January 2020

Elixir News

elixir

CREATING INCOME FOR EVERYDAY PEOPLE BY USING TECHNOLOGY
TO HARVEST VOLATILITY.

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BURNABY, BC, CANADA
ELIXIROFTECHNOLOGY.COM

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Hi, everyone,

I'm writing to you with a heavy heart. I hope that none of our investors and readers have been affected by the challenging global events that took place in January. I know that many Canadians are still mourning the loss from the incident involving Ukraine Flight 752. I also know that many of us are still very concerned about our friends and family members who have been affected by the Coronavirus outbreak. I wish to express our sympathy and concern for all those who were, and who still are, being affected by these two tragic events. If there is anything Eve and I can do to help, please do not hesitate to reach out.

Considering the context above, I want to recap why we started Elixir. Our goal was to manage our family's capital in a way that would protect our wealth, no matter what challenging situations arose in the future—events such as the terrorist attacks of 9/11, the widespread epidemics of SARS in 2003 and H1N1 in 2009, and financial system collapses like the real estate and stock market crash in 2008. Overall, I believe that the world is heading towards an extended period with a sluggish economy, like Japan's "lost 30 years."

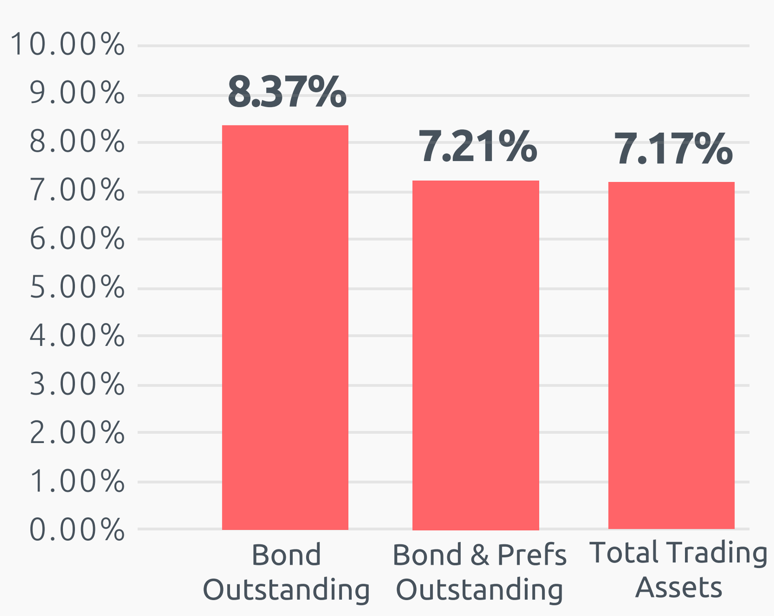
I would like to remind everyone that during times of crisis, Elixir's mandate is to first protect our assets and then to buy cheap assets and turn them into a profit. At Elixir, our primary responsibility has always been, and will always be, "protect first, make money second."

That said, our conservative trading strategies can sometimes pay off significantly, especially when fear escalates sharply over a weekend when the market is closed. I'll explain this in detail in the "January performance explanation" section of this newsletter. It is absolutely not our intent to profit off adverse events and we most certainly do not wish for these horrible events to happen just so we can make more money.

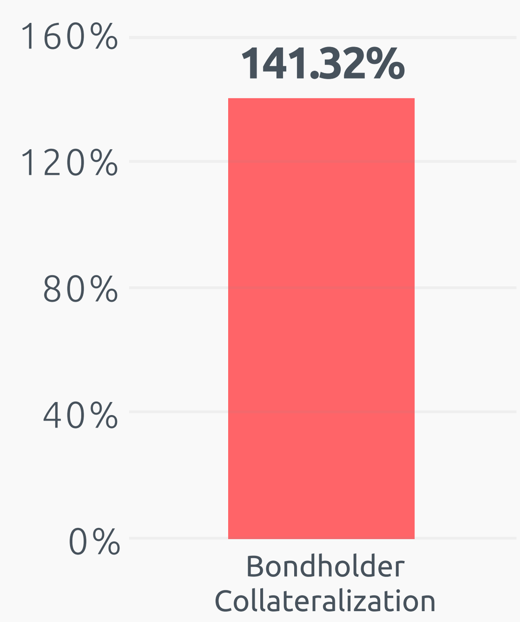
With the above in mind, I would like to notify investors that we broke our trading revenue record in January. The following metrics charts provide a quantitative demonstration of our January trading performance. For those who are interested, Elixir's historical performance metrics since inception (a 30-month track record) appear in an appendix at the end of this newsletter.

