Préfontaine Capital Inc.

- FINANCIAL LETTER -

SECOND QUARTER 2022

Outlook and Investment Strategy

The highlights of the second quarter were the sharp increase in interest rates by the US Federal Reserve and the Bank of Canada in the face of inflation of about 8-9% and its dampening effect on asset prices. The S&P 500 has fallen 20% since the beginning of the year through June 30. The most recent growth estimates for the US economy are 1.7% for 2022 and 0.5% for 2023. The unemployment rate is 3.6% and there are currently more jobs available than there are unemployed workers. It seems that Covid removed a large number of workers from the job market. In Canada, growth is currently estimated at 3.5% in 2022 and 1.8% in 2023. The unemployment rate is very low at 4.9% in Canada. In Quebec, growth is estimated at 3.6% in 2022 and 1.8% in 2023. The unemployment rate is at 4.3% due to an older population, the massive retirement of baby boomers and a lower rate of immigration than elsewhere in Canada.

The media has focused a lot of attention on the fall in stock markets in 2022, the largest in 52 years. However, we must not forget that even after this fall, over the last three years, the stock market has generated an annualized return in the US of 10.6% (S&P 500) and nearly 8% in Canada (as of June 30); over the last ten years, almost 13% annualized (S&P 500) in the US and 8.2% in Canada, which is very good. The media has also placed a lot of emphasis on the risk of a recession. This is not really what is important for us, investors. Whether there is a recession or not does not change much when you are invested in strong companies for the long term, because they take advantage of recessions to strengthen themselves against their competitors. More important is whether there will be a period of stagflation of several years or not, as in the '70s. However, no one can answer this with a sufficient degree of certainty for it to be useful.

Predicting what will happen in the next 12 or 24 months is very difficult, if not impossible. There are many different opinions. Some believe that we are heading for a significant additional correction in the stock markets (20%-25% additional fall) following a very rapid and severe monetary tightening in the coming quarters. They think that central banks will not be able to come and save the economy as they did in 2001 and 2008. Further, world trade is not in a period of expansion as in 2001 but rather in a phase of deglobalisation following the China-Russia/US conflict. The energy transition to a green economy ("greenflation") and the ageing of the population are other structural factors that could be inflationary. Other commentators, however, point to the already marked decline in stock prices in certain sectors such as technology (-50% for many securities), the very low unemployment rate, as well as the solid balance sheets of households and banks to say that stock market valuations are reasonable. We lean towards the idea that cleaning up the excesses of the last ten years should normally take time – probably a few years – and this view guides for the moment the more defensive stance of our portfolios. One of the uncertainties that we believe argues for prudence is the impact of a plan to reduce the debt portfolios ("balance sheets") of the central banks (US-Europe-UK) in the coming years. Unlike significant increases in interest rates, where the '70s and '80s can serve as a benchmark, there is no historical precedent for such a monetary experiment. The US Federal Reserve plans to reduce its portfolio by $95 billion per month by September (on a balance sheet of about $9 trillion). Theoretically, when liquidity is reduced, volatility increases. This could lead to situations of excessively low or high prices, which paradoxically could create opportunities for us as long-term investors. But the best intellectual attitude is to admit that we cannot rely on an accurate forecast and we must therefore diversify our assets, in order to be ready for several possible scenarios in the short and medium term.

However, the most important thing is to try to get an idea of the specific longer term prospects (5 to 10 years) of each of the companies in which we invest. Investing in high-quality companies is the best way to weather inflation or recessions. Our analysis focuses on competitive strength, the ability to raise prices, growth prospects, and the quality of managements, rather than what the Federal Reserve, interest rates, inflation, the economy, or Vladimir Putin will do. We are more interested in major structural and long-term sustainable trends such as an ageing population, climate change/biodiversity and automation-robotisation of the economy. When buying a publicly traded security, we seek to know to the best of our knowledge whether at the price paid, we can expect to compound at an adequate annual after-tax return above inflation over the next 5 to 10 years.

In conclusion, the cleaning up of excesses is taking its course, and we see favourably the rise in interest rates, the stock market correction and the fall in real estate prices, which should in turn lead us to a stronger and more sustainable economic environment and asset valuations.

Our investments

At the very end of the second quarter, the sale of **Intertape Polymer Group (ITP)** to Clearlake Capital Group for $40.50 per share was completed. Since ITP accounted for almost 10% of our equity portfolio, this left us with a large cash cushion. After the end of the quarter, we completed the final sale of **Abbvie** (**ABBV**), which further increased our cash position. Our portfolios are positioned with the highest proportion of cash and near-cash since 2007 (including very short-term fixed income) relative to equity targets, which is advantageous at this point in the economic and stock market cycle, as we will be able to take advantage of lower prices to buy excellent companies.

During the second quarter, we added to some of our equity positions in portfolios with particularly low equity weights relative to their target.

Our stock market returns during the correction have been particularly good. We exceeded our benchmark index (50% S&P 500 TR CAD – 50% S&P TSX TR) by 516 bps (5.16%) since the beginning of the year and by 502 bps (5.02%) over the past year. This helped to improve our outperformance over the longer term.

Our fixed income portfolio did very well since we had a very short average maturity. Since the beginning of 2022, our return in bonds was -0.1% vs. -11.8% for the Canadian Universal Bond Index, an outperformance of 1,170 bps (11.7%). Our money market return was +1.0%. In total, our fixed income portfolio (money market plus bonds) remained in slightly positive territory with a return of around +0.06%.

If we take our equity and income returns together, we can say that we had the foresight to position our portfolios well – relatively defensively – to adapt in advance to the current environment.

In the coming months and quarters, we expect to continue to increase the equity weighting of portfolios in order to achieve the equity target for each of us, starting with those with a significantly lower equity allocation vs. their target. If the price of excellent companies we track falls very sharply from this point, we expect to increase the equity weightings above targets, moving towards maximums, depending on the severity of future price corrections and opportunities we can identify, on a case-by-case basis.

The following sections are reserved for our clients