TSX CALL

ANNUAL COMMENTARY

Evolve U.S. Banks Enhanced Yield Fund

CALL invests in large cap U.S. banks with the added value of a covered call strategy applied on up to 33% of the portfolio.

As at December 31, 2020

TICKER: CALL (Hedged); CALL.B (Unhedged); CALL.U (USD)

MACROECONOMIC HIGHLIGHTS:

Shares of the biggest U.S. banks by market cap, including JPMorgan Chase, Bank of America and Citigroup, which are significant holdings in the Fund, were all negatively impacted by the economic effects of the global pandemic. U.S. banks declined by more than 30% in the first half of 2020, significantly underperforming the S&P 500 which fell by 4%.

Bank stocks tended to move in sync with the rest of the market in response to news relating to the coronavirus pandemic – rising on positive news and falling on negative news. However, unlike many other sectors, banks did not recover as quickly when the markets rebounded because they are uniquely vulnerable to changes in interest and unemployment rates.

With unemployment rates reaching record highs during the first half of the year and interest rates record lows, banks experienced a two-fold challenge – lower profitability on loans, accompanied by declining demand for loans. In addition, existing bank loans have become risker with higher potential for default in the current high unemployment environment. As a result, big banks have added cash to their balance sheets in the form of loss reserves and provisions, indicating they are preparing for high levels of loan defaults, which would eventually be written down.

To make matters worse, the Federal Reserve ordered banks at the end of June to suspend stock buybacks in the third quarter, and capped bank dividend payments at their present level, with further limitations based on recent financial results. Banks also had to resubmit capital plans to take more specific account of the stresses that the COVID-19 pandemic has put on them and the broader economy.

Into the third quarter, the largest U.S. banks reported stronger sequential results but uncertainty around the level and timing of credit losses related to the pandemic-induced economic downturn and results in consumer and commercial lending that were down year-over-year continued to drag down the banks.

“Third-quarter earnings for the largest U.S. banks improved over the second quarter, primarily on lower provisioning for future losses,” said Fitch Senior Director Bain Rumohr. “If the economic environment continues to stabilize, we would expect banks to remain profitable, although at structurally lower levels given lower customer activity and a glut of liquidity in the system.”

Late in December, the Fed rescinded its prohibition on stock buybacks by large banks for the first quarter of 2021 but did so with the caveat that buybacks be limited to an amount based on profits in 2020. The Fed also limited dividend payouts to an amount based on 2020 income and said it would not adjust capital requirements for banks right now.

In company specific news, Wells Fargo & Co, another holding, announced that it would donate over $400 million toward helping small businesses recover from the coronavirus pandemic, giving away all proceeds from its participation in the Payroll Protection Program. Other major lenders, including Citigroup Inc, have made similar pledges not to profit from the government stimulus program meant to help small

businesses hard hit by mandatory COVID-19 related shutdowns. But those banks have said they will use some of the fees generated to cover costs associated with quickly rolling out the infrastructure needed to run the program.

On a positive note, the investment banking operations of banks such as Goldman Sachs (which is a significant holding in the Fund) did well in 2020. While commercial banking operations, such as loans and deposits, have performed poorly, investment banking activity tends to increase in times of market volatility. Goldman Sachs investment banking reported net revenues of $9.42 billion for 2020, 24% higher than 2019, despite the pandemic. These results reflect significantly higher net revenues in underwriting, offset by significantly lower net revenues in corporate lending and slightly lower net revenues in financial advisory.

Throughout the period, the manager periodically used a covered call strategy to add value to the portfolio with the option of writing covered calls on up to 33% of the portfolio.

PERFORMANCE ATTRIBUTION:

In 2020, the Fund held a diversified portfolio of banks and finance companies. The top-performing holdings for the year were SVB Financial Group, followed by Ameriprise Financial Inc, and First Republic Bank. The Fund's largest exposure by weight was to Truist Financial Corp, SVB Financial Group, and Ameriprise Financial Inc.

SOURCES:

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