Préfontaine Capital Inc.

- FINANCIAL LETTER -
FOURTH QUARTER 2022

Review of 2022

2022 was marked by a surge in inflation, the rapid rise in interest rates followed by a corresponding fall in stock and bond markets, the war in Ukraine and some normalization of the pandemic (except in China). The World Bank estimates that the global economy grew by 2.9% in 2022. The unemployment rate is at an all-time low, notably in North America (3.5% in the US). Inflation in the 20 most developed countries (G-20) was at 9.0% in November 2022 according to the OECD. In the US, inflation in December was at 6.5%, down from a high of 9.1% in June and was 6.3% in Canada, down from 8.1% in June.

2022 was very positive on several fronts. What struck us most is the extraordinary adaptability of human beings, which manifests itself especially well in the face of existential crises, be it a war, a pandemic or a natural disaster. The speed with which Europe has adapted to Russian aggression, with the help of the United States, is truly remarkable. Whether in strengthening European political unity or in the ability to restructure the energy supply and production of an entire continent, Europe adjusted very quickly. In the face of the pandemic, the speed with which science developed a messenger RNA vaccine against Covid and its variants is another phenomenal revolution and which hints at other spectacular advances in medicine. The gradual waning of the appeal of populists and dictators in many parts of the world is a cause for rejoicing and hope. Finally, the outcomes of COP 15 on biodiversity and COP27 on climate are also encouraging steps forward, even if much remains to be done.

In terms of the negative aspects of 2022, global warming and its catastrophic manifestations remain at the top of our list. The rapprochement of the dictatorships of China and Russia in 2022 augurs for difficult global economic and political relations and a diversion of resources towards armament, especially in Germany and Japan. Investment in armaments increases GDP, but does not increase productivity (and thus increases inflation) nor does it help the transition to a sustainable economy.

Major scientific breakthroughs that marked 2022 include California's first successful nuclear fusion (as opposed to fission) reaction producing a net energy gain; Open AI's generative artificial intelligence (GPT Chat) and the widespread use of AI, including in medicine, transportation, communication, climate science and robotics; messenger RNA technology and its future use for universal multivalent vaccination (Covid-influenza-RSV combined), and its prospects against cancer, malaria and other serious diseases; IBM's new 433-qubit quantum computer; the James Webb Telescope; the reviving of dead organs by the OrganEx machine; the change of direction of an asteroid's trajectory by NASA; the whole (100%) sequencing of the human genome by the National Human Genome Research Institute; the creation of living synthetic organs in laboratories; the first hydrogen-powered trains in Germany.

With respect to the economy and the markets in 2022, the clean-up of excesses continued its course and we still see favorably the fall in the prices of financial assets and real estate. Obviously, it is the most overvalued assets whose prices have fallen the most. We believe that some parts of the economy have been transformed structurally by governments through national economic and industrial policies, in particular in the US and Europe. Examples include the fields of renewable energy (the $369 billion Inflation Reduction Act in the US), technology (the $280 billion Chips and Science Act), infrastructure (the $1 trillion Infrastructure and Jobs Act) and data protection. Other industries have been transformed by the pandemic (real estate, retailers, etc.) probably for the better. The threat of the Chinese and Russian dictatorships has encouraged greater involvement of governments in the economy and a readjustment of certain markets and supply chains (reshoring/friendshoring manufacturing – LNG infrastructure in Europe, etc.). The major changes of 2022 at times affect the competitive environment and require a revision of the outlook for our portfolio companies.

Review of our investments in 2022

"Simplicity is the ultimate sophistication."

-Leonardo da Vinci

We had a good year in terms of our investments. Our return on equities (all our consolidated accounts, time-weighted returns) is -4.4%, compared to -9.0% for our indices. We achieved this favorable result despite having no exposure to energy producers who significantly outperformed in 2022. Our return in fixed income of +1.1% in 2022 strongly exceeded the market, which returned -11.4% (i.e. an outperformance of +12.5%). A typical portfolio of 60% equities and 40% bonds would have given us -2.2% compared to -10% for the markets (i.e., +7.8% better). Three stocks exited the portfolio in 2022: **Intertape Polymer (ITP),** which provided us with a compound total annual return (including dividends) of 28.7% since our first purchases in 2018; **Abbvie** (**ABBV),** which provided us with a compound total annual return of approximately 25% in Canadian dollars since January 2013; and **Manulife Financial** (**MFC**), sold for $27.50 in February 2022, which we first purchased in September 2011 and held as a "bond substitute" when bonds paid little interest. MFC has given us a compound annual return of 12.7% since then. The company's prospects over the next five to ten years seem unconvincing to us and we no longer need bond substitutes. In 2022, we invested very little of the cash provided by these three sales, so we have "dry powder" ready to be deployed in equities.

Our stock that suffered the most in 2022 is **Intel (INTC),** whose price fell by 50% in USD. If we add the dividend and the effect of the Canadian dollar, the drop is around 40%. We continue to own Intel because we believe the company, which is going through tough times and has lost some technological and competitive advantages, is in a turnaround phase with an impressive new CEO (Pat Gelsinger) at its helm since 2021. We still believe that the company, at current prices, will offer us good returns over the next five to ten years, but believe that the turnaround will take a few years. We are closely monitoring the progress of the company and its competitors. Our best performing stock in 2022 was **Mckesson** (**MCK)** with a total return of 53% in USD and about 58% in CAD.

We remind readers that what is important for an investor is his total return, including fixed income and equities, weighted according to dollar value (internal rate of return), net of inflation, taxes and fees, over a long period of time (10-20-30 years). Although this figure is difficult to calculate and impossible to compare, in our view, it is the proper definition of wealth creation. Its outcome depends on our individual decisions about when we move funds in and out of the markets and on our individual tax rates. The key to having a good internal rate of return is not to panic during stock market crashes and not to become greedy during speculative bubbles, to ignore the ups and downs of the markets and to focus on the long term, like a private business owner does. Also, an effective and continuous management of taxation makes a big difference when compounded over a long period of time.

Outlook for 2023 and beyond

The World Bank forecasts global growth of 1.7% in 2023, down from its last estimate of 3.0% in June. For the US, the forecast for 2023 is 0.5% and is similar for Canada. Over the medium term, the big question is the length and scope of the current inflation cycle. A recent poll of US economists sees inflation at 3.3% by the end of 2023 and 2.4% by the end of 2024 and this seems to be the current consensus. However, some studies show that once inflation rises to 8% (we exceeded 9% in June 2022), historically it took an average of 9 to 12 years before inflation returned to 3%[1]. During these cycles, there have been false starts in the stock market, over many years. It is therefore possible that inflation will be embedded for several years and that stock market values will be affected in the medium term. However, the context is always different from one era to another and we don't think anyone really has the answer.

In the face of medium-term uncertainty, we will invest our cash gradually through the inflationary cycle when a particularly attractive opportunity arises, while accepting that we will not hit the bottom in prices. The type of company we are interested in, inflation or not, recession or not, is one that has the ability to raise its prices and clearly stands out from the competition, either through a dominant position in an oligopolistic niche, through an unequalled capacity for innovation (patents, strong brands), or through unparalleled economies of scale, and always led by an outstanding management team that has a detailed knowledge of its markets. We have the advantage at the beginning of 2023 to be in a good psychological predisposition to invest in equities, since we did not really suffer in 2022. If opportunities arise, we will look a little more towards mid-sized companies that have a good prospect of compounding our returns over 5-10 years and move the needle a little away from mature companies.

[1] History Lessons: How Transitory Is Inflation? George Santayana, Research Affiliates, November 2022