Préfontaine Capital Inc.

- FINANCIAL LETTER -
FIRST QUARTER 2022

Outlook

The highlights of the first quarter were the war in Ukraine, the recognition by central banks of the importance of inflation and the emergence of the Omicron BA.2 variant. The International Monetary Fund lowered its projection of global growth in 2022 to 3.6% from the 4.9% expected last October.

The war in Ukraine, a human tragedy, has left a deep impression on people's minds and has caused a lot of insecurity in everyone and in the financial markets. The sanctions of democratic countries against Russia were the most severe ever imposed on a large country. They were swift and unprecedented in their content and scope. Their long-term consequences and duration are still uncertain, as is the outcome of the war. Meanwhile, the war is causing additional upward pressure on commodity and energy prices and possibly a food crisis in certain developing countries. In the longer term, we are probably entering an era of economic division between the China-Russia axis on one hand and the axis of democratic countries on the other, with many countries seeking to remain neutral. This would lead to less international trade, more local production and therefore theoretically more inflation and downward pressure on living standards. All this remains to be determined.

The U.S. Federal Reserve and the Bank of Canada both plan to raise interest rates and reduce their bond portfolios, which usually causes volatility in the markets. Several experts believe that central banks will have to raise rates more aggressively than the markets expect to curb inflation and that this will cause a recession. This is quite possible. Recessions are a healthy and necessary phenomenon for the economy because they help clean up the excesses that accumulate over the years: excess debt and liquidity, excess consumption, overconfidence and the excess in asset prices such as real estate and stocks. A decline in economic activity, financial and real estate markets would only be normal and we, long-term investors, do not worry about it. For people with a shorter time horizon, it is better to have a larger allocation to fixed income to properly withstand the stock market corrections and crashes that occur regularly.

The Omicron variant prolonged the dislocation in supply chains in the first quarter, especially with China taking strong steps to stop the spread of the virus. It should be noted, however, that there appears to be recent improvement in certain supply chains. Here in America as well as in Europe, economies are adapting, for now, with vaccines, anti-viral drugs, and distancing measures. It remains necessary to keep closely following the evolution of the virus and its future variants.

Our investments

The first quarter was marked for us by the sale of **Intertape Polymer Group** to Clearlake Capital Group for $40.50 per share. This was our third largest equity position with nearly 6% of the portfolio; the stock jumped 78% on the day of the announcement. This contributed significantly to our performance in the quarter. The stock had been weakening since the summer and we added to the position from time to time – notably on March 7, the day before the announcement – because we thought it was cheap. The sale is scheduled for early in the third quarter (July) and the shareholder vote will take place on May 11. We did very well with this Montreal-based industrial company that seemed to interest no one (which often appeals to us) but whose quality was obvious to us. Our annualized return since our summer 2018 purchases is 30.8%. Our returns on subsequent purchases are even higher, including about 78% in one day for our March 7, 2022, purchase.

We significantly reduced our position in **Abbvie** at the very end of March, following a 56.4% return (including dividends) in the last 12 months. ABBV was our seventh largest position at nearly 5% of the portfolio. We believe that at the price sold, the balance of risk and reward was less favourable, even if the company seems to us to be well managed. Abbvie, which we have owned since January 2013, has the second highest total return among leading pharmaceutical companies since it went public in January 2013 (23.3% annualized in USD, around 25.9% for us in Canadian dollars), after **Elli Lilly**. We continue to retain a smaller position in the company.

Berkshire Hathaway shares have woken up since last December as the company made several sizeable transactions and the market started to perceive it as a good counterweight to inflation and a good defensive stock in case of a recession. The stock's 12-month return as of March 31 was 41.2% in USD. Over the past 10 years to March 31, the annualized return was 15.3% in USD, slightly higher than the S&P 500, which was 14.6%. This 15.3% over 10 years is satisfactory considering the low business risk of this conglomerate and its huge cash reserve.

Alimentation Couche-Tard shares, purchased at an average cost of approximately $36.70 per share on January 14, 2021, the day after the announcement of the acquisition offer for Carrefour, have done very well. The shares have risen over 50% in just over a year, but that does not correct our mistake of not buying the company ten years ago, or even after we read the book about Couche-Tard cofounder Alain Bouchard's life in February 2017.

In early March, we added to some of our technology holdings, including **Microsoft**, at prices we felt were acceptable for long-term holding, without them being screaming buys. We could add to these positions in the coming months if conditions are favorable.

Our worst performer over the last year was **Intel** (-18%), a turnaround situation with a new CEO since February 2021. It may be a long journey through the desert for Intel, as the company must invest a colossal amount of capital in manufacturing and in R&D to catch up with the competition that has surpassed it in recent years, following the lackluster performance of the previous management team. This is a risk we are willing to take because the oligopolistic character of the industry and the geopolitical importance of the major semiconductor manufacturers seem favorable to Intel. Further, the new CEO Pat Gelsinger, appears to us as a technology enthusiast, ambitious, energetic, with a very long track record and well placed to turn around R&D at the company. His new hires over the past year – highly experienced scientists and managers – and capital allocation decisions – including the partial spin-off of **Mobileye**, the purchase of **Tower Semiconductor** and investment announcements of major manufacturing capacity in the U.S. and Germany – bode well in our view. A detailed recovery plan until 2026 was presented to investors last February. Governments, major clients, other industry partners and major investors will be involved (including one of our core holdings, **Brookfield Asset Management**, which has a flair for investment opportunities). A large part of our thesis in all our investments is based on the quality of the leaders. When we see a surge of talent moving towards a company in recovery, in a promising sector, that can be bought at a low price, it is a signal to devote time and learn more. Pat Gelsinger's target is to double earnings per share in five years, which should also help increase the valuation multiple. Over five years, we should do well, but we will have to be patient, follow developments closely and adjust accordingly.

Whether there is a recession or not will not change our philosophy of owning extraordinary companies through the peaks and valleys in the economy. We might buy a more cyclical stock or two if their price drops sufficiently, but otherwise we stay the course. Our portfolios are generally below target in equities, and even more so if we consider Intertape now as a cash position. So we have lots of dry powder ready to be deployed in a recession scenario and a sharp stock market decline.

By maintaining very short average maturities in our fixed income holdings, we avoided the 7% fall in Canadian bond values in the first quarter of 2022 and the 4.5% fall over the last twelve months. We are now positioning ourselves to increase the average duration of the fixed income portfolio.

The following sections are reserved for our clients