Fairlight Alpha Fund LP

Q3 2022 Letter

Dear Partners,

Fairlight Alpha Fund's third quarter 2022 returns were 0.9% net of fees. This compares to -4.9% for the S&P 500 Total Return index. In the year-to-date 2022 we have returned -9.8% for the fund, compared to -23.9% for the S&P 500. Overall, since inception the fund has returned 287.9% net of fees and 45.9% on an annualized basis. Relatively our outperformance this year has been good, against the headwind of a bear market.

Performance vs. the S&P 500

We track the net asset value of Fairlight Alpha Fund (the "Fund") over time as calculated by our fund administrator based on our portfolio positions and prices over time on a dollar basis. The fund financials are also audited each year by an independent auditor with the assistance of the Fairlight management company and the fund administrator.

The tables below show the S&P 500 total return and partnership net returns, after fees, for each year 2019-2021, and for the year-to-date 2022, followed by the compounded returns over the same period, as well as the annualized gains.

Annual Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	……………………........	38.1%	17.9%	20.1%
2020	…………………………	26.3%	18.4%	7.9%
2021	…………………………	146.5%	28.7%	117.8%
2022 (YTD)	…………………………	-9.8%	-23.9%	14.1%

Compounded Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	……………………........	38.1%	17.9%	20.1%
2020	…………………………	74.4%	39.6%	34.7%
2021	…………………………	329.9%	79.7%	250.2%
2022 (YTD)	…………………………	289.2%	36.8%	252.4%
Annualized Gain	…………………………	45.9%	9.1%	36.8%

(1) The S&P 500 returns represent the total return index, i.e., with dividend reinvestment included. Increases in value arise from stock price appreciation as well as dividend reinvestment. This provides a fairer comparison to the fund.
(2) The Fairlight Alpha Fund performance is shown net of partnership fees and expenses.

[1] The Fairlight Alpha Fund was launched on 01-Mar-2019 and so the 2019 performance and any returns are presented for a 10-month period.

Although the fund outperformed this year, the results were still negatively affected by the general bear market. We discuss our performance and market conditions in more detail in the following sections.

Current Market Conditions

Inflation remains high across the G7 and other countries, with energy being the largest component. The outlook remains uncertain with the geopolitical issues driving inflation not having any clear resolution at this point. We believe markets will remain volatile for the near future, but that given recent declines (particularly in the United States) there are pockets of attractive valuations becoming apparent.

Table 1: CPI inflation year-on year for August 2022.

Country	Inflation Rate
Canada	7.0%
France	5.9%
Germany	7.9%
Italy	8.4%
Japan	3.0%
United Kingdom	8.6%
United States	8.3%

Inflation was last close to double-digit levels in the late 1960s, 1970s and early 1980s in a period referred to as the Great Inflation. During this time there were four economic recessions, two severe energy shortages and sweeping changes to the global monetary system.

Prior to this period, it was generally believed that permanently lower rates of unemployment could be achieved at the cost of moderate rates of inflation. Policymakers believed that the Philips curve would remain stable and that the inverse relationship between inflation and unemployment would remain stable and not shift upwards. But inflation drifted higher in the late 1960s and into the early 1970s. A variety of attempts to curb inflation were made, including the Whip Inflation Now (WIN) program encouraging thrift. But all failed, and then Paul Volcker became chairman of the Federal Reserve board (in 1979).

Table 2: United States Real GDP Growth, Fed Funds Rate and Core CPI year-on-year at the end of the Great Inflation (1965-1982).

Year	Real GDP Growth	Fed Funds Rate	Core CPI (YoY)
1979	3.2%	14.0%	11.3%
1980	-0.2%	18.0%	12.2%
1981	2.6%	12.0%	9.5%
1982	-1.9%	8.5%	4.5%
1983	4.6%	9.5%	4.8%
1984	7.3%	8.3%	4.7%
1985	4.2%	7.8%	4.3%
1986	3.5%	6.0%	3.8%

As you can see from the above table, Volcker increased the Fed Funds rate to double-digit levels well above the level of core CPI in an attempt to finally beat inflation. He combined high rates with slow reserve growth, which likely triggered the protracted 1981-1982 recession. As the Fed's commitment to low inflation gained credibility it began to decrease, and GDP growth gradually returned. This period highlights the dangers and persistence of inflation and the severity of the measure that had to be undertaken by the Fed in the 1980s to bring back economic growth.

