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VERTEX ENHANCED INCOME FUND

Third Quarter Report, 2015

Let's not sugar coat it, the last year has been ugly for risk assets. The tough period began about 12 months ago when all risk assets started to decline. It may have started with the decline in oil, or it may have begun when Bill Gross left PIMCO, subsequently causing a ripple effect on assets; it's really hard to tell where it started exactly, but we've certainly seen the effects. The precipitous drop in oil unveiled overleveraged assets that led to a rout in risk assets.

It will be said that 2014 was a defining moment for the energy sector in the United States. For the first time in recent history, the US had no need to import oil and the technology curve had moved so much that the cost of producing each barrel had come down significantly. The tipping point came just after America stopped importing oil and the large third world economies, such as Saudi Arabia, Venezuela, and Russia, realized they had fewer customers and had more competition for their products. Surely you recall Econ 101 where supply > demand leads to a lowered price. At this point, investors worried that energy companies wouldn't be able to pay or carry their debt, so they rushed to the exits and took money out of the entire high-yield bond sector. During the first 8 months of 2015, any and all risk assets declined materially as money left the sector. To put it in perspective, the two high-yield exchange traded funds (HYG and JNK) had a combined market capitalization of over $30 billion. Today, this has fallen to $21.5 billion. This represents a 30% drop largely from investors (speculators) selling their ETFs, and serves as a good depiction of the entire high-yield market.

Without joining these high-yield sellers (a buy high, sell low strategy), we end up owning bonds trading at discounts to their value upon maturity. What difference does today's price of $70 make if we bought a bond at $100, with a 9% coupon, that matures in 2019? In fact, most of our bonds mature within five years; our strategy is to hold these bonds, collect interest payments, and in some cases where we were fortunate to buy at discounts, reap large capital gains upon maturity. This mark-to-market pricing mechanism creates the illusion that there's a permanent decline. This simply isn't true, unless an issuer fails to pay its interest. During the past 12 months, we've seen bond prices move down 15-30% on a very small volume of trading. These changes are meaningless when holding bonds to maturity, yet they materially move the net asset value of your fund in the short-term.

One of our most frequently asked questions is about defaults in the bond portfolio. A better question to ask, perhaps, is how many defaults resulted in large losses? Answer: One (for $400k when the fund was $250m). The great thing about bonds is that bondholders have more tools in their tool belts. In equities, if a company is in trouble they can go to the market and try to raise equity, thus diluting your current investment, but that's about it. There's no way the company can take on debt if they are in trouble, so equity is one of their only options. In contrast, bondholders have a number of levers to pull:

1. Exchange bonds for equity – lower debt and higher cash flow
2. Exchange bonds for longer term/higher or lower security bonds – longer runway
3. Issue common or preferred equity – increase cash

We've been involved in a number of defaults over the past 17 years – we view these as opportunities. In fact, on some occasions we've purchased a bond specifically for the restructuring process. Let's take a look at some recent restructuring examples (we'll start with the bad):

1. Armtec Infrastructure: bondholders decided that the company wasn't worth what was owed to the first lien holder; consequently, we saw our first and only zero return on a bond.

2. Allen Systems: bonds took out all equity and bondholders added new funds to the business in the form of debt lowering debt by 70%. The former equity holder included 2 personal jets and all living expenses as company expenses. Taking out this low hanging fruit, along with taking out the overhang of a restructuring (which had been a problem with customers over the past few years), should allow the company to grow back to old revenue and profitability. Cash flow and revenue should improve materially.

3. Hercules Offshore: bondholders pre-emptively grouped together and approached the company with a proposal to reduce debt. The bondholders ended up with 97% of the equity and debt was lowered by over 60%, extending the company's runway and increasing cash flow by almost $50m per year.

4. Affinion Group: bondholders again pre-emptively grouped together and approached the company with a proposal to reduce debt. The bondholders ended up with 100% of the equity and lowered debt by 27%, increasing cash flow by over $50m per year.

The above cases help to exhibit some of the triggers bondholders have available to them. They also demonstrate why bonds are a much safer place to be vs. equities. Equities can be wiped out easily and, most of the time, it is the debtholders taking control. This is where we want to be in a lot of these situations – we will be involved in more restructurings as opportunities are plentiful. The important thing to note here is that there isn't always a negative outcome, like there are in equities. The more restructurings with which we are involved the better, so feel free to keep asking.

Starting with August earnings calls, we noticed a change in mentality. For the first time in 8 months the tone was upbeat, calls were bullish, and management sounded excited. The general market malaise, however, has tempered this excitement as macro and liquidity trumped everything positive at a micro level. Though this doesn't mean we aren't looking into the future; we do wish we had more cash to buy more bonds. We would love to add to our positions as we don't feel they are priced anywhere near their worth (based on an assessment of risk/reward). Remember that the default rate on bonds is still less than 3%, meaning 97% of all bonds will mature at par. Let that resonate for a minute.

As we all know by now, the last quarter was less than kind to equities. High-yield bonds and equities are two assets that form the bulk of your fund, and it hasn't been easy or fun for anyone. The HYG and JNK are representative of what happened to all risk assets, whether it be a small cap Canadian company, a high-yield bond, or a large cap commodity company. Some of the equity exposure in your fund is in the form of copper miners and offshore drillers – two sectors that have been hit hard with the risk of market mentality of the first 9 months of the year. These companies are 'value plays' that have a large upside when commodities stabilize. We expect them to contribute materially to the fund in the ensuing 12 months as breath gets blown back into risk assets.

Every day we hear about another offshore driller cold stacking (taking the asset off the market) another drilling rig. With every announcement, we move closer to the market bottom (these assets won't be brought back once taken off). When the market finally right sizes itself, stocks should have a material move to the upside as investors realize that their assets are worth something and can finally project revenue moving forward.

The copper market is much the same as offshore drilling or any commodity market. Miners in a down market try to produce more mineral to meet earning expectations and cover debt; they look to high grade their production in desperation. Fortunately, that can't last forever and eventually they need to cut production and face reality. We think we are close to that inflection point and we like the material upside our equity portfolio offers. Having said this, even if commodity prices fail to rebound soon, our holdings in both energy and mining are the lowest cost producers and powerhouses in their industries. We are excited about the opportunities before us!

PERFORMANCE (Class F returns as at September 30, 2015)

Net Asset Value	1 Month	3 Month	Year-to-Date	1 Year	3 Year*	5 Year*	Since Inception*
$9.8103^{+}	-3.00%	-8.44%	-8.31%	-11.68%	2.10%	3.30%	5.47%

Net of all fees and includes reinvested distributions.
$^{+}$Post Distribution *Annualized