Préfontaine
Capital Inc.

- FINANCIAL LETTER -
SECOND QUARTER 2021

Outlook

The World Bank, in its June report, forecasts the world economy will grow 5.6% in 2021, with uncertainties about the progression of the pandemic, vaccination rates and the high level of government debts, especially in emerging countries. For 2022, it forecasts 4.3% and 3.1% in 2023. In the United States, a recent poll of American economists forecast growth of 6.9% in 2021, 3.2% in 2022 and 2.3% in 2023. In Europe, the rise in infections has caused a slowdown, but the World Bank forecasts growth of 4.2% in 2021, 4.4% in 2022 and 2.4% in 2023. In Canada, the Bank of Canada forecasts that the economy will grow by 6% in 2021 and 4.6 % in 2022, helped by the rise in commodity prices and residential investment. It forecasts inflation at a little over 3% in 2021, 2% in 2022, a little over 2% in 2023 and 2% in 2024. The Bank of Canada has started to withdraw some stimulus by reducing its program purchase of bonds and expects to start raising interest rates in 2022. The economic recovery is supported by vaccination, pent-up demand in certain sectors and household balance sheets helped by government transfers. This strong demand continues to create sectoral shortages of goods and labour, causing bottlenecks in the supply chain. In turn, this generates high inflation - deemed temporary by experts - in certain sectors such as microchips, used cars and shipping containers. Very low interest rates are also leading to overheating in real estate.

The Federal Reserve's balance sheet grew from $ 4.4 trillion in March 2020 to $ 7.1 trillion in May 2021. The response of the US Congress to Covid-19 is expected to total $ 5.1 trillion or 4.4% of GDP by 2024 according to the Committee for a Responsible Federal Budget, compared to 2.4% during the 2007-09 financial crisis. We are not experts in economics, but it seems to us that the massive indebtedness of governments will have to be repaid in three ways: either by higher taxes and tariffs, by inflation, by stronger economic growth, or by a combination of all three. Basically, getting richer today with debt means getting poorer later unless we succeed - through productive investments and innovation - in creating enough additional wealth to compensate, which is feasible but not easy. Higher taxes are not easy politically. The easiest of the three seems to be paying off debt through higher inflation (the value of money drops with inflation). Therefore, the issue of inflation for us becomes not whether this year and next year inflation will go up and then go down. The question is over the next ten years, what will be the level of inflation and interest rates and will this be a negative factor on the economy. This remains to be determined as even the experts do not agree.

The stock market continued to advance in the second quarter. The valuation ratio for the S&P500 is near the peak of 2000, although a small number of large, highly valued tech companies skew the average.

Climate risks

When we study the long-term risks and business opportunities, we think that a major theme - if not the most important theme - of the next ten years will be the environmental crisis (climate and biodiversity). According to the upcoming 6th synthesis report of the United Nation's IPCC (Intergovernmental Panel on Climate Change), part of which was unveiled in June, the rate of global warming and its impacts are much faster than we thought. It is inevitable that governments around the world will have to accelerate decarbonization measures even further and this will create a large chunk of stranded assets. According to some researchers, stock markets could drop 20% if a carbon tax of US $ 75 per ton were suddenly imposed globally and 40% with a carbon tax of US $ 150. This is obviously only a guess as no one really knows the answer, but we don't want to be on the wrong side of this financial reality, and we need to ensure the resilience of our companies in the portfolio should environmental laws tighten quickly in the coming years. Note that the cost of emitting a ton of carbon in Europe is currently 55 € and CA $ 40 in Canada (rising to $50 in 2022 and $170 in 2030). There are 64 carbon pricing initiatives globally that cover 21.5% of global emissions. Canada has just adopted Bill C-12 which will more strictly set out the path leading to a carbon neutral economy by 2050 with a reduction target of 40% to 45% in 2030 vs. 2005 emissions. A few days ago, the European Commission announced its climate plan 2030, which includes tariffs for products imported from countries without carbon prices. It is the most detailed and advanced plan in the world. It aims to reduce carbon emissions by 55% in 2030 compared to European emissions in 1990. We can see that there is still some way to go with respect to further government actions with, for the moment, great fragmentation in environmental regulations.

