MARSHALLZEHR MORTGAGE OPPORTUNITY FUND LP

Q3 Commentary

CAPSTONE ASSET MANAGEMENT™

SEPTEMBER 30, 2017

AT A GLANCE

- Construction & development mortgages in Canada
- Diversified by developer and development type (high density residential, retail space, etc.)
- Terms are 3-36 months
- Low to no correlation to bond and equity markets
- Liquidity is accommodated semi-annually with 90 days' notice
- $93MM AUM

MARKET & POOL UPDATE

This past quarter saw a lot of activity in the MarshallZehr Mortgage Opportunity Fund. July's interest payment was unusually low at 0.52% and this prompted some questions by clients. The reduced interest payment was almost entirely due to a large return of capital at the start of the month that was not fully reinvested until the end of July and into August. It was a surprise to us too, as we have never had such a large month over month drop based on cash drag, but we will always prefer prudence over haste when approving new opportunities for capital deployment. August and September's interest distribution was back in line with our long-term expectations for this fund.

Over the last few months, Canadians experienced the first rise in interest rates in nearly 7 years! Responding to positive changes in the economic landscape, the Bank of Canada shifted interest rates out of 0.5% emergency territory to settle at 1% by the end of September. Many have questioned the impact of these rate changes on the Capstone and MarshallZehr Mortgage Pools, and it is important to recognize that unlike some other real estate and mortgage investments, yields relating to construction lending are far more influenced by the quality of the project itself and its underlying factors than those of posted rates. Consideration is given to the financial health of the developer, pre-sale volume and deposit amounts. Many developers are now asking for a 20% deposit instead of 5-10% for new builds, as well as the completion of permit and zoning requirements. These factors provide greater project security and influence the rate that a developer is charged on its loans.

Over time, residential rate changes can affect overall real estate sales volumes, but it is also true that in a healthy economy, interest rate affordability issues may be offset by rising wages. For these reasons, BoC decisions to raise or lower rates are not directly correlated with the Capstone and MarshallZehr Mortgage Pool yields.

OUTLOOK & POSITIONING

While interest rates went up and real estate prices in the GTA softened this past quarter, the MarshallZehr Mortgage Opportunity Fund continues to meet its long term target expectations due to the quality of its underlying projects. Earlier in the summer, we allocated a small percentage of the portfolio into slightly lower yielding projects (A positions at 7.5% – 8.5%) with even stronger credit quality to better balance the risk. Consequently, with some higher yielding projects unwinding, there was some temporary drag on the performance. This is not expected to be a re-occurring event. As the quarter progressed, newly matured money was moved back into projects at similar rates. By August, the yield had returned to normal at 0.75% and in September it was 0.66%.

Capstone Asset Management continues to look for innovative opportunities to provide investors with an excellent return for the risk taken. Targeting a long-term return of 8% net of fees, this pool continues to deliver exceptional value for investors seeking access to the construction financing market in the southern Ontario.

PERFORMANCE (Net of fees)

Performance figures are those of Class F units as of September 30, 2017. Performance is annualized for periods longer than one year.

1 MO.	3 MO.	6 MO.	1 YR.	3 YR	INCEPTION*
0.66%	1.94%	4.00%	8.66%	9.16%	9.07%

**Launched June 30, 2014*