JAN 2020 TRADING PERFORMANCE

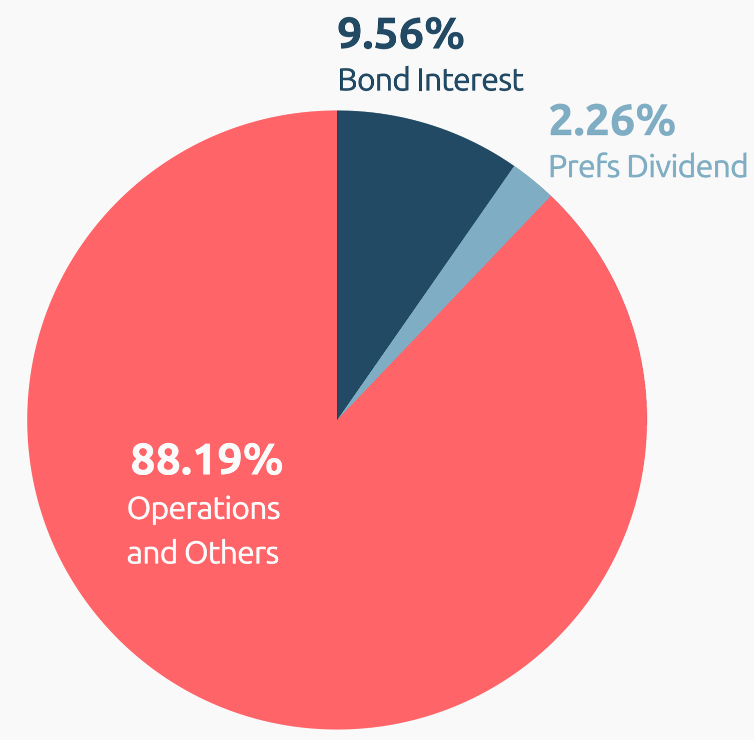
Trading realized gain as a percentage at the beginning of the month



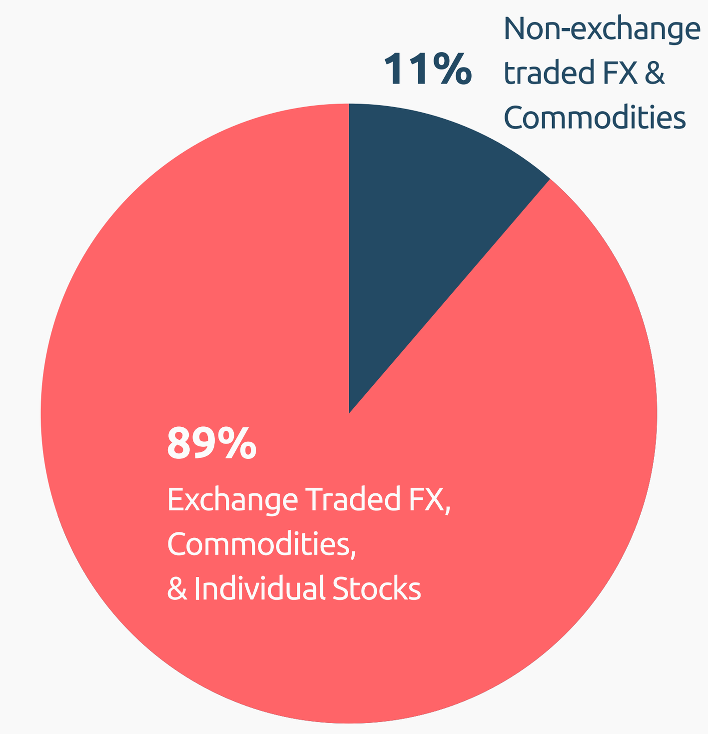
JAN 2020 BONDHOLDER COLLATERALIZATION



JAN 2020 REVENUE ALLOCATION



JAN 2020 TRADING PERFORMANCE BY INVESTMENT



However, I ask that everyone set aside their excitement and understand that the extremely high trading return in January is a one-off situation. We should never expect replication in the future.

I highly recommend that all our investors read this newsletter carefully. In addition to how we made money in January, I will share my market observations. Given recent market activities, you will see why I believe there is still an extreme amount of overconfidence in the capital market and why the phantom of prosperity is fading. Furthermore, we will explain why Elixir will do well when the world falls into an extended period of economic difficulties.

Going forward, I wish to caution everyone that our returns will normalize and, in some months, will be less than our target of 2% a month. I would like to briefly expand on this. When the market collapses, we will not rush into any investment decisions for the purpose of keeping our return high. We will hold onto cash, take some time to evaluate the situation, and then act. When we are in cash, our performance that month will naturally be low.

Lastly, I would like to make an announcement. Ivan Chen, our newly hired research analyst, is working full time to help me create a suite of equity, FX, and commodity research. Our goal is to formally launch our research products for sale to third parties at the annual meeting. In the meantime, I will keep you updated every month regarding the research that is available. If you are interested in any of the following companies, Ivan can email you a copy of the respective report.

- **HUSKY ENERGY INC.**
- **OVINTIV INC. (FORMALLY KNOWN AS ENCANA)**
- **OCCIDENTAL PETROLEUM CORPORATION**
- **WALGREENS BOOTS ALLIANCE**
- **EXCO TECHNOLOGIES**

At Elixir, we subscribe to about 10 different analyst opinions on economics and markets. If you would like to visit our research database, please send me a note and we can discuss access.

