Préfontaine Capital Inc.

- FINANCIAL LETTER -

FIRST QUARTER 2024

Outlook

The US economy grew by 2.5% in 2023, vs. 1.9% in 2022, according to the latest estimates from the US Commerce Department; the estimate for 2024 is around 2.4%. In March 2024, core inflation rose to 3.8% and the unemployment rate fell to 3.8%. In the US, there is debate as to whether there will be 0, 1 or 2 rate cuts in 2024, as the economy, employment and consumption are resilient. Rates on 10-year US Treasuries have risen to 4.61% as of this writing.

In Canada, growth rebounded in January and February, according to early estimates, but the economy remains weak. According to the Bank of Canada, core inflation will hover around 3% in the first quarter and unemployment rose to 6.1% in March. The Bank has raised its forecast for economic growth to 1.5% in 2024, helped by immigration, government spending and exports. For the time being, expectations are for a first interest rate cut in Canada around mid-2024.

As stock market levels rise, investors' guards are increasingly relaxed. As has always happened, human nature never changing, people are willing to take on more and more risk as prices swell relentlessly. More speculative assets like Bitcoin and AI-related securities have reached levels that are hard to justify. Almost all S&P500 sectors (except real estate and energy) are trading at very high multiples relative to their historical averages. This could be justified with interest rates at 1%, but with rates over 5%, the multiples are too high and, all things being equal, the stock market should correct, either slowly or quickly. According to some strategists, the S&P500 should fall by around 25% to return to the average historical valuation when adjusted for current interest rates. If interest rates fall, then the drop required to return to the historical average would be less pronounced. If rates rise again, the stock market drop should be even greater to return to averages. Different arguments can be made, and nobody knows what will happen in the short to medium term, but the fact remains that, in an environment of high prices, it pays to be more cautious than usual.

More interesting and significant are the deeper long-term trends. JP Morgan CEO Jamie Dimon and former governor of the Bank of Canada and the Bank of England Mark Carney do not rule out a scenario of rising inflation and interest rates in the coming years, as structural trends are inflationary, which would normally put downward pressure on stock market values. We have been discounting the more structural inflationary trends (massive government spending, deglobalization, decarbonization of the economy) for over two years (see our Q3 2021 letter), which has enabled us to outperform in our fixed-income portfolio by a wide margin, with a very short average duration. Current expectations for average inflation over the next 5 years are 2.6%. At present, we can obtain around 5.10% for a highly rated corporate bond with a 1-year maturity, around 4.80% for a 2-year and around 4.55% for a 3-year.

Our investments

« Simplicity is the ultimate sophistication. »

- Leonardo da Vinci

Our 2024 results are off to a good start. When we invest, our first goal is not to be out on three strikes (not to lose our capital); our second goal is not to forget the first goal; our third goal is to hit safe base hits. Sometimes, without trying to swing harder, we hit a home run. Our definition of an ideal home run is an investment that compounds (without selling it) for more than 10 years at more than 15% annually (quadruple), net of tax, in a normal inflation and rate environment. Our investment in **Hammond Power Solutions (HPS.A)**, a small manufacturer of transformers and other electrical products based in Guelph, Ontario, offers a good start. We took a position at around $51 last September. Seven months later, the stock is at around $159, an increase of over 210% (we more than tripled) including the dividend. Fortunately, our starting position was large enough to move the needle on our total return. We have no immediate plans to sell, even if the stock is now far from a bargain. We're prepared to live through the ups and downs of the stock from the current point. So far, we like the new management team and believe that the tailwind in electrical infrastructure is not about to go away. The main risk for this company is that its success attracts competition from larger companies in the sector. Another risk to watch out for is the expansion of the product range, which could lower the return on capital during a running-in period. We'll see long-term if the home run is confirmed.

Here are the returns on our model equity portfolio as of March 29, 2024:

As of March 29, 2024 (annualized for a period exceeding 1 year)

	1y	3yrs	5yrs	10yrs
Préfontaine Portfolio	34.2%	18.3%	16.6%	14.5%
Reference Index	16.9%	10.1%	11.1%	10.4%
Difference	17.3%	8.2%	5.5%	4.1%

Returns before fees, including dividends. Fees vary according to the size of each portfolio. As an indication, our average fee as of March 29, 2024, for the total portfolio of all clients is 0.74% annually. Comparable index (total return -TR i.e., including dividends and in CAD) adjusted each year according to the allocation of the Préfontaine Portfolio; as of March 29, 2024, 56% S&P500 Equal-Weight TR, 38% S&P TSX TR and 6% MSCI Europe TR. Over the entire period, the Préfontaine Portfolio is made up of all Stéphane Préfontaine and Fondation Préfontaine-Hushion accounts and serves as a model for the portfolios of Préfontaine Capital clients.

Return vs. risk: performance isn't just a number.

In our last letter, we reported that over the last 10 years, our model portfolio has fallen by just -0.6% in 2018 (vs. -4.3% for our index) and -1% in 2022 (vs. -5.6%), with all other years having been positive. Just as importantly, our portfolio's performance is not based on just a few strongly outperforming stocks. Rather, our performance has been well distributed across most of our portfolio holdings. Over the past year (last 12 months to March 29), for example, 72% (26/32) of our holdings outperformed our benchmark and 97% (31/32) generated a positive return. We believe that broad, well-distributed outperformance offers better value and less risk than outperformance that is highly concentrated in a limited number of stocks. **Good risk management is part of performance, even if it is more difficult to visualize.**

The following sections are reserved to clients of Préfontaine Capital.