GMP Investment Management
Maximizing Return, Minimizing Risk

GMP Diversified Alpha Fund

Monthly Market Commentary August 2012

The Diversified Alpha Master Fund (the "Fund") ended August close to flat (preliminary figure was –8 bps, net of fees and expenses). Global markets rose during the month on extremely weak volume in anticipation of potential further quantitative easing by the U.S. Fed and continued progress towards a more permanent solution to the European debt situation.

Investors continued to watch mixed earnings and economic data and the continued trudging through the European debt mess. August was very weak in terms of market volume. The low volume was likely as a result of two events: firstly, the trading glitch at Knight Capital in New York caused several high frequency trading firms to decrease trading activity during the month. Secondly, retail investors continued to favour bonds over stocks. Average daily U.S. market volume was 5.7 billion shares, the lowest monthly average since September 2007. The market's rise during the month on weak volume is not a catalyst for changing investor confidence, which is already low. In addition, there was a mixed bag of corporate earnings news from some of the largest U.S. companies. Cisco, Home Depot and Walmart all saw profits rising with a positive view looking forward, while CNOOC (recently a buyer of Nexen in Canada), Lowes and John Deere missed. Against this news, the U.S. Congressional Budget Office ("CBO") issued its mid-year forecast in which they were focused on the pending "Fiscal Cliff" - the combination of expiring Bush era tax cuts and automatic spending reductions. According to the CBO, this duet of events could cause U.S. GDP to shrink 0.5% in the first half of 2013. This is a contrast to the earlier CBO forecast of growth of 0.5%. Adding to woes during the month, Japanese exports fell in July as shipments to both the Eurozone and China decreased. In conjunction with it a string of weak trade figures from Asia's major exporting countries, this fueled worry over global demand. As the markets digested all of this information, equity markets advanced for the first 3 weeks of the month, softening into the 10 days. CBOE Volatility Index (VIX) traded below 15 during the month, helping to make short term option prices very cheap. Yields on debt in Europe (particularly in Spain and Italy) fell as rumours emerged of the ECB setting a target for bond yield spreads in Europe. Germany has publicly criticized this potential course of action. After a relatively quiet August (from a Euro news perspective) it is likely that events in early September will have headlines ringing again, not the least of which will be Greek Prime Minister Antonis Samaras and his series of meetings with European leaders wherein he is expected to request a two year extension on debt repayment. Of note, Germany and Switzerland now show a negative interest rate for 2 and 5 year bonds, respectively. This is the strongest evidence of fear in the market…. "give me your money, and I will pay you back less in the future"! Investors considering a variety of safe havens for their Euro debt investments are now willing to except a negative return on their money in exchange for safety. We have seen this story before as 3 month U.S. T-Bills traded with a negative yield back in 2009, as investors flocked to safety. An additional, and U.S. focused, economic disaster might well be playing out on the food front. With the continued drought in the farmland of America, U.S. food prices are on the rise. The U.S. is experiencing its worst drought since 1956. The USDA has said that over 50% of the U.S. corn crop will be in "poor to very poor condition". Given that corn feeds virtually the entire U.S. food chain (from chickens to salmon) and virtually every beverage (from milk to beer) relies on corn within its chain of production, prices across the board will be challenged to stay low. Substitutes are in equally dire times, with soybean inventories at their lowest in 32 years. 39% of this year's soybean crop is in poor to very poor condition. Increasing food prices, on the back of high unemployment and decreasing incomes, leads to unhappy citizens. There is agreement that one of the contributing factors to the rolling revolutions that began worldwide in 2010 was increasing food prices eating into an already constrained family income statement. By the way, corn prices are up 40% and soybeans are up 33% over the last 3 months while cattle and hogs are down 12% and 15% respectively.

With respect to the broader equity markets, technology stocks (led by Apple) propelled the Nasdaq ahead. The S&P 500 advanced while the advance in precious metals and oil led commodities led the TSX higher. The U.S. dollar and both short and longer term U.S. bonds lost money during the month. Natural gas continued its fall after a brief rally from mid-June through the end of July. Investor fund flows continued to favour the bond market and away from the equity markets, although macro and diversified hedge funds continued to attract new capital.

The Fund was flat in aggregate across all of our strategies in August. Last month we had a couple of specific single trades that had a positive impact on our Fund returns. The opposite was true this month. Within our Credit book, a name which has generated significant historical profit, traded off sharply due to the announced sale of certain non-core assets. Given that the Company will use the proceeds to fund their capital expansion program as opposed to repaying debt, the credit market reacted negatively to the sale. In addition, a private equity investment suffered a mark to market loss as it came to market to raise additional growth capital. It is very expensive to raise equity in these current market conditions. These idiosyncratic losses offset the broad-based gains that occurred in the rest of the portfolio. Our strategies were mixed for August, Equities and Quant up, Credit and Protection down.

In terms of portfolio construction, our positions continue to reflect our mild "policy driven" optimism. The majority of our positions are liquid and we have begun to layer in put positions to protect the portfolio from potential adverse moves that could occur as a result disappointing action from either the Fed and/or out of Europe.

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