Préfontaine
Capital Inc.

- FINANCIAL LETTER -
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Economic and Financial Outlook

In its January report, the World Bank forecasts a slowdown in global growth in 2022 to 4.1% (from an estimated 5.5% in 2021) due to Covid, the reduction in fiscal and monetary support and persistent problems in supply chains. Depending on the trajectory of the pandemic, the Bank estimates that growth could range from 0.2% to 0.7% around its baseline projection. The forecast for 2023 is 3.2%. In the United States, a recent poll of private sector economists indicates that growth expectations for the year 2022 have fallen from 3.6% in October to 3.3% now, which remains solid growth. Experts believe that the pandemic will enter an endemic phase - that is, the virus will persist and transform - but that its effects will be more limited so that we can gradually return to a somewhat more normal life, but still subject to adaptation measures.

Inflation was 7.0% for the twelve months to December 31 in the U.S. (4.8% in Canada). Experts agree that some of this inflation is due to the effects of the pandemic on supply chains and is temporary: supply chains of physical goods are being disrupted by high demand combined with low supply. The demand for goods has increased by the money that has been put in the hands of consumers by governments and by the reduction - due to the pandemic - of the alternate possibility of spending on services (travel, restaurants, personal services, etc.). The supply of goods is also diminished by the pandemic that has left manufacturers, producers, distributors and transportation companies short of employees. Experts do not agree on what proportion of current inflation is more permanent and due to high fiscal deficits and loose monetary policy that has injected economies with massive amounts of money. For now, the Federal Reserve (the Fed) estimates that inflation in the U.S. will be 2.6% in 2022 and 2.3% in 2023, but this is continually changing, and the Fed must be careful in its predictions so as not to itself create inflationary expectations. The market is currently expecting four to five rate hikes in 2022 in the U.S. and five to six in Canada. The U.S. unemployment rate fell sharply to 3.9% in December, which could fuel inflation. Some experts estimate that inflation in 2022 could range from 1% in a recessionary scenario to 6% in a scenario of major geopolitical instability. Over a longer period of five years (2022-2026), the markets expect inflation to be just under 3%. The main risk for stock markets is that the rate hikes required to contain inflation in the coming years will be faster and more pronounced than currently anticipated.

How to invest: focus on what is strengthening companies but is not yet visible.

It is difficult to say what an asset is worth when monetary conditions are very loose. We would also have a better idea of the sustainable value of our portfolios (and real estate) if interest rates were

more normal and central bank balance sheets were less inflated (in the US, the Fed's balance sheet is near $9 trillion vs. $4 trillion before the pandemic). The range of future possibilities is wide, and we prefer not to venture into making predictions, but we would say that the combination of high valuations, very low interest rates relative to inflation and the phase of liquidity reduction by central banks that we are entering increases the risks of a stock market correction, especially among securities whose future expectations are overvalued by the market.

During 2021, we continued to rebalance portfolios by gradually selling/reducing stocks that we felt were overvalued or fully valued to increase our safety cushion (cash and short-term bonds) or to reinvest in undervalued stocks, depending on each person's circumstances. We have generally increased our safety cushion from year to year during the last years of strong growth of valuation multiples. Those of us who are older are in a better position than ever in terms of the dollar value of the safety cushion, after crystallizing solid gains. When the stock market suffers a sharp fall, we will be able to calmly evaluate the opportunities. However, even after three years of strong growth, we think that there are opportunities currently in the stock market for those who hold too much cash or have new money to invest. In the current environment, these are often companies with poorer prospects for the coming year, for all sorts of reasons; the market is not ready to wait and focusses on the past rather than the future. Sometimes it is a turnaround situation with a new management team following several years of disappointment. It then becomes a question for us to judge the new business plan and to assess the skills of the new leaders. This is what we did with Microsoft, which gave us an annualized return of 33.1% over ten years, or 15.7X our initial investment (not counting the additional gains on the currency). Microsoft was viewed as a dinosaur when we bought it and few people believed in its potential. We however thought that value was being built, only it was not visible, like the growing roots of a bamboo[1]. In evaluating business recovery situations, we won't always be right, but the important thing is our batting average. In other instances, a high-quality company is doing well, but the market perceives it unfavourably due to a negative external reason, whose duration and actual scope must be judged; we must evaluate if and why we disagree with the market. Here too, it is our batting average that counts. The ideal environment to buy is during a stock market crash because we can then buy high quality, dominant companies, without specific problems at good discounts. However, this happens on average only every 10-12 years. March 2020 gave us a correction of about 35%, which was good, and we took advantage of it, but 2008-2009 was even better, with a crash of about 55%. There we "backed up the truck" with highly undervalued quality stocks.

