BrightGateCapital
INVESTMENT~INTELLIGENCE

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

January 5th, 2023, Madrid

"One day in retrospect the years of struggle will strike you as the most beautiful."
Sigmund Freud, Complete letters

Dear co-investors,

We hope you had a happy holiday season and wish you all the best for the year ahead.

We would like to start with a quick summary of the Fund. The Fund closed on 31st December 2022 with a NAV of 124.03, which represents a net annual return of -3.9%. The Fund was launched on 14th October 2013, and the annualized return since inception has been 2.3%. The ISIN codes for the different share classes of the fund are LU0942882589 (class A) and LU1984948874 (class F).

As you know from previous letters, the Fund's philosophy is Buy & Hold with a mandate to invest in global credit with low durations, generally below 3. The portfolio is currently relatively concentrated, between 40 and 50 positions, and captures our best ideas, which we believe offer a more attractive risk-adjusted return than the average credit that can currently be found in the High Yield (HY) markets. Although we like to hold positions as long as we can, our Fund in this respect is not a traditional Buy & Hold fund, where positions are bought and held to maturity, but we constantly evaluate these positions based on the price at which they are trading and the evolution of business fundamentals. In the current environment of tight credit spreads and low interest rates, we believe that traditional Buy & Hold strategies are poor candidates to be in any investor's portfolio, as high valuations make it difficult to reinvest coupons, with interest payments being used to buy increasingly expensive bonds. We believe that the proper reinvestment of coupons is an important, and very often underappreciated, source of long-term returns; our investors can be assured that a large part of our attention is devoted to this task.

Regarding the currency hedging policy, the portfolio was fully hedged at the end of the year. We do not expect any changes to the currency hedging policy for 2023. In the rest of the letter, we will review 2022, what lessons we have learned during the year for our investment process and what our main positions are for 2023.

Some thoughts on 2022: base rates in high yield markets

It is difficult not to use superlatives to describe what 2022 has meant for fixed income. Interest rate hikes by Central Banks around the world, together with initial valuations that left no room for error (which we have been discussing in previous years' letters), have made 2022 one of the worst years in the history of fixed income, especially in those segments most exposed to rate hikes - investment grade (IG) and emerging market credits. Interestingly, despite the also poor performance of high yield (HY) fixed income, 2022 was once again a year that stood out for its low default rates, well below historical averages for this asset class. Imagine what HY returns would have been with default rates of 4, 5 or 6%. The returns (in euros) of the US corporate credit index (both IG and HY) were -16.3%, those of the European corporate index were -13.6% and those of the emerging HY market were -14.9% (emerging indices that also include IG credit were even worse). In short, *the losses in 2022 mean that the annualized returns of all these indices have been negative for the last five years, and in some cases even for the whole decade* – and there are still people who think that a "lost decade" has no place in this new world of lax monetary policies from the Central Banks.

With regard to the Fund's performance during the year, the lower declines we have suffered with respect to the indexes are due to two factors. Firstly, the higher cash percentage with which we started the year and, secondly, our higher yield to maturity, which has allowed us to cushion the falls. Unlike the indices and most funds that are "actively managed" (but end up with vehicles crammed with 200 positions), our three- and five-year performance is positive and, as we did during 2020, we have used this year to improve future returns.

As we did last year, we would like to share with you the following metrics, as we believe they are the best summary for an outside observer. As of January 1, 2022, the Fund had a YTW (in euros) of 5.4%, with a duration of 2.9, compared to the YTW of 7% and duration of 2.6 at the end of the year, while the return for the year (which already incorporates management fees) was -3.9%. We have not had any insolvency situation in any of our bonds.

The purpose of this analysis is to understand whether the loss we have incurred during the year offsets the additional future return we can expect from our new acquisitions. Assuming an average maturity of our bonds of five years (which roughly corresponds to the 2.6 duration with which we closed the year), this would imply that we have given upfront 3.9% of our Fund's assets to close an additional five-year cash flow stream of 1.6% (without taking into account the potential impact of insolvency situations), so in principle, the outcome is favourable.

