climate of narrow credit spreads and low interest rates, we believe that traditional Buy & Hold strategies are poor candidates for any investor’s portfolio, given that elevated valuations make it difficult to reinvest coupons, and interest payments are used to buy increasingly expensive bonds. We believe that the correct reinvestment of coupons is an important, and very often unappreciated, source of long-term profitability; our investors can be assured that a large amount of our attention is dedicated to this task.

With regard to the currency hedging policy, the portfolio was completely hedged at the end of the year. We do not expect changes in the hedging policy for 2021. Now, we will review the year 2020, how we see the markets, and what our main positions are for 2021.

A few thoughts on 2020

Given that 2020 will go down in history as one of the darkest years for world economy, and at the same time one of the most “idiosyncratic” (to put it mildly) for financial markets, we could expand on this part of the letter explaining our “outlook” or our vision of the world. However, given the length and number of issues we shall address in this letter, we shall leave it for another time. It suffices to say that many of the trends which we have been witnessing in recent years, especially the unequal distribution of income and wealth and the dysfunctional performance of various Western democracies, accelerated in 2020. These

factors, which we do not expect to change, together with others such as i) wages that will remain depressed for many years, ii) lax corporate tax regimes, iii) low interest rates for a long time, and iv) continuous (and exponential) technological progress, make us expect a strongly deflationary environment with extreme valuations. Although the persistent deflation we will live through for the next few years will somewhat sustain valuations (of both equities and fixed income, which is what we are concerned with here), we believe that the prices of various asset classes are on absolute *terra ignota* – far above the scenarios we considered a year ago in this same letter.

From a management point of view, I believe we have learned a lot from this year, which has been equivalent in terms of lessons to several years combined. In particular, we are going to highlight three conclusions which we have drawn that we think are interesting and that will have a fundamental impact on the management of the fund from now on.

The first conclusion is that a slightly greater concentration of the portfolio will help us in our return objective and allow us to focus on our best investment ideas. The volatility we have experienced in 2020 and the impact of the economic crisis has clearly taught us that our main positions (which are obviously our best ideas) have performed better than those credits in which we had smaller positions. We now aim to have 40-45 different issuers in our portfolio, down from the 50-55 we had been managing before. We believe that such a level of diversification will remain prudent for a fixed income fund. An additional advantage of this new focus is that, in environments with few good investment ideas such as the current one, it allows us to be more selective and to “pass up” on more mediocre investment ideas. Lastly, this focus has allowed us to have the lowest portfolio turnover levels in the history of the fund, despite a year of extreme price variations between stocks. In this respect, Pascal’s quote in the heading sums up these ideas perfectly.

Secondly, we have thought sufficiently about *the relationship between credit ratings and the yields that different bonds earn over an economic cycle*. There is now considerable [rigorous research](#), (and [here](#)), which shows that, although lower credit ratings in principle have higher yields on paper, realised yields are much lower, due to their high default rates and low recovery rates. How much lower are these yields? Roughly lower enough that on average *the CCC credit index earns less (and with higher volatility) than the BB index over an economic cycle*. Conversely, many BB credits usually end up in the promised land of investment grade, and the capital gains in these cases [are not insignificant](#). This kind of perverse effect is rightly called *fool’s yield*. Although one of the reasons for the existence of this effect is the human cognitive bias to estimate more positive default and recovery rates than there end up being, we believe that further research is required to show whether this effect has always been present (not just in recent decades) and will exist in the future. In any case, given that we do not wish to be the *fools* of the party, we have included these conclusions (and some others from additional papers) in our investment process and, as a consequence, we expect the credit rating of our stocks to rise gradually in the next few years. This migration will also be easier for us to implement given the more concentrated nature of the fund, making the task of looking for undervalued credits in the BB/B spectrum less demanding. We have been applying this philosophy for months now, which has led us to buy (and overweight) credits with these traits, such as Turning Point Brands, CoreCivic, Ulker Biskuvi, BofA, and Syngenta.