I hope you find this issue of the newsletter to be insightful. I wish you good health.

Sincerely,

Bill

William McNarland, CFA

Elixir Technology Inc.

Chairman of the Board & CEO

In January, our trading revenue stemmed mainly from the following three areas. The list is in order of contribution size.

- We profited from selling our portfolio volatility insurance positions on the morning of Monday, January 27, when the capital market experienced a spike of volatility due to fears about Coronavirus.
- We profited at different times throughout the month from shorting some extremely overvalued health care and technology sectors in the US market.
- We also profited from daily natural gas trading.

Over 75% of our trading revenue in January came from our portfolio volatility insurance trade. I would like to provide the details about what happened. As I referenced in the previous two newsletters, volatility in November 2019 was 37% below the 20-year historical average, while in December 2019, 87% of retail investors remained extremely confident.

Overconfidence brought down the price of portfolio volatility insurance. The premium kept dropping until January 21, 2020. In early December, to prepare for the return of volatility, we started pilling up insurance positions, as they became cheaper and cheaper. The decision to purchase insurance was based purely on technical and historical analysis. When the market is too calm for a while, spikes of volatility should take place. However, we certainly don't know when this will occur. It could happen in January, February, or even March. At the time, we just know that if something happens, we are protected.

PROTECTING OUR PORTFOLIO was my number-one purpose for buying portfolio volatility insurance. This is a very important message and I want our investors to understand it. Making a 300% return on our insurance positions was not my intention. We were lucky. Here is why.

First, I will explain the five main conditions, in order of importance, that would drive up the value of portfolio volatility insurance.

1. When fear builds while the capital market is closed (during the weekend, for example), insurance increases in value when the market reopens.
2. When the volatility level is lower on Friday than it is when the market opens on Monday morning, the price of insurance goes up.
3. When the stock market level is lower on Monday than it is on Friday, the value of insurance goes up on Monday.
4. When volatile events take place at a time when short-term insurance will soon expire, the expiring short-term insurance will increase in value.
5. The portfolio volatility insurance payout is priced in USD. Therefore, when the USD is stronger than the CAD, our insurance positions are worth more.

These five conditions all worked in our favor in January. However, what was most significant for us this time was that fear increased over the weekend.

Normally, we set our systems to sell our portfolio volatility insurance for a 10% profit when volatility increases. For example, if fear enters the market on a Tuesday, we will make a 10% profit on our insurance position. In January, our system was not able to execute the trade because the market was closed for the weekend. By the time the market opened on Monday, January 27, fear had built up over the weekend, allowing us to sell our insurance for about a 300% profit. We achieved an exceptional return on the portfolio volatility insurance trade solely because fear arose and then worsened over the weekend. Because such timing is very rare and not likely to repeat itself in the future, investors should not expect this type of monthly performance to be a regular occurrence. I would like to repeat myself: Our January performance was a very rare event.

It's also worth mentioning that the capital market bounced back on Tuesday, January 28, almost completely recovering its Monday loss. This means that if we had been greedy and held on to our positions for another day, we would have missed this 300% insurance profit.