For a more complete analysis, we should understand the credit quality of the portfolio versus last year (there is no point in adding yield to maturity if we are incurring proportionally higher risk) and, secondly, the percentage of cash invested. Regarding the first issue, we have mentioned in previous letters the progressive credit improvement of our portfolio over time, and we hope that in the "commentary" section below this evolution will be made clear. Regarding the percentage of invested liquidity, the cash we have at the end of this year is higher than what we had a year ago, although this is basically due to a number of credits that we have sold in the last weeks of the year, and which could not be immediately replaced due to the lack of year-end liquidity. However, during the first days of 2023 we have made some acquisitions that have reduced the cash percentage in line with that of a year ago.

Rather than bore our investors with our view of the fixed income markets (an analysis that can easily be found elsewhere and on which we can provide relatively little value added), in this year's letter we have preferred to explain in depth a tool that we have included this year to our investment process, and that we believe will help us from now on. We refer to the base rates of HY markets. In order not to take too long, in the letter that we will publish next semester we will present the second tool that we have learned this year, the Hamilton Helmer's 7 powers scheme, which will help us from now on to improve our understanding of the strategic qualitative factors of a company that determine its competitive position in the long term against its competitors.

The concept of base rates is widely used in the discipline of behavioural finance and has been successfully employed in several experiments and competitions in order to make better predictions.[1] At the risk of simplifying, when making predictions about a given event, we can take two routes. The first, known as the inside view, consists of using the elements particular to the problem in question and using them exclusively to form our prediction. The second route, which is known as the outside view or reference class, takes the opposite position, abstracting from all the particular elements and using as a basis the average probabilities of events similar to the one we want to predict. For example, using the internal view we can be overly optimistic and think that we can write a 500-page book in less than a year (we know the subject, we are eager to start, we have a publisher, etc.), whereas the external view would require us to obtain specific information on how long it has taken people on average in the past in a similar undertaking (say, two years). The behavioural finance recommendation is *always to start with an external view of the problem (base rates), and then gradually adjust these base probabilities with our internal view of the problem.*

Although obtaining baseline probabilities on certain problems can be an arduous task (in fact, *this pitfall is the main stumbling block in the application of baseline probabilities in many fields*), in the field we are dealing with, HY credit, the task is quite straightforward. Credit rating agencies regularly publish very comprehensive reports on the main historical metrics of this universe; in particular, they cover all those metrics related to insolvency rates, which are a fundamental parameter when estimating future returns in this asset class. Hereafter, we will use the latest study conducted by S&P in this regard, which covers a sufficiently long period, from 1981 to 2021, and which we consider as representative of the base probabilities of the HY universe. [2]

The main conclusion we have drawn after studying the statistics in depth is that *insolvency rates are strongly non-linear as credit quality varies*. To give an example of the non-linearity of these statistical distributions, the historical average insolvency rate (measured over one-year periods) for BB+ was 0.5%, compared to 0.7% for BB, 1.2% for BB-, 2% for B+, 5.6% for B, 8.5% for B- and 24.6% for CCC/C. In other words, sacrificing one credit quality step in the BB+ range implies a 0.2% increase in the probability of bond insolvency, while a similar deterioration in the B range implies an additional 3%, i.e., ten times more than in the first case. Since yields to maturity do not increase in such a disproportionately non-linear fashion in the BB/B range, the result is that the average realized returns of a BB

[1] Kahneman, Sibony and Sunstein's recent book, *Noise: A Flaw in Human Judgment*, is an up-to-date treatment exploring the importance of base probabilities. On the other hand, Tetlock and Gardner's 2015 work, *Superforecasting: The Art and Science of Prediction,* remains the most comprehensive treatment to date on the application of base probabilities in superforecasting contests.

[2] The study, entitled 2021 *Annual Global Corporate Default And Rating Transition Study*, is available at this link.

versus a B credit have been roughly similar, but with a significantly lower risk profile (a result we discussed in the letter two years ago, and which has been poetically dubbed by Verdad Advisors as the "*fool's yield*").

