Q3 2020 Commentary

By Gregg Bell, Portfolio Manager of the A3 Alternative Credit Fund (AAACX)

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To Our Investors:

A3 Financial Investments was formed in 2019 to help investors find quality income in their portfolios through our alternative credit expertise. We launched our fund, the A3 Alternative Credit Fund (AAACX) September 30, 2019 with an objective of constructing a portfolio of non-correlated, niche, structured credit investments that provides for an attractive income stream to our investors.

We are pleased to report to investors that over the past year our strategy has delivered a one-year net total return of 8.52% since our 9/30/2019 inception[1]. Our 2020 year to date net performance is now 4.83% which includes our September net return of - 0.97%[1]. As of this writing, 89.48% of the portfolio holdings are AAA rated, government insured investments[2].

People need alternatives.
We believe that in todays near zero yield environment, allocating within and not merely to fixed income, is what matters the most. Traditional credit strategies which neglect important income opportunities have left many investors in need of alternative solutions. Investors seeking to diversify, require uncorrelated alternatives which are not linked to the economic cycle nor derive their value primarily from interest rate policies. With these criteria in mind, there are limited choices available to investors that have the potential to generate meaningful alpha without undue risk. Alternative credit has proven to be a viable solution.

We strategically positioned our actively managed alternative credit portfolio this year by overweighting reverse mortgages in response to the economic stress we were seeing in markets globally. With the downside probability of many traditional asset classes increasing, we found and continue to see exceptional value in these collateralized, government supported cash flows which do not rely on monthly payments; a key characteristic which adds tremendous value in a time where the ability to repay is uncertain, be it due to job loss or deterioration of corporate revenues.

Given the tremendous uncertainty present in credit markets today, reverse mortgages stand out amongst a limited number of uncorrelated alternative assets, for their potential to generate significant alpha with minimal default risk compared to other niche credit products that we cover and research. To reiterate, our expertise includes private loans and structured products, as well as non-traditional assets like life settlements, litigation finance, and insurance, credit and tax linked investments. It is worth noting however, that taking advantage of these asset classes requires experience and technical expertise. A highly selective portfolio construction is an absolute necessity.

We witnessed several large market dislocations this past quarter, which provided us with a variety of opportunities to add quality positions. We believe this allowed us to add holdings at attractive prices where there is a sizable gap with our modeled expectations relative to the street's more negative assumptions. In our view, many of our positions are now being publicly valued with some unlikely future punitive scenarios, such as COVID mortality rates spikes affecting at home seniors with reverse mortgages. We feel this may provide us with downside management and the potential of greater upside compared to other credit markets that have rallied recently. We are excited about this current opportunity set.

In addition to the high-income cash flow distribution we have delivered, a real diversifying benefit has been the low, near zero, monthly correlation to broad equity and bond indices. The low correlation of AAACX means the investment also offers a highly attractive, asymmetric risk profile, for investors prioritizing income.

Central Banks appear to have succeeded in calming market volatility, driving a financial asset recovery that appears to have far exceeded the one seen in the real economy and unfolded at a speed that took many investors by surprise. The rally in credit markets has been in stark contrast to ever-rising delinquency data. Additionally, the credit market appears surprisingly unaffected by the record number of defaults and distressed situations resulting from the extreme economic impact of lockdown measures globally. We find ourselves in a situation where wages in the US and salaries, the core of labor income are down more than 5% yet total personal income is up 12% the result of policy stimulus. This buys time but such an imbalance is unlikely to be sustained with continuing job loss. All of this adds to market uncertainty and volatility.

Asset prices in the traditional credit markets still don't reflect economic reality, because they've been so heavily supported by unprecedented fiscal and monetary policy stimulus, which masks price discovery and distorts supply/demand dynamics. This is true in larger markets but less so in niche segments of the market where distortions are less obvious, and investors can be adequately compensated for taking on risk.

Our focus remains centered on delivering non-correlated income, while managing the downside risks related to cash flow deterioration once deferral programs expire and stimulus checks run out. Structural protection with an emphasis on assets as collateral is essential to how we think about each investment thesis and as is the case with reverse mortgages, further supported by a government insurance program.

Throughout our decades of experience in the investment management industry, we have learned that volatility creates opportunity for those who are prepared, disciplined and guided by a long-term focus. Uncertainty remains at levels which prove problematic for traditional income focused investors who rely on their capital producing a steady flow of income. We are in a period where active management and bottom-up security selection are absolutely essential.

In times of high equity valuations and ultra-low expected returns for traditional fixed income investments, alternative credit presents a unique, uncorrelated source of alpha. On behalf of all of us at A3 Financial Investments, thank you for your continued trust, and we look forward to serving you in the years to come.

Best Regards,
Gregg Bell

1 Inception date is September 30, 2019. Returns are net total returns. Results are unaudited.
2 "Rating Exposure" reflects the underlying securities nationally recognized statistical ratings organization's credit rating.

The returns quoted present past performance. The performance shown is net of all fees (including a monthly advisory fee of 1.50% per annum) and expenses and reflects the reinvestment of dividends and investment income. Depending on an investor's investment date, holding period and other factors, an investor may have an overall performance that underperforms or outperforms the data shown.

Inception date for AAACX is 09/30/2019. Returns greater than one year are annualized. Current performance may be lower or higher than the performance data quoted. Investment return and principal value will fluctuate so that shared, when redeemed, may be worth more of less than their original cost.

Management fee: 1.50%
*Net Expense Ratio/ **Gross Expense Ratio: 3.30%/3.40%
***Expense limitation: 1.95%

*The Net expense ratio reflects the reduction of expenses from fee waivers and reimbursements. Elimination of these reductions will result in higher expenses and lower performance. These reductions are contractual and will continue until at least 9/12/2020.
**The Gross Expense Ratio reflects additional expenses embedded in the Fund's performance, such as the indirect costs of investing in other investment companies.
***The Adviser has entered into an expenses limitation agreement to pay the ordinary operating expenses of the Fund that exceed 1.95% per annum.

The AAACX prospectus is available here.
The A3 Alternative Credit Fund is a continuously-offered, non-diversified, registered closed-end fund with limited liquidity.
Distributor – Foreside Fund Partners LLC

Past performance is no guarantee of future results.

A3 Financial LLC is a SEC-Registered Investment Adviser. Registration as an investment adviser with the SEC does not imply any level of skill or training. A3 Financial LLC complies with the current notice filing requirements imposed upon SEC-registered investment advisers by those states in which A3 Financial LLC maintains clients.

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