With respect to fixed income, the rise in rates over the next year will give us the opportunity to increase our average maturities, which are currently very short.

The last ten years and the next ten years

It is useful to regularly look at the past to help us judge how we have done, what has worked and what should be corrected to try to do better in the future. This is the Japanese principle of *"Kaizen"*, or continuous improvement.

[1] A Chinese bamboo tree will not break through the ground for five years while the roots are growing. Once it does break through, growth will be very quick (90 feet in five weeks).

Our 10-year annualized average return (time- weighted, composite of all clients) in equities is 15.3%. We have a portfolio of mostly Canadian and U.S. equities. On this basis, we believe this ranks us among the best in Canada, all the while having taken little company specific risk. However, our real goal in building our portfolios is not to beat anyone, but rather to build for each of you a resilient portfolio, adapted to your situation and which allows you to reach your financial objectives. Most of you have entrusted us with almost all your savings and are in the distribution phase of your life, which can influence stock portfolio composition. Our 15.3% average should also be viewed in this light and cannot be compared with aggressive hedge funds.

In addition, in our opinion, what is important for individual investors is a money-weighted rate of return (MWRR), net of taxes, costs and inflation (let's call it *triple-net)* of their entire portfolio (stocks and fixed income), which allows them to achieve their personal and family goals. This rate is not part of the disclosure available in our industry because it is difficult to calculate and impossible to usefully compare from one person to another. However, this is the only real measure of wealth creation. We put a lot of effort into minimizing the tax impact of our investments so that our returns net of tax have been enhanced over the past ten years. This makes a big difference over time but is not easily measurable. An even more important factor in achieving a high long-term *triple-net* MWRR is not to panic during crises and stock market crashes and not to get carried away by greed and euphoria during excessive periods of stock market rises such as we have been experiencing for the last few years. For example, anyone who has the courage to inject fresh cash after a stock market crash and remain more defensive after exaggerated stock market hikes will generate a higher internal return (MWRR). One of the great added values of a portfolio manager and advisor is at this level and our success in helping you defy the herd depends largely on the trust we manage to build with you. Maintaining a vision of investing over several decades is the key to success, although this is easier said than done given the pressures from the media and from the financial industry that generally favor a short-term view.

The S&P 500's price-to-earnings (P/E) ratio has risen sharply over the past 10 years. The current ratio can be interpreted in different ways, but for the next 10 years, no one can predict what the markets in general will do. We can make several assumptions. A typical example of an assumption is to bring the P/E multiple of the S&P 500 back to normal in the next 10 years, to about 15-16X and assume a certain annualized profit growth. Depending on the assumptions, we will have different projections of annual growth of the S&P 500. A host of variables can change over 10 years and the range of forecasts can be wide (some range for example from 4% to 8%). The important thing for us in the face of uncertainty is to have a diversified portfolio of about twenty companies of a quality well above the indices and invest when the market expectations are in our opinion too low. Investors must therefore have the expertise and judgment to first identify exceptional companies and then to know how to determine their value. This is what has allowed us to do better than our indices over the last 10 years. However, to do even better in the future and apply *Kaizen,* we will work on three types of mistakes we have made in the past: 1/ not having bought exceptional companies because we thought they were too expensive; 2/ having misjudged companies we thought were in recovery mode that ultimately never recovered (i.e. trying to increase our batting average); 3/ to have kept in the portfolio companies that we thought were "stable and predictable" but that did not really stand out.

In conclusion, we will always try to do better, but we cannot promise anything in terms of returns for the next ten years. However, we can assure you that 1/ during the past decade, we have

accumulated even more experience and refined our philosophy, practice and processes 2/ we have made a list of our mistakes and our good investments long-term and have learned lessons from them 3/ we have developed our knowledge in new industries to expand and diversify our circle of competence 4/ we will not let our past success lead to overconfidence and will keep a healthy Cartesian doubt of ourselves 5/ we will not take more risks to try to do better and will always favor the preservation of capital 6/ our enthusiasm, passion and energy remain very high.

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