Since the Fund's philosophy has traditionally been to invest in bonds with maturities averaging five years, we prefer to use other metrics from the study that we believe are better suited to our investment horizon. For example, of the issuers originally rated BB, those that ultimately became insolvent took an average of 7 years to become insolvent, compared to 5 years for Bs and 2.1 for CCC/Cs. In fact, the standard deviation of that statistical distribution becomes progressively narrower as the classifications worsen - that is, most insolvencies in the CCC/C range are going to be clustered around 2.1 years, while for BBs the 7-year mean is somewhat less informative. In other words, the long period of time between obtaining the credit rating and entering insolvency for those BB credits suggests that *credit deterioration is gradual, and therefore proper monitoring of the history and understanding of the business fundamentals should be able to mitigate a large part of the potential credit losses*.

Finally, it is worth mentioning that those financial issuers (to which the Fund usually has a smaller exposure) that end up entering insolvency situations generally start with higher credit ratings (usually IG) than their industrial counterparts, but *their path to insolvency is usually faster* than in the case of the latter, whose path is more predictable. The fact that such issuers start their route to insolvency as IGs simply indicates that the banking and insurance business is very difficult in the HY world, given the high capital costs borne by businesses of these characteristics.

Although we are aware of the limitations that the analysis may have (such as taking a period that has been characterized by easy money and few bankruptcies, or that S&P's criteria are different from those of Moody's or Fitch and in many cases we only have ratings from one of these two institutions), we believe that it serves as a powerful anchor for the expectations we manage in each of the credits in which we are invested. We believe it is also a natural complement to the evolution of our investment criteria over the past three years, which we expect to continue to refine in the future.

Commentary on the main positions

Looking in more detail at the composition of the portfolio, the percentage invested is in line with the one we held at the end of the previous year. The higher yield to maturity at the end of this year (7% versus 5.4% last year) is simply because the turnover of credits we have made this year has allowed us to lock in higher yields, without at the same time penalizing the credit quality of our portfolio or adding duration (in fact, the percentage invested in BB credits has increased again this year and duration has gone down from 2.9 to 2.6). Although the Fund's losses during the year have added some additional return, these losses have only contributed a small percentage to this increase.

Unlike in previous years, current fixed income market valuations are significantly more attractive, both in investment grade and HY. This has been especially the case in Europe, where we have added a multitude of businesses for the first time since the Fund's launch. On the other hand, our share of the portfolio invested in industrial preferreds has been sharply reduced, as most preferred stocks have outperformed the broad market, leaving us with fewer investment options in this segment. Finally, despite the declines and the relatively good performance of energy companies, the latter are still trading at a substantial discount to the rest of the HY universe one year later. As we mentioned in last year's letter, we believe that the rise of ESG investing is primarily responsible for this discrepancy, and while we will see if this trend continues to create these distortions in the years to come, we will continue to take advantage of these opportunities for our investors in the meantime.

Below are the Fund's main investments at the end of the year, ordered by weight in the portfolio. Some of them have been grouped by theme, as we believe this facilitates the overall understanding of the portfolio. Given that the rotation of securities has been higher than last year, we also detail those main investments that we have recently incorporated. Many of them were already in place at the end of the first half of 2022, so we invite our investors to read this section together with the letter from six months ago to better understand the investment thesis we have in each of these businesses:

- **Energy infrastructure (Teekay LNG, Enbridge, Brooge Energy, PBF Logistics, Peru LNG, Blueknight Energy, Golar LNG):** this group, which last year represented the largest percentage of our portfolio, currently has a testimonial weight. The reasons for selling each of the credits we held have been different, although mostly it has been because either the bonds were close to maturity and have been (or will be) retired (as in the cases of PBF Logistics or Blueknight Energy), or because in relative terms they have performed much better (Teekay LNG, Enbridge) than the new names we have added; in fact, their performance has been so good that several of these credits have started to trade below the minimum return we require from our investments. Some others, such as Peru LNG and Brooge Energy, have suffered events that were not in our original investment thesis, in the case of the former, political uncertainty in the country and, in the case of the latter, problems with the company's corporate governance. In both cases, these events have not affected their share price and we have been able to sell them recently with solid capital gains. As of December 31st, our only two relevant investments in this area are the bonds of MC Brazil and Energy Transfer, which represent approximately 4% of the Fund.
- **Oil producers (Frontera, Genel, IPCO, Lime, Pandion, PetroTal, Ping Petroleum):** we still have a significant exposure to oil producers, spread across seven names (no single issuer exceeds 2.5% exposure). During the second half of the year, we have had no significant changes in any of these positions, and we continue to reiterate in all of them our conviction of previous letters. The assets of all of them generate free cash flows at Brent prices of $50-55 and their balance sheets have improved significantly during the year as a result of high oil prices. Several of them have net cash. As always, we do not know what the oil price will do this year, but we do not count on $80 prices in our models for our companies to continue to generate cash and deleverage their balance sheets.
- **Homebuilders (Aedas Homes, Neinor Homes, Vía Célere):** we have an exposure of approximately 6% of the Fund to the Spanish residential construction sector, a position we have built during this year after the sharp declines suffered by these names. Although second-half home delivery numbers are not yet known (and there is a risk that they may disappoint to the downside), our thesis is based on the lack of residential construction experienced in Spain over the past decade. All three