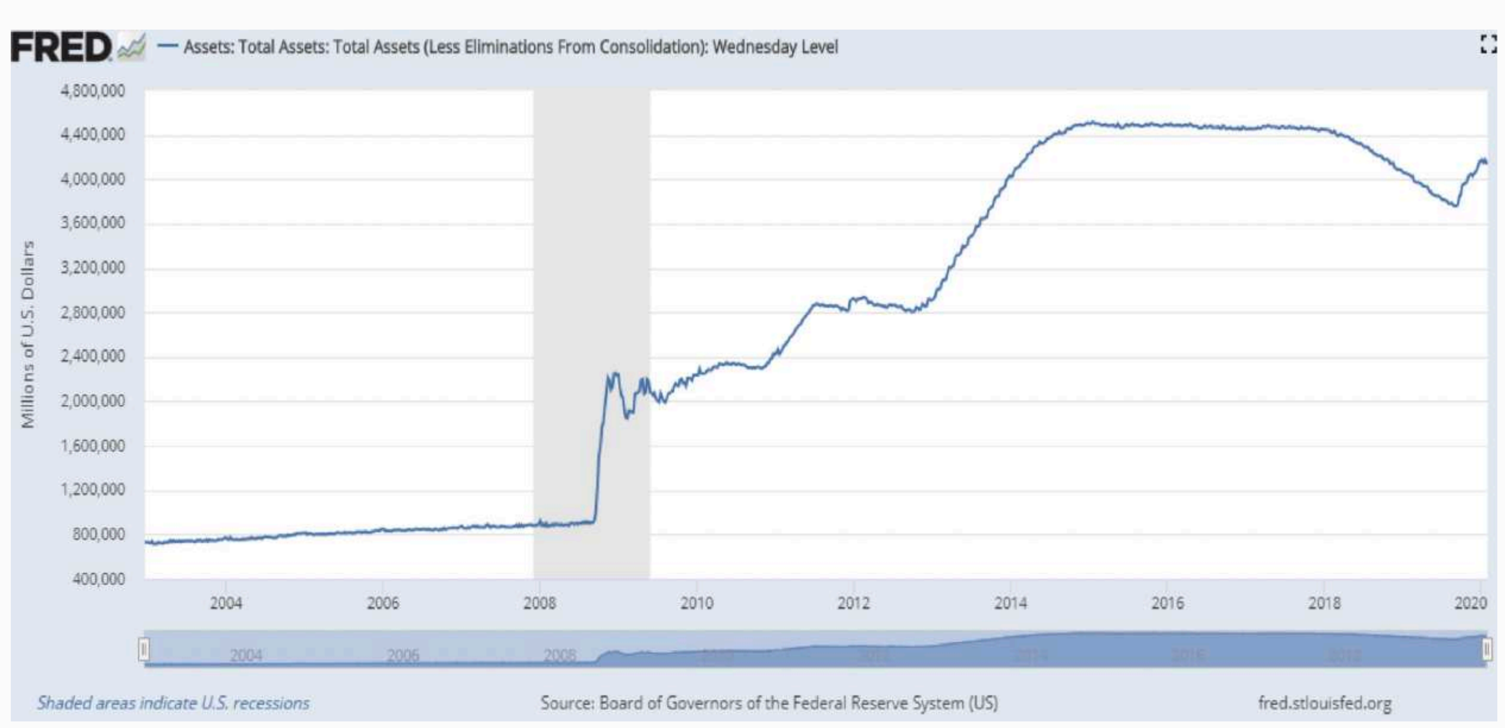
The last comment I would like to make: We are not the only one that did well in this type of trading. Back in January 2018, a small hedge fund manager in Denver, Colorado did something much more remarkable, using a similar strategy. **Here is a link to the Bloomberg article.**

As the days pass, more signs indicate that the phantom of prosperity is fading. For a long time, the capital market has been filled with overconfidence. Investors are still feeling positive about the future. People are still ignoring signs of risks and are not preparing themselves for the next 2008. After 29 newsletters (this one being the 30th!), I know that I sound like a broken record. Nevertheless, I will share five recent market observations that support my view.

1 THE US FEDERAL RESERVE PLANS TO STOP PROVIDING LIQUIDITY TO THE MARKET.

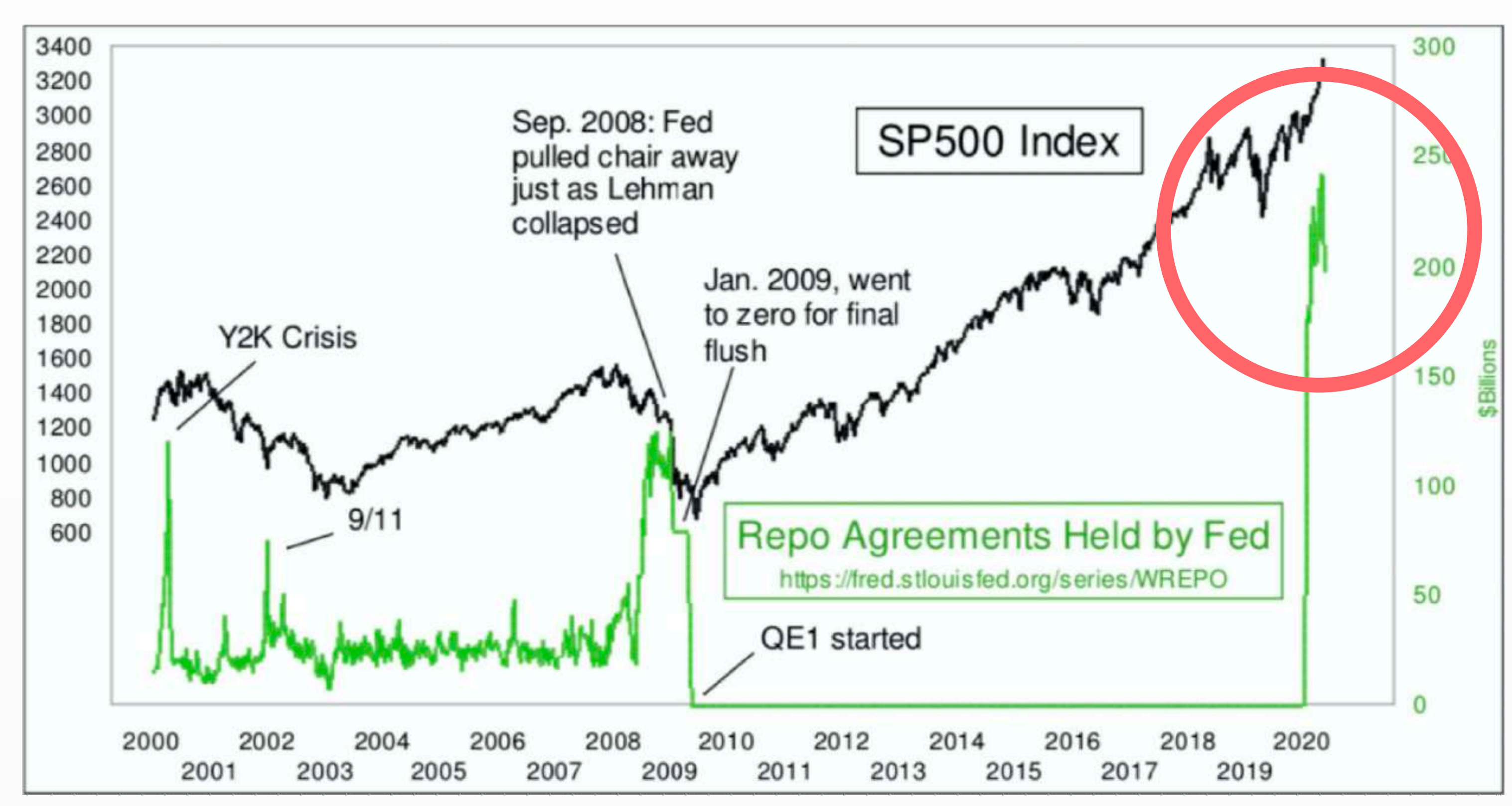
Over the past 11 years, you may have noticed certain phrases becoming popular and getting quoted often in the global financial news: Quantitative Easing, QE, printing money, dumping money out of a helicopter, and stabilizing the repo market. All these phrases essentially mean one thing: Central banks are injecting liquidity into the financial system.