Finally, we wanted to briefly mention the topic of the management of the duration of the fund. The fund was originally created as a *Buy & Hold* mandate five years ago and in 2017 we decided to extend it with no fixed maturity date, while maintaining the short duration spirit— ideally below 3, which roughly translated into credits with maturities below five years, given the high coupons in our fund. Since then, the average duration of our fund has been 2.7 – and remember that this is not a made-up duration, as we have never taken a short position on any loan. We now believe, however, that such a restriction is artificial, and we expect to have more flexibility in this regard moving forward. You may be wondering what the point is of wanting to increase duration when interest rates are at an all-time low and most of the “duration cycle” we have experienced in recent decades has already run its course. Firstly, we are not expecting much change in the fund duration in 2021, and we aim to be in the range of 2.7-3.2, which is still a low range in comparison to the average fixed income fund. Secondly, the reason for increasing the duration is basically to have the flexibility to be able to move into the longer maturities in credits which we know when there are sharp price shifts, as has been the case this year. To give an example, this year, the bonds of the agricultural company MHP, which we have been invested in for over three years, were heavily impacted during the strong sell-off in March and April. Given the stable behaviour we saw in grain prices and the good behaviour of proteins (due to the African Swine Fever outbreak in China), we knew that, in this case, business fundamentals were not a problem and we decided to increase the position. MHP has three bonds issued, to 2024, 2026 and 2029. While the bond to 2024 was trading at 77 at the trough of March, the 2029 bond was trading at 68 – a difference of over 10%. Optically, the difference in yield to maturity between the two bonds was not so large, since the MHP curve was fairly flat (both were trading at similar yields and above 10%). However, today the 2024 bond is trading at 109 and the 2029 bond at 103, which represents a gain of 41% for the 2024 bond and 52% for the 2029 bond. In a world of abysmally low returns, we believe that a 11% difference leaves a lot of money on the table, and it is for these kinds of one-off opportunities that we expect to use this additional flexibility.

Commentary on the main positions

Going into more detail in the composition of the portfolio, the percentage invested is higher than last year, in part due to our policy of greater concentration and the greater number of investment opportunities in sectors other than oil production, which was where we had most exposure a year ago.

As we mentioned in last year’s letter, we still believe that current valuations, both in fixed income and equities, are unparalleled throughout history, with returns in the long run poised to be mediocre. In fact, all the events of this year, as well as the additional appreciation of the main indices, have only reinforced our view. Given that the portfolio’s turnover during the year was the lowest in the fund’s history, our task of credit searching during the year focused on defensive businesses (protein, energy infrastructure and consumer goods) yielding reasonable returns, which can protect us from both an eventual rise in rates and from a potential widening of credit spreads.

The fund’s main investments at the end of the year are listed below, in terms of weight in the portfolio. We have grouped some of them thematically, as we believe that it will facilitate the overall understanding of the portfolio:

- Energy infrastructure (Teekay LNG, Enbridge, Brooge Energy, PBF Logistics, Peru LNG, Navigator Gas):** between these businesses, the fund has the highest exposure per theme, at 15.4%, and no single name exceeds 3.5%. Although for convenience we have put them in the same group, it is important to note that the dynamics of these businesses are very different, as the transport of liquefied natural gas (Teekay LNG) has nothing to do with the storage of crude oil (Brooge Energy), or with its own transport (PBF Logistics, Enbridge), to give a few examples. Most of these credits are old friends to our participants, as we have invested in them successfully for many years. In these credits, and against our expectations, their balance sheets have surprisingly improved over 2020, either because of the stability of their cash flow (fixed by contract in many cases) and ability to continue repaying debt (PBF Logistics, Teekay LNG) or simply because of corporate news or particular milestones reached for the company in question (Navigator Gas). The two incorporations this year have been Peru LNG, which we bought at the low point of the crisis, and Brooge Energy, a United Arab Emirates company dedicated to the storage of crude oil and which held its inaugural issue a few months ago. For the latter, we expect to be investors for several years as it is a recurrent business, with a certain visibility, a conservative balance sheet and whose bonds present high yields. Given that it is a credit from a lesser-known area, we expect most of our earnings to not come through capital gains, but rather through coupons.
- Oil producers (Siccar, Okea, DNO, GKP):** one year later, we have an important exposure to oil producers, around 8.5%, which is distributed fundamentally among four names. Compared to other years, our exposure to this group is smaller, as we have found opportunities in other sectors (such as the infrastructure companies mentioned above), as we considered wise to diversify our risk. Despite us seeing the pandemic coming in February and sold several of our energy positions before, of our remaining positions the worst performers were (obviously) those with the worst balance sheet, and so we have decided to improve the average credit quality of this block. Although on average our investments in energy have been profitable, this year we have learned that sacrificing a few yield basis points at the time of buying (yield which does not always materialise) is worthwhile in exchange for a better balance sheet. In the particular cases of DNO and GKP, we have decided to change credit risk (both companies have a net financial debt of zero) for geopolitical risk (both companies have their assets in the Kurdistan region of Iraq, although it is worth noting that the Kurdish government has paid the companies on time in the last few months, and the relationship in general has been very good in recent years) and for higher quality assets, as the extraction costs of both companies are one of the lowest in the world, below \$10 a barrel. In the case of Siccar and Okea, credits we already had in 2019 (although we were able to sell Siccar before March and bought it back), both operate in the North Sea with low costs, as offshore assets tend to have lower operating costs once the initial high investment has been carried out. We believe that both companies still have some way to go, their bonds have generous coupons, and they can cover debt without difficulty, which is also spaced over time, in a Brent environment of \$50.
- Thermal coal (Alliance Resource/Consol Energy):** in our last letter sent in April, we wrote that “we believe that the opportunity to close returns above 20% [...]

