Arrow Capital Management Inc.

Experience. Active Management.

ARROW GLOBAL ADVANTAGE FUND

Q1 2020

The Arrow Global Advantage Fund returned +1.12% for the month of March and was up +3.09% for the quarter.

	January	February	March	Q1
S&P 500	-0.16%	-8.41%	-12.51%	-20.00%
S&P TSX 60	1.78%	-5.89%	-15.66%	-19.22%
Nikkei 225	0.00%	-8.89%	-10.53%	-18.48%
STOXX Euro	-2.78%	-8.55%	-16.30%	-25.59%
ASX	4.98%	-8.21%	-21.18%	-24.05%
Emerging Markets	-4.69%	-5.35%	-15.61%	-23.87%
MSCI World Index	-0.68%	-8.59%	-13.47%	-21.44%
US 10 YR	2.65%	2.56%	2.98%	8.42%
German 10 YR	2.07%	1.14%	-1.14%	2.06%
BAML Hyield	-0.14%	-1.75%	-13.05%	-14.70%
FTSE CAD Universe Bond	2.91%	0.71%	-2.00%	1.56%
Gold	4.74%	-0.22%	-0.54%	3.95%
WTI Oil	-12.85%	-12.93%	-45.65%	-58.77%
Copper	-9.83%	1.22%	-12.14%	-19.81%
Ags (DBA)	-5.50%	-2.56%	-7.74%	-15.04%
USD/CAD	1.90%	1.28%	4.89%	8.25%
AUD/USD	-4.69%	-2.64%	-5.89%	-12.68%
USD/JPY	-0.24%	-0.42%	-0.32%	-0.99%
EUR/USD	-1.07%	-0.60%	0.05%	-1.62%

Source: Bloomberg and Morningstar

Before we discuss our outlook for the Fund, let me on behalf of all the people at Arrow offer up our best wishes to our clients and their families in this difficult time. Clearly this global pandemic has wreaked havoc on so many lives and disrupted our livelihoods. In particular, our hearts go out to those who have passed and the front-line individuals and organizations who risk their lives for our safety and health. Arrow has made donations to local charities in support of their efforts and will continue to do so as part of the community response. I want to also assure our clients that the Arrow team is well and operating remotely except for a few office staff. The portfolio team is working remotely and making good use of Zoom and other technologies to ensure our portfolios are well managed.

A Brief Market Comment

Turning to markets it would be a massive understatement to say that we are witnessing extraordinary events today. At these times it can be difficult to step back from the day to day headlines and look at the bigger picture when that picture is so cloudy and the daily news is largely tragic and polarized. Professionals however try their best to maintain discipline and stick with their process that has served them well over time. Arrow is no exception. We continue to “stick with our knitting” and process as it has served us well through numerous challenging markets and we are confident it will not be different this time.

If you recall, we have been very leery of equities and risky assets for several quarters – our models coming into 2020 had U.S. growth decelerating for 3 quarters straight and inflation beginning to perk up. Therefore, our asset allocation had our portfolio very defensively positioned when the Covid-19 crisis began to expand beyond China’s borders. The demand side of the global economy effectively collapsed with the resulting “lockdowns” of many economies, leading our models (and everyone’s models) to signal a collapse in economic growth. At the same time Covid-19 was disrupting demand and supply chains, Russia and Saudi Arabia declared war in the oil market drowning the market in crude as OPEC+ collapsed. The knock-on effect was a crash in WTI price and the incredible occurrence of a negative front month contract price! Inflation expectations have collapsed and real interest rates have gone into negative territory. As you can imagine, the markets for commodities, interest rates, equities, currencies became extremely volatile – and that is an understatement.

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Some Thoughts on Volatility & Our Process

In our process we do spend a good amount of time monitoring volatility. For many investors this is a complex topic but it is a core feature of how we manage portfolios. Let me give you a few examples. With equities there is something called the VIX index which many people colloquially call the “fear gauge”. It measures what the market is thinking about the riskiness or volatility of stocks – the higher it goes the more volatility the market expects for stocks. In our process, once this level breaches 30 (in normal times it generally around 15) we begin to raise cash. Why? Because we need less exposure to stocks for the same “bang for the buck”. In this crisis the VIX went to 80! There is a volatility measure for any security if you want to calculate it but suffice it to say that ALL asset classes and securities experienced massive spikes necessitating more cash in our portfolios – as you can see in the chart below, we have very large cash balances. The process of raising cash took place in the weeks leading up to late February and early March – it was not a market call but a feature of our risk management process.