The following chart demonstrates the US Federal Reserve's capital backing to the US financial market since around 2003. A review of this chart can lead to three simple observations. First, the Fed has been injecting liquidity into the US financial system since the financial crisis in 2008. Second, the Fed has not been able to lower "money pumping" to the pre-2008 level. In fact, today's level is almost double that of the 2008 peak. Third, since the last recession, the Fed has only slowly and gradually been able to let off the gas for a period of time; in fact, it had to turn the tap back on.



Why won't the Fed stop providing liquidity to the market? It would if it could. In September 2008, the Fed stopped pouring money, as it thought the market had stabilized. A few weeks later, the market crashed and Lehman Brothers disappeared.

Now let's look at 2019. Last year, one of the most popular phrases in the press was "The Fed was trying to stabilize the repo market." In simple terms, repos are short-term bond contracts like the money market. The significance of stabilizing the short-term bond market is that it happens only during major crisis events such as Y2K, 9/11, and the 2008 housing market collapse. This is demonstrated in the "green spikes" shown in the following chart.



Despite how positive investors felt in 2019, the Fed considered the capital market to be unstable. Therefore, it injected capital to help stabilize it. However, on January 22, 2020, the Fed announced that it would remove liquidity from the repo market by April 2020. What will happen when the Fed pulls out? Could this be another "September 2008"? We are certainly very concerned and are monitoring the market closely.

One last comment I would like to leave you with. The US has been printing money to support its economy for over a decade. How much of the prosperity we've experienced since the 2008 crash has been real? How long can the Fed sustain its money-printing operation? A country can't endlessly print money without facing pressure on its currency and the interest rate. What will happen to the US economy and the world economy when the Fed is forced to stop?

2 FLIGHT AND HOTEL PROMOTIONS ARE GETTING MORE AGGRESSIVE.

I always say that the travel industry is most sensitive to a recession. In the **September 2019 newsletter**, I talked about Thomas Cook's bankruptcy and the fact that Frankfurt Intercontinental was so cheap. Since then, it seems that the travel industry has gotten more desperate.

Throughout the past couple of months, I have been nudged almost daily with flight offers from Air Canada and stay promotions from IHG. Air Canada offered 20%-off flight coupons, while IHG offered 4X bonus points on stays.

I must say that out of my 15 years of loyalty to the two brands, these were the most aggressive offers I had seen since 2009. I will be in Toronto during the first week of February; the rate that my usual hotel offered to me is only about one-third of the peak price in 2018! The economy is softening. It's a fact. People need to face that reality and be prepared.

3 INVESTORS REMAIN CONFIDENT IN THE REAL ESTATE MARKET.

I recently came across this ad from a mortgage broker. It is suggesting that people with young kids should buy big houses with big mortgages. The idea is that as your kids get older, the house will increase in value. Then, when the kids are ready to go to university, you will be able to take out a larger mortgage to pay for their school.

While I hope nobody falls for this, salespeople always know what works in the market and what messages can attract business. So, in a way, this ad reflects the fact that people are confident about real estate investment.

