Préfontaine
Capital Inc.

- FINANCIAL LETTER -
FIRST QUARTER OF 2020

« This too shall pass »

- Ancient Persian adage, quoted by Abraham Lincoln in 1859

The Coronavirus that struck in the first quarter is a reminder that any number of risks can strike at any time. Think of natural catastrophes, nuclear terrorist attacks, wars, etc. We cannot predict them, but as investors we must always keep these possibilities in mind and ensure that the allocation between our equity, fixed income and other private investments, including real estate, form a well-balanced portfolio suited to our age, risk profile and needs.

Our current view

It is very difficult to determine the impact of Coronavirus on the economy, as a multitude of factors may change in the coming months and quarters. With that in mind, we as investors must still try to sketch out the more likely scenarios. We must then follow events as they unfold and adjust our view when necessary.

In our opinion, the most important feature of this crisis is that it is a temporary economic shock. With what we know now, we could divide the impact into three periods: 1/ Very painful initial shock during a near-total lockdown (3-4 months at most) resulting in a sharp fall in economic activity and corporate profits; 2/ A smaller but still relatively significant shock across different economic sectors and geographic regions (from the 3rd-4th month to the 18th-24th month, until a vaccine is found or we have reached herd immunity); 3/ Longer-term residual effect after the vaccine or immunity, which would be more or less important depending on the regions and sectors and their ability to adapt. The effect of elevated government debt is likely to weaken growth and profits in general over a good number of years, but this could be offset by other factors. On April 14th, the International Monetary Fund released its latest forecast for the global economy. The IMF expects global growth of 2.9% in 2019, -3.0% in 2020 and 5.8% in 2021. There are no forecasts for 2022 to 2025. This base case scenario is subject to many unknowns, the IMF warns.

At the time of writing, in mid-April, we are seemingly approaching the second phase. The duration and magnitude of the negative economic impact of this phase will depend on the success in finding drugs for Covid-19, but above all the success in massively testing the population and tracking the movement of the virus by tracing cellular data, so as to quickly identify and isolate infected people. There will surely be waves of resurgence of the epidemic before we find a vaccine, as governements try out different levels of deconfinement. There are already tests with very fast results available. This could allow many activities to return to normal.

How to invest

For us long-term investors, the crisis first required assessing the resilience of our companies and their ability to survive a difficult period. Once that was done, we thought about whether their business models could be negatively impacted in the longer term by changes in consumer behaviour, by government intervention, or by changes in the competitive structure of the industries in which they operate. This reflection is ongoing. We believe that the best-managed companies with strong balance sheets could strengthen their competitive position by buying weaker competitors or seeing them close their operations.

After analysis, we believe that, in general, the Coronavirus crisis should not significantly affect the intrinsic value of our businesses. **The intrinsic value of an asset consists of the sum of all its free cash flows, throughout its lifetime, discounted to its present value at a rate that reflects its degree of risk. This means that a year or two of reduced cash flows does not significantly affect the true value of a quality company. Some of our businesses have been around for over a hundred years.**

As a result, since the beginning of the crisis, we have decided to buy stocks that we thought were available at a discount to their intrinsic values. On average, we made a few purchases in the last few days of February, a good number of purchases in March and we have room for further purchases in the coming months, depending on the evolution of the price-to-intrinsic value ratio of each company and the situation of each portfolio. **The important point is that we do not pretend to accurately predict the stock market bottom. Rather, we are satisfied with the price paid for each tranche of our purchases when looking out 3 to 5 years.**

We also keep in mind the more recent importance of automated investing by algorithms. This increases volatility in stock markets and causes unreasonable lows and highs. In addition, after a cycle of more than 10 years of stock market rises, there are many more investors who have gone into debt to buy securities on margin. When there is a strong correction, margin calls force these investors to sell. Forced sales exacerbate declines. When you understand that and you're patient, you can buy at prices that you think are exaggeratedly low with more confidence.

In the longer term, if the economy grows slightly slower due to excessive government debt following the epidemic, the stock market could theoretically yield lower returns, all else being equal. Whatever happens, we believe that our companies' returns will be comparatively better than alternatives and that is what drives our investment decisions.

This is our current view. We will review it for future developments.

(THE FOLLOWING SECTIONS ARE RESERVED FOR CLIENTS)