companies are prominent participants in the Spanish real estate market, and yet their delivery volumes are modest (about 3,000 homes per year, versus 70k-80k units nationally), suggesting they have capacity for growth ahead. Although Spanish construction companies' returns are well behind their US and UK counterparts (where it is not uncommon to see companies with returns on equity in excess of 10% and 20%, respectively), their current returns cover their cost of capital, suggesting that their assets should at least be worth their book value (with the resulting cushion that this implies from a credit point of view), and we also think that future improvements in their ROEs are feasible.

- **U.S. chemical companies:** during the year, we added two U.S. companies operating in the chemical industry: Celanese Corporation and Kronos Worldwide. Both companies have significant footprints in their respective niches: Celanese is a world leader in the production of acetates, while Kronos is one of the five largest companies in the world in the production of titanium dioxide. Superficially, there is nothing special about the bonds of both companies, but if one digs a little deeper into their capital structures you will find bonds issued in euros, which trade at the same yield to maturity as their dollar counterparts. Anyone with a basic understanding of the foreign exchange market will grasp that *such a discrepancy is absurd since, in equilibrium, dollar bonds should trade at a premium exactly equal to the cost of hedging the euro against the dollar* (just over 2% in annual terms currently). That this is not the case tells us that these bonds are trading inefficiently. We always wonder what we are missing when we add a credit to the portfolio, as we may have had gaps in our analysis. The elegant thing about investing in these credits is that we can point out, without a doubt, what the reason for the inefficiency is, which we think is absolutely absurd and will be corrected sooner rather than later - and that, if we had to hazard a guess as to why it exists, it would probably be because of this year's falls in the European fixed income market and the tightening of many funds whose "investment mandate" is to buy euro-denominated issues. Such a situation bears some resemblance to our investment in Turkish credits during the summer of 2018, where there were solid credits penalized by a turbulent political situation and low levels of liquidity. While Celanese and Kronos bonds are not an opportunity like Turkish bonds then, it is still one of the most inefficient situations we have encountered this year.

- **Turning Point Brands:** since our investment in the company's convertibles four years ago, 2022 has undoubtedly been the most turbulent year in TPB's recent history. And there have been several reasons for this. First, the strong growth experienced during the Covid years has given way to more modest growth, something the market was not prepared for. Secondly, the company changed CEO twice during the year. And thirdly, the next-generation product portfolio has not yet been approved by the FDA, which creates uncertainty about the valuation of this part of the business. These three reasons have caused both TPB shares and bonds to fall sharply in recent months, lagging behind the indices. However, if we look at the fundamentals of the company's two core businesses, Zig-Zag (rolling papers) and Stoker's (chewing tobacco), it has been a solid year. In addition, the introduction of new products, such as Clipper lighters, will allow the growth of these two segments to continue in the coming years. While not necessary to TPB's investment thesis, the progressive legalization of marijuana in more states should provide another tailwind to Zig-Zag's business. Although the convertible matures in a year and a half and the share price is well off strike, the bond has a very attractive yield to maturity, with very low credit risk, which is why we continue to have a high exposure to the issuer.

In summary, the portfolio has a YTW (in euros) of 7% and a duration of 2.6. We believe these metrics will continue to allow us to outperform our competitors in 2022 and provide us with the flexibility for potential opportunities that may arise throughout the year.

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

Sincerely,

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