But many market observers have highlighted that this would now cause parts of the economy or financial system to "break". As the Fed increases rates today this will increasingly impact house price valuations and fixed rate assets. The UK pension market highlights possibly the first of probably many parts of the market that could "break" (see the section on the LDI pension crisis below).

Market Performance in 2022

In the last letter we reviewed performance across the global stock markets since mid-2021. These showed disparate movements with some Asian and European markets holding up well. Now comparing these global markets since the beginning of the year the performance has begun to level out with some European markets falling by double-digits, with only Singapore among this group remaining strong (although this is a smaller market).

Table 3: 12-Month Comparison of Global Stock Market Indexes vs. December 31, 2021

Market	Dec 31, 2021	Jun 30, 2022	Change %	Sep 30, 2022	Change %
S&P 500	4,766	3,785	-20.6%	3,586	-24.8%
DJIA	36,338	30,775	-15.3%	28,726	-20.9%
NASDAQ Comp	15,645	11,029	-29.5%	10,576	-32.4%
FTSE 100	7,385	7,169	-2.9%	6,894	-6.7%
DAX	15,885	12,784	-19.5%	12,114	-23.7%
CAC 40	7,173	5,923	-17.4%	5,762	-19.7%
SSE Comp	3,640	3,399	-6.6%	3,024	-16.9%
Hang Seng	23,398	21,860	-6.6%	17,223	-26.4%
STI Singapore	3,124	3,102	-0.7%	3,130	0.2%

The market in the United States continued to drop in Q3 albeit at a slower rate than Q2. By contrast the Hong Kong and Chinese markets fell more rapidly seeing double-digit falls for the year.

Banks in the United States

We mentioned in previous letters that we were seeing good value in the US market, particularly in financials. First of these areas were the US banks and specifically US community banks. Some excellent analysis has been published in this area by @dirtcheapstocks highlighting some particular opportunities arising from the Emergency Capital Investment Program ("ECIP"). Under the ECIP the Treasury will provide up to $9 Billion to depository institutions with $2 billion set aside for CDFIs (Community Development Financial Institutions) and MDIs (Minority Depository Institutions) with less than $500 million in assets, and an additional $2 billion for CDFIs and MDIs with less than $2 billion in assets.

As of September 21, 2022, a total of 162 community financial institutions have received investment of $8.28 billion. Several banks have been given transformative amounts of funding from this program in order to boost economic growth in their local communities. Two of note are M&F Bancorp Inc. (the parent company for M&F Bank) and Citizens Bancshares Corporation (the parent company for Citizens Trust Bank). They issued preferred stock of $80 million and $95.7 million respectively in June of this year. The preferred stock has been confirmed to qualify as Tier 1 capital by the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC)[2].

This means that the Tier 1 capital for these two banks has changed from $44 million (19.9% bank Tier 1 ratio to risk-weighted assets) at year-end 2021 to over $120 million for M&F Bank and from $56.2 million (18% bank Tier 1 ratio to risk-weighted assets) to over $150 million for Citizens Trust Bank. Over time we would expect these banks to leverage this capital, thus increasing the overall size of the banks and their ability to fund loans for their respective communities. The earnings of these banks have begun to increase as assets grow and they build up low-cost deposits. They are also being supported by the larger banks. For example, Citigroup enlisted several community banks (including M&F Bank) in a $1.2 billion syndicated corporate loan deal. And Bank of America recently doubled their MDI deposits with an additional $100 million invested.

The LDI Pension Crisis

Events in the United Kingdom (UK) may point to what is in store for global markets for the remainder of the year. The turmoil in the UK pension markets may be a sign of some of the difficulties to come as the world moves from an environment of free money to a historically more normalized level of interest rates. There follow a few thoughts on these pension fund issues (that could also be affecting the United States) and possible implications for the outlook in 2022 and beyond.