What if real estate does not go up in the next two decades, similar to what we have seen in Japan? Of course, there will be plenty of challenges and perhaps every real estate investor's situation is different, but let's focus on just this ad and education. Being a Canadian, I am less concerned, as the cost of our kids' post-secondary education will be reasonable. For those countries where high-level education is costly, I fear not only that these countries will face a troubled financial future and all its related social issues but also that it will be harder to pull out of the negative cycle when most young people can't afford education and can't create value for our society.

4 BOND INVESTORS STILL BELIEVE IN A BULLISH FUTURE.

Credit rating agencies have been known to be overly kind and optimistic due to their unavoidable conflicts of interest. Therefore, I pay attention to them only when they say something negative about a company. When they put out a negative rating, you know it's bad.

A rare "CCC" junk rating is what Standard & Poor's eloquently describes as "a company that is currently vulnerable to nonpayment and is dependent on favorable business, financial and economic conditions to meet its financial commitments." Allow me to translate. A CCC-rated company is one that is doing so bad that, unless the future is perfect, the company is surely heading towards bankruptcy.

On January 28, 2020, Altice Europe—The Netherlands' multinational telecom and mass media company—completed its 500 million USD bond raise for eight years at 4.88%. Money poured in despite the fact that the company has a confirmed CCC rating. Basically, investors risked their whole principle on a close-to-bankruptcy company so that they could earn less than 5% a year.

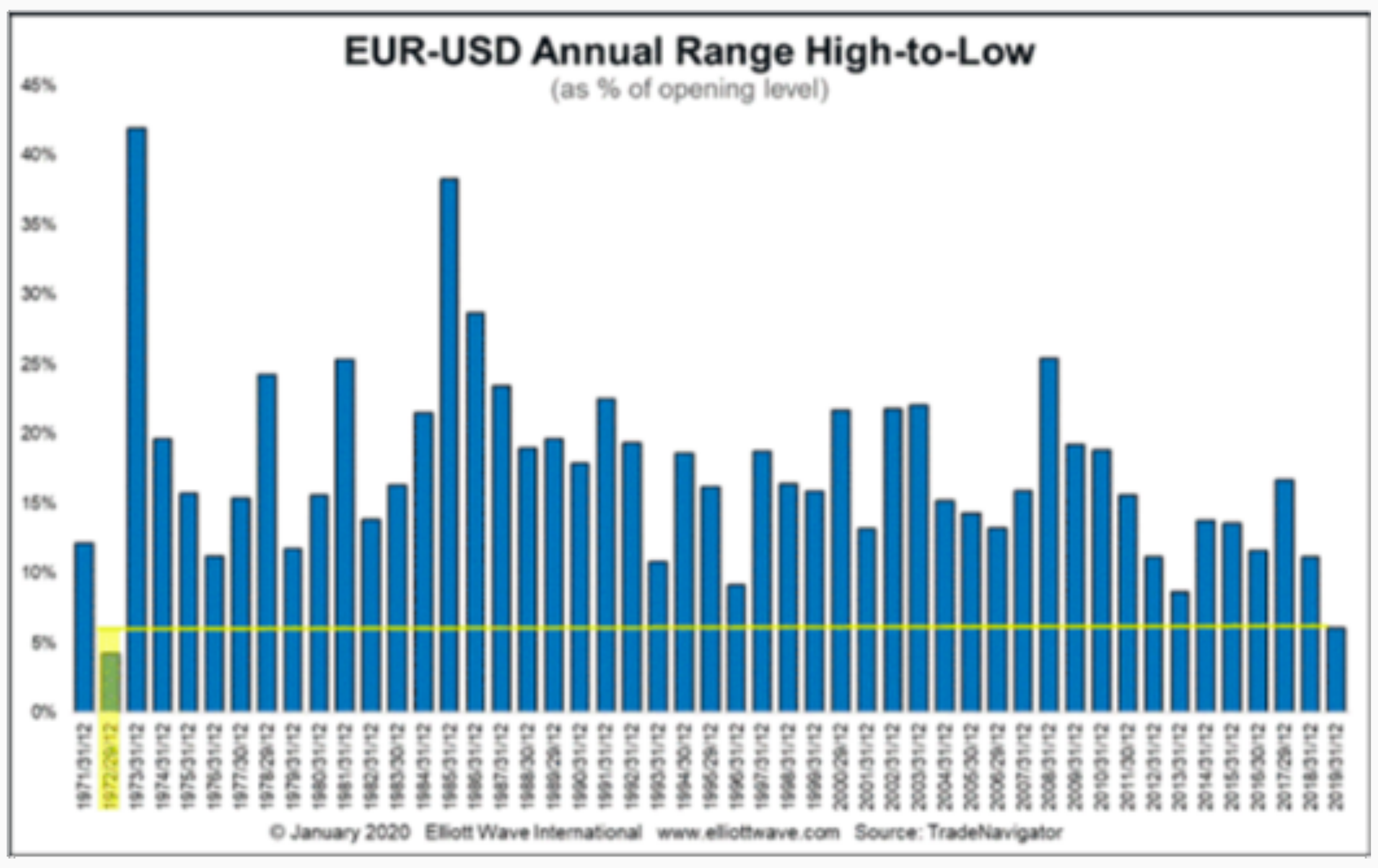
Back in 2008, people could blame the credit agencies for causing them to lose their shirts, due to high ratings for CDOs. Today, however, overconfidence about the future is causing investors to ignore clear warnings. Why do I think the next crash is going to be a lot worse than the one in 2008? This is one of the reasons.

