Q1 2022 Cidel Global Equity Strategy Commentary

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Asset Management

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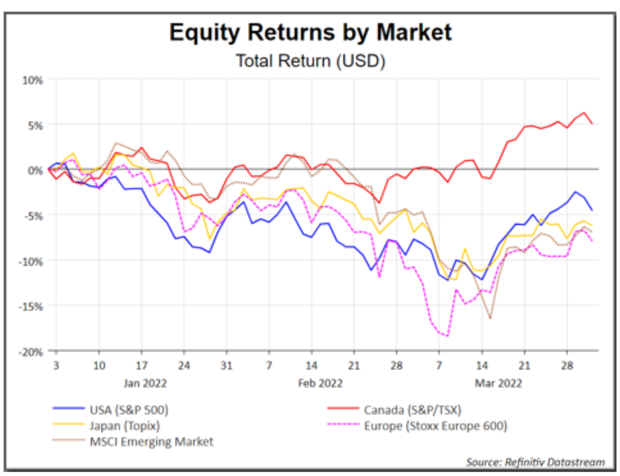
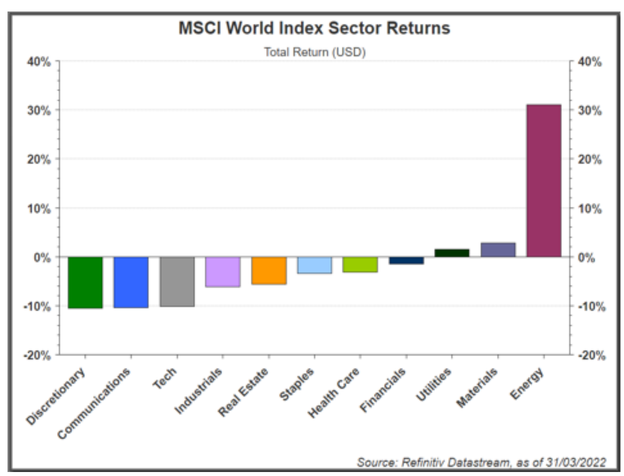
Equities had a memorable first quarter of 2022, but entirely for awful reasons. Early in the quarter markets exhibited weakness as they continued to digest the reality that persistent inflation was helping to bring the era of extreme central bank and fiscal liquidity to a close. Long duration assets, which in the equity market often means higher growth, high valuation stocks (frequently but not exclusively found in the Tech sector) were particularly vulnerable, and continued their corrective slide that started in November 2021 with the Adobe Inc. earnings and guidance "miss", and continued with the release of the Federal Reserve minutes (which revealed growing concern by Fed Board members surrounding inflation and inflation expectations).

Equities further weakened in the immediate wake of the horrific and previously barely imaginable February 24th invasion of Ukraine by Russia. For the quarter the MSCI World Index ended down 5.1% in $U.S. terms (and down 6.3% in $CAD terms). Canadian equities did relatively well in the quarter. They obviously benefited from the local markets higher weighting in Energy stocks, and less obviously probably tangentially benefitted from the country's relatively low absolute and relative geopolitical risk. Energy, whose medium term fundamentals – specifically the prospects for a limited supply response to rising "re-opening" demand – was already performing well prior to the war. Energy stocks further benefitted from the spike in geopolitical risk, and as such proved to be the only sector that offered up significant returns during the quarter. The below left chart recaps how various equity markets have performed thus far in 2022, and the below right chart illustrates how weak sectoral breadth – ie the proportion of sectors that have enjoyed good returns - has been thus far this year.





The Cidel Global Equity Strategy made a number of portfolio changes during the quarter. Apart from the stock specific considerations described below, factors that influenced the trades included a desire to use the market volatility to improve the long term capital appreciation potential of the portfolio, an opportunity to improve the portfolio's quality characteristics, and to reduce exposure to pockets of the economy where we think medium term results are most at risk from inflationary pressures.

1. We have built a small position in PayPal Holdings Inc. We believe this American provider of digital payment solutions is well positioned to benefit from the ongoing rise of cashless transactions and e-commerce purchases. Some of its newer product offerings, and in particular peer to peer money transfer app Venmo, are modest profit contributors at present but offer compelling long term potential. Correspondingly we believe the company has many years of low double digit organic revenue growth potential ahead of it. The stock was bid up to (an arguably insane price of) over $300 last summer, but with the above described weakness in higher growth tech stocks the shares ended the quarter at just $116. The company should generate nearly $6b in free cash flow this year, which equates to a 4.5% free cash flow yield. As such we think this is a good entry point for this high quality compounder.