Source: Bloomberg

With our Fund you may also recall that we have “hedges” in place at all times. We do take market risk but in a controlled fashion with the result that our performance will never be top of the charts in a bull market but it will often be solid performer when markets fall. We also have exposure to securities that often benefit from rising equity volatility – U.S. government bonds are one such security and despite the very low yields, bond prices went up substantially as the FED re-introduced unlimited quantitative easing to help the economy. In fact, the U.S. 10 year yield plunged to 30 bps – can you imagine 0.3% per year on your savings – we are getting close the Europe and Japan and maybe this actually goes negative? We have substantially reduced our government bond positions as the crisis progressed.

In our Fund we also have so-called “tail” hedges that are designed to capture returns from extreme events. Like any type of insurance this costs money but it is “cheap(er)” when things are calm and becomes very expensive when things get nasty. In our portfolio these are often longer dated “puts” on over-priced asset classes (usually stock indices). Coming into the crisis our tail hedge focussed on the leveraged loan market. Many advisors and investors know little about this market but 18 months ago we began buying puts on the BKLN ETF with a $20 strike price that expires in January 2021. Volatility on this asset class was extremely low (i.e. cheap) so we could be a lot of these puts very cheaply. Our view was that any credit crisis (and leverage in the U.S. corporate world was growing to excessive levels) and this sector of credit would be hurt. While we had no idea at the time about Covid-19, this “insurance” policy kicked in and we made outsized returns on a small position. We have since sold all of these puts.

Source: Bloomberg

Where Do We Go From Here?

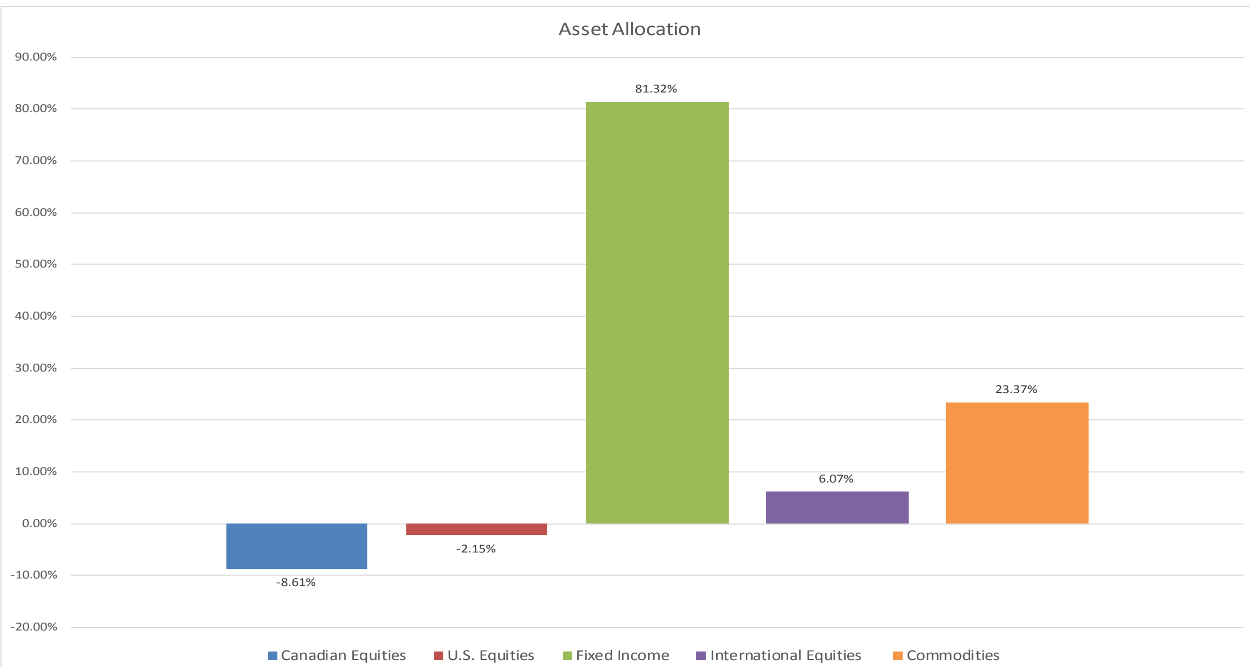
What makes this crisis a challenge for investors is determining when and how demand returns to economies and the structure of the economy post crisis. Our process focusses on the "cycle" and our forecast of where we are going in the next few quarters with respect to inflation and economic growth. The medical crisis impact on the cycle was a downside accelerator on what was an already a slowing global economy. We have continued to measure and map the cycle but it is a challenge as our forecasts for real GDP have wide bands of expected outcomes i.e., we are less confident in our predictions as you would expect. The market, as it always does, has created a mental short cut i.e. we use the alphabet to express the forecast – do we have a U, V, or L shaped recovery. The reality is that nobody really knows but clearly some kind of bounce will occur as people eventually go back to work. We believe the clues for the health of the economy will first be evidenced in credit markets. In particular we are optimistic that investment grade bonds and certain areas of the high yield market look very attractive. We have started to deploy our cash in this area. This is in part due to the FED's investment grade backstopping announcement which offers a kind of "free" put and in part that spreads to government bonds are at attractive levels.