on businesses which under normal circumstances would generate an abundance of cash [...] is one of the greatest cognitive dissonances we have seen in all the years that we have been investing in the debt markets". Several months later, and with thermal coal prices sufficiently recovering from lows (Newcastle 6000 kcal is around \$85 as we write this) the market seems to be realizing that the US companies Alliance and Consol will be among the survivors at the end of this cycle. Despite 2020 being the worst year in history for US thermal coal, at the end of September both companies had managed to weather the storm reasonably well, with a neutral cash flow generation in the case of Alliance, and negative but manageable in the case of Consol. In the latter's case, there have been a couple of corporate transactions (the sale of non-core assets and the merging of CCX and CEIX, which gives us 100% of the Pennsylvanian mining complex) which have brought some value to the surface and have allowed the bond asset package to be larger than it was a year ago. Remember that both companies have historically generated average returns on their net operating assets in the mining business of 20% in the case of Alliance, and 13% for Consol, earning thus more than their cost of capital, and they should have no problem in repaying their debt in the future. Additionally, Alliance has a small royalty business in the main US oil basins (Permian), which provides extra diversification, which is beneficial to us. Between the two companies we have a 7% weighting, and, although their bond prices have recovered significantly in the last three months, we believe they continue to trade at an unjustifiable discount to the indices, and we still believe, both in relative and absolute terms, that they remain great investment opportunities. For 2021, we expect higher gas prices than in the last few years, in the range of 2.75-3 USD, given the closure of much non-conventional oil production in the US (which was also providing natural gas), and in this scenario the coal producers should be able to generate copious amounts of cash. Turning to the supply side, the permanent closures of many coal mines, not only in the US but also in other large producing countries such as Colombia, will further help our investment thesis. The lack of high-quality thermal coal worldwide has become clear recently in China, where in the harshest winter months, electricity (and coal) prices have shot up and there have been recurring power cuts, both due to the lack of imports (partly caused by diplomatic tensions with Australia) and due to the inability to rapidly increase local production – which, furthermore, is often of poor quality for Chinese utility companies.

- **Turning Point Brands:** Turning Point Brands (TPB) represents 5.6% of the current portfolio, the largest position we have ever held in the fund, and which would have been higher had it not been for the gradual cuts we have made to the position recently after its sharp rise. As you will recall, TPB is a US company dedicated to the manufacturing, marketing, and distribution of tobacco products, specifically rolling paper (through the iconic Zig-Zag brand) and chewing tobacco; TPB's products operate in the low-cost segment, in comparison with its larger competitor, Altria. The price environment in the US tobacco sector since the 1990s has been extremely rational, years in which price wars ended and Altria assumed the role of the leader in setting prices. Since then, Altria has consistently increased prices of traditional cigarettes every year by about 6-10%. These dynamics of conventional tobacco will favour the chewing tobacco segment (which, although has not had such robust price dynamics, has still remained favourable) where TPB operates with its more affordable

