Préfontaine Capital Inc.

- FINANCIAL LETTER -
THIRD QUARTER 2024

Outlook

The US economy is resilient, with a good employment performance and core inflation remaining around 3.3%. The manufacturing sector is still under pressure, with the US Purchasing Manufacturers Index (PMI) showing under-utilization since the end of 2022. In particular, political uncertainty is slowing industrial investment for the time being. The OECD forecasts growth of 2.6% in 2024 and 1.6% in 2025. In Canada, the Conference Board forecasts growth of 1.1% in 2024 and 1.7% in 2025. Inflation in Canada is now around the 2% target, but its cumulative effect of nearly 20% over the past three years is affecting consumption by the 40% lowest-income households, who have lost purchasing power.

After abnormally high returns in recent years, you'll forgive us for being a little cautious about what comes next. On average, stock markets have delivered around 9% annualized returns over the past century. Over the past five years, the S&P 500 has annualized at 16.5% in Canadian dollars, and the S&P Equal Weight Index 13.3%. The S&P 500's price/earnings ratio is 24.7x (last 12 months, according to Birinyi Associates), while the historical average is around 16x.

There are a host of arguments for and against this very high stock market valuation. The main argument for higher-than-average valuations is the impact that artificial intelligence and other innovations will have on future productivity.

The argument for caution is that no one has ever been able to predict the next crisis (war, pandemic, financial crisis, etc.), and that when valuations (expectations) are very high, the downside shock is always greater during a crisis, more so when the US governement is at historically unprecedented levels of debt outside of wartime. Prudence during periods of high market overvaluation translates into a lower weighting in equities, more resilient business models for our companies, but mostly a reasonable average valuation for our stocks. The situation depends on each individual, their age, tolerance to volatility, income requirements, current portfolio status and opportunities to find solid, undervalued stocks.

Some investors prefer to be 100% invested in equities all their lives, riding out the ups and downs without flinching and continually investing in equities as soon as they have surplus cash. This is easier when you have ample resources to maintain your lifestyle during crises. However, you have to be able to keep your cool during crashes, and not everyone can do that. For us, the possibility of a “Black Swan” event, i.e. a major financial or human cataclysm, means we prefer to suggest keeping a safety cushion of several years' expenses.

It's always psychologically very difficult to be cautious when the stock markets are booming. Conversely, it is very difficult to buy after a major stock market crash. But this is what we strive to do.

Our investments

"Simplicity is the ultimate sophistication."

-Leonardo da Vinci

"Invest at the point of maximum pessimism".

-Sir John Templeton

Most of our stock portfolio is made up of multinational companies that are very dominant in their markets. But the business context is constantly changing: once-dominant companies are sometimes overtaken by competition or by changes in technology, regulations or habits. We have a few companies in our portfolio that have suffered such shocks, but whose turnaround plans we find credible, and whose stock prices are sufficiently depressed (expectations are sufficiently low) for us to consider reasonable the likelihood of good future gains.

Our portfolio also includes solid, well-managed companies in an economic sector that is currently under pressure (e.g. home building and renovation). We are holding these stocks because we believe that, over the long term, the trends are favorable, and their prices are not overvalued.

We also have companies that are in a very favorable phase, where we have made strong gains, but for which we believe the trend will continue, despite a high market valuation (e.g. our technology stocks).

In general, when the news is very bad, the market underestimates the possibility of a turnaround, and when the news is excellent, the market overestimates future gains; but this is not always the case, as sometimes the market is right. Our difficult task is to continually monitor the business development of different companies vs. the state of market expectations, to detect if there are any aberrations.

As for fixed income, we remain short. We are still leaning towards those who believe that inflation will be fairly persistent over the coming years, and that the downward trend in rates will be slower than the markets currently expect, notably due to the gigantic US government debt, which will put upward pressure on rates. If the market eventually recognizes this and longer rates rise, we will lengthen our average duration. We are monitoring this closely.

Here are the returns on our model equity portfolio as of September 30, 2024:

As of September 30, 2024 (annualized for periods over 1 year):

	1 yr	3 yrs	5 yrs	10 yrs
Préfontaine Portfolio	30.7%	17.3%	17.6%	14.4%
Benchmark index	27.7%	10.1%	12.0%	10.9%
Difference	3.0%	7.2%	5.6%	3.5%

Returns before fees, including dividends. Fees vary according to the size of each portfolio. As an indication, our average fee as of September 30, 2024, for the total portfolio of all clients is 0.745% annually. Comparable index (total return -RT i.e. including dividends and in CAD) adjusted each year according to the allocation of the Préfontaine Portfolio; as of September 30, 2024, 52% S&P500 RT, 41.1% S&P TSX RT and 6.9% MSCI Europe RT. The Préfontaine Portfolio is an actual portfolio made up of all Stéphane Préfontaine's personal and corporate accounts and those of the Fondation Préfontaine-Hushion over the entire reference period.

The following sections are reserved to clients of Préfontaine Capital.