First some background on how pension companies manage assets and liabilities in defined benefit schemes. Many of you will know that there are two broad categories of pension scheme: defined contribution[3] (or money purchase) and defined benefit. With money purchase there is a pension pot that depends on contributions by the member or employer, the performance of investments and any changes to the plan. For defined benefit schemes there is a defined scheme benefit level defined by:

- An accumulation or accrual rate, (e.g., 1/40th, 1/60th, 1%), multiplied by the number of years of scheme membership; and
- A definition of pensionable salary, such as final salary (usually a salary figure at the point of accumulation, or at/near retirement).

For defined contribution pension schemes there is essentially a pot of money that is invested in a variety of assets and so the pension manager is largely an asset manager with relatively little hedging except for some FX (for overseas assets) and interest rate hedging depending on the asset rate sensitivity.

Defined benefit schemes are different because they (as the name suggests) have a fixed point of reference for the pension payments to the members of the scheme. This means that they are liability driven because the payouts are more certain given the accrual rate and final salary levels. Assuming the pension modelers have a schedule of fixed term payments then how should one hedge this so that the assets purchased by the scheme are at least sufficient to meet these liabilities?

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[2] https://www.occ.gov/news-issuances/bulletins/2021/bulletin-2021-14.html

[3] Leaving to one side relating types such as cash balance and collective money purchase schemes for simplicity's sake.

The manager could buy a series of safe, fixed-term investments like US Treasuries of different durations to cashflow match the payments and net off these as closely as possible. But in the recent low interest environment this has been very difficult (if not impossible) because bond coupons or discounts to par value of bonds were too small. So, the asset-based approach of the 1980s and 1990s has migrated more towards a Liability Driven Investment (LDI) approach.

Using LDI the pension manager invests in a combination of riskier assets like PE funds, stocks, and derivatives as well as another portion of fixed income and cash or close-to-cash investments. The hedging approach is driven by the liabilities so that a decrease in liabilities also results in a decrease in asset values (and vice versa). In recent weeks and months rates have increased causing the PV of future fixed liability payments or inflation adjusted future payments to decrease. Therefore, the funding level of the schemes was hedged. This is all very well, except for one thing: liquidity.

This hedging approach also means that some of the associated derivative hedges put on by the pension managers decreased. The derivatives require margin payments if the value falls below certain key valuation levels versus where the trade was made. This requires cash and pension companies to keep a store of cash for swings in interest rates (typically a reserve for 100bps is kept). But rates have gone up more than 200bps in recent weeks and are still climbing. To make matters worse the assets that can be used to post margin have also fallen in value, US Treasuries and fixed government bonds, any stocks (the S&P 500 is down over 25% as of the date of this letter). We also would not like to be calling Goldman Sachs to sell any PE investments right about now!

In the UK these problems with pension funds caused a collapse in government bond (Gilt) prices in late September and October and similar pressures are likely to be being faced by some United States pension funds (Raytheon, UPS and GE named as companies using this type of approach). Government bonds in the UK fell in price as yields rose in anticipation of rising rates and missteps by the UK government. Selling pressure from pension managers then caused prices to fall further with prices falling from 80 (versus par) to 45 on the 30-year Gilt bond from six months prior.

Outlook for the Remainder of 2022

Many market commentators have pointed out that rates increasing to 5% in this environment with government and mortgage debt levels is comparable to at least 10% in the 1980s. Perhaps the government's hands are tied. Will rates fall back quickly as these cracks appear, but what then will happen to inflation which doesn't show much sign of falling back quickly yet (PPI and CPI remain elevated)?

Is the UK pension fund crisis a specific endemic problem, or the canary in the coalmine highlighting that other fractures exist? Will we look back at this as one of the first indications of a future global crisis, and is this the "New Century" moment (occurring in April 2007, portending the global financial crisis) that indicates the coming tidal wave of defaults? Only time will tell.