« Greenwashing »

In the investment world, we saw a resurgence during the quarter of what is called "greenwashing", or the claim by certain companies and funds to be green and sustainable when it is not really the case. International standards regarding what can be qualified as green, sustainable, or responsible are being formulated, but for now let's say they are very elastic and subject to abuse. The Task Force on Climate-Related Financial Disclosures (a body of the Financial Stability Board, an international body for the management of the international financial system) has issued recommendations that are a good first step for companies to calculate and disclose their carbon emissions. Also, the G7 countries have set up the International Sustainability Standards Board (ISSB) which should begin this fall to establish common standards for disclosing the effects of climate change on companies. A first set of standards should be issued in mid-2022. Also, central banks are developing climate related stress tests for banks and insurers, but we are in the early stages. Further, in Europe, a regulation has just emerged against "greenwashing" at mutual funds: the Sustainable Finance Disclosure Regulation. The first phase of this regulation took effect on March 10.

How to Invest

As you know, we invest in companies that we hope to hold for at least 5-10 years, and ideally longer, as our goal is to compound our after-tax returns at a high rate. As a result, some of our attention is focused on major economic, political, social, technological, scientific, and environmental trends. However, we devote most of our time trying to understand the competitive dynamics specific to our companies and evaluating the quality of their managements. We try to form an opinion on the outlook for our businesses over the next decade. We also look, where possible, for specific situations where the success factors will be independent or less sensitive to the future direction of the economy (what some call idiosyncratic situations). An example would be a revolutionary new cancer drug with no credible competition. Even if the economy faltered or inflation raged, this drug would likely sell well and provide good profit margins. Accordingly, we put additional capital into our strong biopharmaceutical company in May, its share price having declined as the market shifted its attention to passing fads.

As you have noticed, we took profits on stocks where the ratio between expected return and risk was becoming less favorable in our opinion. Our goal was also to build up reserves of "dry powder" (cash) to position ourselves to buy when the pitcher (the stock market) throws us an easy ball. We will wait until the pitcher is distracted, over-excited, or depressed (ideally at a point of maximum pessimism) and throws an easy one at us. Unlike baseball, we as investors can let as many pitches go by as we want. That's why our batting average is high.

Another characteristic of the way we invest is the great attention (some would say obsession) we pay to risk, that is, to the probability of permanently losing our capital. Our focus is mostly on the specific business risks of the companies we assess. A small part of our attention is on systemic risks, that is, general market risks, which are however very difficult to judge and less important for a long-term investor.

Warren Buffett's Ground Rules

We recently reread some passages from the book *Warren Buffett's Ground Rules* by Jeremy Miller on Warren Buffett's early years as an investor, from 1957 to 1969. The whole book is exceptional, but one passage from young Buffett particularly struck us:

> *The evaluation of securities and businesses for investment purposes has always involved a mixture of qualitative and quantitative factors. (…) although I consider myself to be primarily in the quantitative school, the really sensational ideas I have had over the years have been heavily weighted towards the qualitative side where I have had "high-probability insights". (…) So the really big money tends to be made by investors who are right on qualitative decisions but, at least in my opinion, the more sure money tends to be made on the obvious quantitative decisions".*

When Amazon's share price went from over $ 105 in 1999 to around $ 6 in 2001, we doubt there was much comfort in terms of quantitative factors in 2001. So, an investor had to believe in the business model, which was not yet proven at the time. It is important to understand that the economy has dematerialized significantly over the past two decades and that intangible assets now form a significant part of economic activity if not dominant in terms of future growth. This means that the valuation of companies becomes less and less quantitative and more and more qualitative. This also implies that the risk of making mistakes becomes greater for those who do not follow guidelines and let themselves be carried away by wishful thinking. We must let pass many situations where it is impossible to quantify the risk with a reasonable degree of conviction and not despair in regret for everything that turns out a posteriori a success in which we did not participate. However, the needle will need to move a little further to the right on the scale from "*tangible evidence of past success"* to *"hope for future success based on a good idea"*. But we will need to properly mark our high-probability insights to make sure that we limit ourselves to situations where the probability of losing our capital is very low. This must remain our priority.

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