Source: Bloomberg

If our forecasts signal a more robust turnaround will begin to add to lower rated credits – high yield, emerging market bonds etc. We would rather be higher up the balance sheet than in equities currently. Our hedge to these positions remains a short position in small cap equities (high levels of debt with low profitability) and select companies whose price is likely to fall given their tenuous industry position. In our long short equity portfolio we remain focussed on high quality business across all sectors. These are companies with low levels of debt, decent growth prospects (pre and post Covid-19) and reasonable dividends. We are somewhat nervous that everyone is doing the same thing i.e. upgrading their portfolios, such that the S&P 500 and Nasdaq markets are likely stretched. The concept of TINA ("There is no Alternative") to equities is alive and well given the levels of dividends versus government bond yields. Given the backlash on company buybacks we can expect dividend yields to have a greater focus in the boardroom.

On the commodity front, our favourite position remains gold. We expect real yields to remain in negative territory for some time given the actions of the FED and the outlook for low global growth. Oil will likely remain under pressure until further supply is shut in globally. The one beneficiary of this will be natural gas supply – we have traded natural gas futures and have small exposure to natural gas equities.

We are currently sitting around 50% cash and our invested capital is allocated as follows:



A Few Comments On The Big Picture

Our view, like others, is that the pandemic has accelerated trends that were previously in place. If this proves correct, then we are sure the investment implications will be profound and we will look to take advantage of the changes. Here, in no particular order, are some of those trends:

1. Digitization becomes even more critical across all facets of the economy
   a. 5G
   b. Cloud computing / AI
   c. Online retailing
   d. Healthcare Capex

2. De-Globalization intensifies given supply chain weaknesses / national security
   a. On-shoring of many industries (pharma in particular)
   b. Protectionism - Trade War 2 with China

3. Government Role in Economy Rises / Populism
   a. MMT and the role of deficits
   b. Income / Wealth inequality debate

4. Resiliency
   a. Personal savings rates rise
   b. Companies reduce leverage

5. Green Economy
   a. Low oil prices impact?

All the above will produce winners and losers in the corporate world. The upshot in the short run is that we will have likely global growth that is sub-par. Will be watching for the impact on economies around the world and for the opportunities these will certainly foster.

Concluding Remarks

We have deliberately not made comments on Covid-19 in terms of the probability or possibilities about vaccines / therapeutics or about re-infection rates etc. We are not medical experts but rather will watch the economic data very closely along with what companies are saying and doing. We are also not making any political comments on how governments have handled the crisis although many of us have personal views. Let's hope that lessons can be learned and not forgotten – that cuts across governments, business and individuals.

We hope that everyone remains healthy and safe as the economy gradually re-opens. We remain committed to managing your hard earned capital prudently with our proven and effective process.

Yours sincerely,

Jim McGovern

Jim McGovern
Managing Director & CEO

Ted Whitehead
Senior Portfolio Manager

Ahson Mirza
Portfolio Manager

Effective January 1, 2019, the fund was renamed Arrow Global Advantage Fund.

Effective January 1, 2015, this fund was renamed Arrow Global Growth Fund and James McGovern was appointed as the sole portfolio manager. Prior to January 1, 2015, the fund was managed by different teams with substantially different investment parameters. For a complete history of this fund, including returns, please contact Arrow Capital Management Inc. Unless otherwise stipulated returns are net of all fees, in Canadian dollars, reflect class "F" units and assume reinvestment of all distributions.