There could be some beneficial effects of rate increases. Higher rates will make capital deployment much more discerning. For example, this could cause capital to be deployed into real cryptocurrency and blockchain use cases that will move the world forwards rather than capital being tied up in NFT images of the Bored Ape Yacht Club[4].

There's a lot of opportunities appearing now in the markets. Although the transition to higher rates is difficult, we remain positive for the outlook on the other side. We agree with Buffett that America's

[4] We believe the BAYC make tulips look like a good investment, but perhaps our cynicism is unwarranted as they have only fallen by around 60% this year.

best days lie ahead. And to paraphrase: look around you and see a world beyond the dreams of any of our ancestors. Now, as in 1637, 1720, 1869, 1929 and 1987, the world's best days lie ahead.

We have found additional ideas in Western and Asian markets and continue to deploy new capital. We continue to scour the United States and all global markets (going from A to Z). If you are interested in Fairlight or want to discuss anything in the letters we write, our research or our general approach then do reach out using the contact details at the bottom of this letter.

To our partners we would again thank you for your support. And we look forward to more stable political and economic times, but we plan our efforts based on the possibility of future volatile times.

Yours,

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AN INVESTMENT IN THE FUNDS IS SPECULATIVE AND INVOLVES A HIGH DEGREE OF RISK. OPPORTUNITIES FOR WITHDRAWAL, REDEMPTION AND TRANSFERABILITY OF INTERESTS ARE RESTRICTED, SO INVESTORS MAY NOT HAVE ACCESS TO CAPITAL WHEN IT IS NEEDED. THERE IS NO SECONDARY MARKET FOR THE INTERESTS AND NONE IS EXPECTED TO DEVELOP.

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THE PERFORMANCE DATA SHOWN HEREIN REPRESENTS THE PERFORMANCE OF THE FUND. THE RESULTS REFLECT THE DEDUCTION OF: (I) AN ANNUAL ASSET MANAGEMENT FEE OF 2%, CHARGED QUARTERLY; (II) A PERFORMANCE ALLOCATION OF 20%, TAKEN QUARTERLY, SUBJECT TO A "HIGH WATER MARK;" AND (III) TRANSACTION FEES AND OTHER EXPENSES ACTUALLY INCURRED BY THE FUND. THE RESULTS REFLECT THE IMPLEMENTATION OF THE INVESTMENT STRATEGY DESCRIBED IN THE FUNDS' OFFERING DOCUMENTS AND APPLIED IN THE FUNDS' TRADING ACCOUNTS. ALL INVESTMENTS INVOLVE RISK, INCLUDING THE LOSS OF PRINCIPAL.

RESULTS ARE COMPARED TO THE PERFORMANCE OF THE S&P 500 TOTAL RETURN INDEX (THE "COMPARATIVE INDEX") FOR INFORMATIONAL PURPOSES ONLY. THE FUND'S INVESTMENT PROGRAM DOES NOT MIRROR THE COMPARATIVE INDEX AND THE VOLATILITY OF THE FUND'S INVESTMENT PROGRAM MAY BE MATERIALLY DIFFERENT FROM THAT OF THE COMPARATIVE INDEX. THE SECURITIES OR OTHER INSTRUMENTS INCLUDED IN THE COMPARATIVE INDEX ARE NOT NECESSARILY INCLUDED IN THE FUND'S INVESTMENT PROGRAM AND CRITERIA FOR INCLUSION IN THE COMPARATIVE INDEX ARE DIFFERENT THAN THOSE FOR INVESTMENT BY THE FUND. THE PERFORMANCE OF THE COMPARATIVE INDEX WAS OBTAINED FROM PUBLISHED SOURCES BELIEVED TO BE RELIABLE, BUT WHICH ARE NOT WARRANTED AS TO ACCURACY OR COMPLETENESS. UNLESS NOTED OTHERWISE, THE RETURNS OF THE COMPARATIVE INDEX PRESENTED HEREIN DO NOT REFLECT FEES OR TRANSACTION COSTS, BUT THOSE RETURNS DO REFLECT NET DIVIDENDS, IF ANY.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.