products in competition with Skoal and Copenhagen, both Altria brands. Finally, TPB has an electronic cigarette business which started to grow a few years ago after a string of purchases but was impacted strongly by the news of deaths in the US and the bad press of JUUL. Since it has been proven that closed system e-cigarettes were not the cause of the deaths, and that in general they are a much healthier alternative to conventional cigarettes, the vaping market is growing again, and this time in a much more rational way, with the exiting of many producers who have not been able to comply with the new rules of the FDA. Our investment in TPB is through convertible bonds. Although the bond's yield to maturity is currently zero, we believe it still presents an attractive optionality to the price of the underlying asset: given that the bond matures in 2024, there are still years left to increase the intrinsic value of the business (which we estimate to grow in the range of 6-10% annually), so the convertible still has a run of 15-20% above the current levels, which would imply underlying prices of higher than \$54 sometime in the next few years. We consider the convertible an investment in which potential losses are next to none, given the excellent balance sheet of the company and the interesting potential gains. Finally, it should be noted that the company's business has clearly been benefitted by the pandemic, reporting growth in its main business lines well above those estimated by the analysts at the start of the year, largely due to the migration towards more affordable products.

- **Aimia:** Aimia, a Canadian company, is another well-known business where we are still invested after many years, with a position of 4.3% that we increased during the trough. Although the crisis has had a strong impact on the returns of Aimia's biggest asset, its 49% stake in Aeromexico's loyalty programme (Club Premier), the company otherwise managed to extract more favourable conditions for its stake from Aeromexico itself during the year, basically extending their relationship with Aeromexico for Club Premier, and setting a (generous) purchase price in the hypothetical case that Aeromexico wants to buy Aimia's stake. Aeromexico's insolvency (and subsequent recapitalization) is what allowed Aimia to achieve such favourable conditions, being further proof of the enormous strategic value for airlines of loyalty programmes already in operation. In the long run, Club Premier will continue to be the excellent business that it already is, based on low capital, network effects (it currently has 7 million registered users) and the secular trend towards increasing credit card usage. In the rest of the businesses, Aimia is changing rapidly since Christopher Mittleman joined as a shareholder, and this year the number of changes has been high. First of all, the holding company's costs have fallen sharply. Secondly, the traditional marketing and loyalty side of Aimia, which we never thought to have any value, has been restructured and is on its way to being able to contribute positively to the company's NAV in the near future. Thirdly, Aimia now has interesting positions in businesses as diverse as Clear Media. In short, our estimation of the value of Aimia is in the range of 550-750 million CAD, without counting the almost 200 million CAD in cash which it had at the end of June, while the only debt are the preferreds in which we are invested, which amounts to 236 million CAD, so we believe the credit risk is low (even more so if we take into account the discount at which the preferreds are trading).

- **Agriculture (Kernel, MHP, Aragvi):** in these three businesses we ended the year with a combined share of over 6.5%. In general, it has been a good year for these businesses, whose fundamentals depend largely on crops (which are unpredictable in any year) and the price of grain, and both have been good in 2020. In fact, the prices of these products have broken a long sequence of years in which they had remained flat. In the case of Kernel and MHP, the companies have continued to execute their high investment programme (for Kernel, infrastructure such as silos and ports, and the capacity for processing chickens in the case of MHP) in an orderly fashion, and the profit margins of these investments are in line with history – around 8%. Aragvi will be the biggest beneficiary of what we expect to be a good year for the price of the different grains. Although Aragvi’s productivity per hectare has been lower than those of Eastern European producers and the business is not as vertically integrated (which gives a higher volatility to the results account if the harvest of the year is bad), the balance is reasonable and the yield at maturity of the bonds (over 7% in euros) is very attractive for the low intrinsic risk of the business.
- **Fannie Mae and Freddie Mac:** although our joint position in the GSEs (*government-sponsored enterprises*) is much lower than the rest of the themes discussed previously, the impact that its eventual recapitalization could have on the fund’s performance makes it worth making a brief summary. It is fair to say that we are disappointed with how little the situation regarding the GSEs has progressed during the last few months of the Trump administration, as we were of the opinion that substantial progress would be made, including the removal of the dividend payment to the Treasury (*net worth sweep*), an agreement between the Treasury and the main plaintiffs (among which is Fairholme) for the pending litigations, and finally, the approval of a more lenient capital rule than what Mark Calabria has finally done, which overcapitalizes the GSEs unnecessarily, which will make it more difficult to raise capital when the time comes. On the positive side, the Supreme Court hearing in the *Collins vs. Mnuchin* case in December went reasonably well, and we expect a favourable verdict in the first half of this year. That, together with changes we expect to see at the last minute before the 21st of this month, including the increase in the minimum capital which companies can hold right now, will set the GSEs in an irreversible direction towards their eventual release from state protection, whether that be under the Biden administration or any other future administration. At current prices, we believe that the opportunity to invest is more attractive than ever, given that the preferred continues to trade at one-fifth of par, the progress of the last few years has been distinctly positive, and the pandemic has shown that the GSEs business is strong, extremely profitable, and vital to the functioning of the US mortgage market.