Back in **June 2019**, we also talked about Austria's century sovereign bonds and the €5.3 billion worth of orders that were placed to catch the 1.17% annual interest. For those who are interested, here is a link to that newsletter.

5 FX VOLATILITY PAINTS A PICTURE OF AN OVERCONFIDENT 2019.

In 2019, we experienced the lowest FX volatility since 1972 (yellow highlights in the chart). Because of this, we didn't make any significant money on FX last year. But see what happened in 1973?

The year 2020 has had a rough start, with the Australian fire, the US/Iran tension, Brexit, and now the Novel Coronavirus. Still, although we saw spot volatilities in the market, January was overall positive—or, at least, people seemed to "force" themselves to be positive. I feel that it's getting harder for the market to remain in its rosy bubble. We may start returning to trading FX and enjoying good profits once again.



Final Remark:

Some of you have known me personally for years. Some of you have connected with Eve over the years as well. I would say that we are, by nature, very positive people. I am a firm believer in being positive and in believing that things will work out for me. That said, I am scared by this overconfidence in the market and by what our financial world has become since 2008. Every day I read the news and it reminds me why we founded Elixir. Being positive is a good thing but people also need to be realistic about risks. They need to be prepared for when the illusion can no longer be sustained.

Elixir will do well when the world falls into an extended period of economic difficulties. Why?

Potential Investor
Email from a potential investor on January 5, 2020

Further to our conversation yesterday, I want to clarify that as an investor I worry about the uncertainties in the market (given most analysts suggested a recession is imminent; even Bill was saying that in our meeting on Dec 24). Elixir revenue is mostly derived from trading; it seems to be a considerable risky position this year economically and politically. If Bill can demonstrate I need not worry, I can certainly park my fund with him, so both parties are benefited.

Eve Qian Zhang, GPC.D
Response from Elixir on January 8, 2020

This is an excellent question and a very valid concern. First, all investments have risk. We can't guarantee that investing in Elixir bond is 100% safe. That said, the following explanation may help you better understand how our trading works and, as a result, make you feel more comfortable about investing your capital with us.

We founded Elixir precisely because we see a recession coming. In fact, we believe that the next recession is going to be a really bad one. We may be facing an extended period of global economic difficulty akin to Japan's "lost 30 years." This belief has been well-documented in our deck and throughout the previous 29 issues of our monthly newsletter.

The reason we say that an extended period of economic difficulty is good for Elixir is that it causes market volatility to go up. We make much more money when there is volatility in the market.

The first thing to understand is that when the economy is sluggish for an extended period of time, the capital market doesn't just go down and stay down. While the trend is downward, the market will still have very active volatilities. For example, the following chart demonstrates the movements of the Japanese stock market since the 1980s. As you know, the big crash in Japan happened in 1991.

We are now in 2020 and the Japanese stock market is still way below its 1990 peak. However, as you can see in the chart, the market has taken an extremely volatile journey throughout the past 29 years. All the yellow highlights in the chart represent high volatilities, which are opportunities for Elixir to trade and make money.

Perhaps this is still abstract. Our own performance track record offers the best way to explain how volatility is extremely good for our return. I created the following chart to show our 2019 monthly return (as a percentage of trading assets) compared to the US Dow Jones Index performance that month. Our best performing months last year (green-highlighted) were May at 2.73%, August at 2.70%, September at 2.68%, and October at 2.92%. Our worst performing months last year (red-highlighted) were April at 0.49% and November at 0.64%.

Continued on the next page

Compare the red and the green. You can easily see that April and November had much smaller—and fewer—up-and-down movements in the market (low volatility) as compared to the green months, when volatility was either high throughout the month or showed an extreme up or down at the beginning or end of the month. When the market experiences downward movements and frequent ups and downs, we can make great returns. This is supported not only by our 2019 return but also by our 2018 and 2017 performances.

As to why this is the case, it's very simple. Volatility allows us to more frequently get in and out of our investment positions. If there were no movement in the market, we would have nothing to buy or sell. Things like political instability, wars, natural disasters, epidemics, and recessions are all unfortunate events. Fear stirs up volatility.