In summary, the fund has a YTW (in euros) of 6.6% and a duration of 2.7. We believe that these metrics will continue to allow us to outperform our competitors in 2021 and provide us with the flexibility for potential opportunities which could arise over the year.

We are at your disposal to answer any questions that you may have or to go into detail on any name in our portfolio.

Yours sincerely,

Jacobo Arteaga Fierro
Portfolio Manager

Javier López Bernardo, Ph.D., CFA
Portfolio Manager

BrightGate Capital, SGIIC
c/ Génova, 11 – 28004 Madrid
Tel. +34 91 441 00 11
www.brightgatecapital.com

Legal Notice

This message is intended exclusively for the addressee and may contain confidential information subject to professional secrecy, the disclosure of which is not permitted by law. If you have received this message in error, please inform us immediately by e-mail to brightgate@brightgatecapital.com or by telephone (+34) 91 441 00 11 and proceed to delete it, as well as any document attached to it. We also inform you that the distribution, copying or use of this message, or any document attached to it, for any purpose whatsoever, may be prohibited by law.

We inform you, as the recipient of this message, that e-mail and Internet communications do not ensure or guarantee the confidentiality of the messages transmitted, nor their integrity or correct reception, and therefore BrightGate Capital SGIIC, S.A. assumes no responsibility for such circumstances. If you do not consent to the use of e-mail or Internet communications, please inform us immediately.

This document is for information purposes only and should not be considered or used as an offer to subscribe to Funds. This document has been prepared using sources of information believed to be reliable. However, no guarantee is given as to the accuracy or completeness of the information, nor is any liability assumed in this regard. The total return of the Funds is subject to market fluctuations. Past performance is no guarantee or projection of future performance. The opinions and forecasts reflected herein may not be shared by all employees of BrightGate Capital SGIIC, S.A. and may be changed without notice. BrightGate Capital is a trademark of BrightGate Capital SGIIC, S.A.

Data Protection Information. Responsible: BrightGate Capital SGIIC SA (A85543239)

We inform you that your identification data and the contents of the e-mails and attached files may be incorporated into our databases for the purpose of maintaining professional and/or commercial relations and will be kept for as long as the relationship is maintained. If you wish, you can exercise your right to access, rectify and delete your data and other recognized regulations by contacting the issuing mail or at protecciondedatos@brightgatecapital.com.

This message and any document attached to it, if applicable, may be confidential and intended only for the person or entity to whom it has been sent.

If you wish to unsubscribe from our publications and commercial mailings, please reply to this e-mail indicating the word "UNSUBSCRIBE" in the subject line.

Data Protection Information of BrightGate Capital SGIIC SA (protecciondedatos@brightgatecapital.com):

PURPOSE: To inform you about our products and services by electronic means.

LEGITIMACY: Legitimate interest in keeping you informed as a client and/or user.

ASSIGNMENTS: Not contemplated. **CONSERVATION:** During the contractual relationship and/or until you ask us to cancel the commercial relationship and during the periods required by law to attend to possible responsibilities once the relationship has ended. **RIGHTS:** You can exercise your right of access, rectification, deletion, portability of your data and the limitation or opposition in the email of the person responsible. In case of divergence, you can file a complaint with the Data Protection Agency (www.aepd.es).