To expand on your question about trading risk: Proprietary trading's biggest trading risk comes from high leverage. High leverage means you can't afford to be wrong (or to be off on your timing) because you would quickly run out of money on margin calls and would not be able to wait for the market to bounce. Our custodian would give us 50:1 leverage but, as a firm, the board allows for only 2:1 max leverage. Fifty percent of our portfolio is always in cash. We can afford to be off on timing and to wait for profit to sell. This is also why we can offer liquid bond to investors.

Another one of Elixir's effective trading risk mitigation strategies is that we allow wide diversification for our trading mandate. Unlike some hedge funds, which have only a commodity mandate or a government bond mandate, we consider everything and every hedging correlation. We do direct FX, commodities, government bonds, options, and individual stocks and we do indirect investment on these asset classes through ETFs and spread trading. Bear in mind that also, when the market is down, not everything goes down. For example, a declining stock market indicates that investors are selling their stock holdings. However, they need to put their money somewhere, so we see an increase in the value of assets like the Japanese Yen, the Swiss Franc, gold, etc.

Knowing what—and how—to trade during a volatile period in an extended period of economic difficulty is the secret sauce that allows Elixir to make money. Through methodical research and analysis, as well as disciplined trading, we have achieved this and will continue to improve in the future.

I hope the above explanation answers your question. Please feel free to reach out at any time.

Sincerely,

Eve Zhang

Elixir Historical Performance Metrics

elixir	TRADING PERFORMANCE Trading realized Gain as a percentage at the Beginning of the Month			REVENUE ALLOCATION			BONDHOLDER COLLATERALIZATION	TRADING PERFORMANCE BY INVESTMENT	
MONTH	Bonds Outstanding	Bonds + Prefs Outstanding	Trading Assets	Bonds Outstanding Interest	Prefs Dividend	Operations & Others		Non-exchange traded FX & Commodities	Exchange Traded FX, Commodities, & Individual Stocks
20-JAN	8.37%	7.21%	7.17%	9.56%	2.26%	88.19%	141.32%	11%	89%
19-DEC	2.83%	2.37%	2.29%	32.35%	8.07%	60.00%	122.92%	0%	100%
19-NOV	0.78%	0.64%	0.61%	100%	0.00%	0.00%	119.91%	4%	96%
19-OCT	3.56%	2.92%	2.81%	22.13%	7.21%	71%	134.27%	13%	87%
19-SEP	3.29%	2.68%	2.93%	23.99%	8.12%	67.89%	141.00%	33%	67%
19-AUG	3.32%	2.70%	3.29%	23.70%	8.12%	68.18%	137.28%	52%	48%
19-JUL	2.60%	1.96%	2.13%	33.99%	14.51%	51.51%	197.63%	69%	31%
19-JUN	1.74%	1.52%	1.48%	50.20%	15.41%	34.39%	144.36%	100%	
19-MAY	2.79%	2.73%	2.86%	33.43%	7.00%	59.56%	134.50%	100%	
19-APR	0.50%	0.49%	0.47%	100.00%	0.00%	0.00%	120.14%	100%	
19-MAR	1.48%	1.44%	1.72%	69.09%	2.42%	28.49%	119.91%	100%	
19-FEB	1.17%	1.14%	1.30%	83.67%	3.11%	13.22%	105.22%	100%	
19-JAN	1.62%	1.56%	1.51%	63.49%	2.54%	33.97%	132.09%	100%	
18-DEC	1.96%	1.90%	2.24%	52.37%	1.87%	45.75%	127.52%	100%	
18-NOV	4.83%	4.65%	5.83%	25.21%	0.98%	73.81%	135.46%	100%	
18-OCT	3.01%	2.89%	3.52%	41.41%	1.67%	56.93%	106.89%	100%	
18-SEP	1.53%		1.57%	100.00%	0.00%	0.00%	213.49%	100%	
18-AUG	2.58%		2.55%	61.03%	0.00%	38.97%	102.70%	100%	
18-JUL	1.54%		1.43%	100.00%	0.00%	0.00%	104.32%	100%	
18-JUN	1.86%		1.94%	95.03%	0.00%	4.97%	88.03%	100%	
18-MAY	4.03%		3.98%	48.25%	0.00%	51.75%	104.10%	100%	
18-APR	1.98%		1.98%	100.00%	0.00%	0.00%	102.09%	100%	
18-MAR	2.50%		2.50%	90.21%	0.00%	9.79%	100.09%	100%	
18-FEB	2.69%		3.05%	82.52%	0.00%	17.48%	100.11%	100%	
18-JAN	1.81%		1.80%	100.00%	0.00%	0.00%	99.55%	100%	
17-DEC	2.00%		1.98%	100.00%	0.00%	0.00%	100.88%	100%	
17-NOV	1.21%		1.12%	100.00%	0.00%	0.00%	101.44%	100%	
17-OCT	6.22%		6.14%	41.15%	0.00%	58.85%	107.67%	100%	
17-SEP	2.60%		2.81%	98.51%	0.00%	1.49%	101.39%	100%	
17-AUG	2.02%		2.02%	100.00%	0.00%	0.00%	120.24%	100%	