2. We've also built a small position in Argentine ecommerce and fintech company Mercadolibre Inc. Similar to Paypal, Mercadolibre's share price had run well ahead of reasonable estimates of intrinsic value over the course of 2021. And as is inevitably the case when shares hit valuation extreme's (in Mercadolibre's case shares traded in excess of 25x sales – not earnings, sales – at points in 2021) the shares have had a torrid few months, falling from a high of $1954 in early September down to $1191 at March 31st 2022 (after having hit an absolute low of $884 in mid- March). We were happy to add this high growth company at a price well below our estimate of its value. The company operates in a variety of Latin American countries, where penetration of ecommerce, online banking and online advertising is still in its relative infancy. The company has and will continue to invest heavily in both its technological and logistics capabilities. This heightened spend has depressed near term profits but we are confident it will maximize the performance and value of the business in the long run. Despite the high level of internal investment, the company is free cash flow positive, its balance sheet is strong and we expect revenue growth to be in excess of 20% for many years to come.

3. We established a full position in French luxury goods conglomerate LVMH Moet Hennessy Louis Vuitton SE. Apart from the well known and iconic Louis Vuitton leather goods, the company business lines include champagne, cognac, watches and jewellery, perfumes and travel. The company's other brands include Tiffany, Christian Dior, Sephora, Hennessy, Veuve Cliquot, Zenith and many others. While Louis Vuitton never puts their purses on sale, the shares can occasionally be had on the cheap. The shares experienced weakness as European equities sold off in the immediate wake of the Russian invasion of Ukraine and this past winter's rising COVID 19 case count in China (a key market for luxury goods). They have declined from an all time high €758 in early January to a low of €550 in early March before rebounding to end the quarter at €649. We expect that the company will continue to take market share from rivals and is well poised to continue to demonstrate organic growth well in excess or the overall economy or greater consumer sector. We also believe LVMH has excellent pricing power relative to most other consumer (or even industrial for that matter) businesses, which is a key consideration in an inflationary environment.

4. Finally we have also built a full position in U.S. defense contractor Lockheed Martin Corporation. Lockheed Martin is well positioned to win business from higher NATO and allied defense spending in the years (and likely decades) to come. The order backlog should grow at an accelerated rate,

4. Cont'd: and this in turn will drive better revenue growth and an uptick in margins. Lockheed's key products include the multi-decade F35 fighter jet program (Canada, Finland and Germany have come onboard as new customers in just the last few months), which provides a high level of earnings visibility for years to come. While the factory in Ft Worth Texas that manufactures the F35 is fully utilized, there is the opportunity to expand it to improve capacity (and thus Lockheed Martin's revenues). The company's other segments are Space, Missiles and Mission Systems. Even prior to the outset of the war defense stocks are worth investigating in an environment of slowing growth, as they typically have attractive cash returns, and often have low correlations with other parts of the equity market. While Lockheed Martin's medium term revenue growth profile is not on the order of Paypal, Mercadolibre or even LVMH, its cash return prospects are excellent. We expect Lockheed Martin to generate roughly $6.5 to $7.0b of free cash flow in each of the next three years. This will enable a cash return of roughly 5.5% this year, with 2.5% coming from the dividend and 3.0% from a share buyback. At quarter end the stock was trading at approximately 17 times forward earnings, well below the overall S&P 500 PE ratio.

These four new investments were financed by selling four existing investments. We sold our positions in Irish construction materials firm CRH and in Dutch brewer Heineken NV. Both companies are executing well, and neither company's shares are overvalued. However, they both face rising input cost pressures in the near and medium term. We believe that LVMH has much better pricing power and long term growth potential, and these two sales largely funded the LVMH purchase. Despite howls of protest and indignation from the author's school aged children, we also sold our position in American chocolate and snacks firm Mondelez International Inc. for similar reasons. We are worried that the maker of Cadbury chocolate and Oreo cookies will struggle to maintain margins and market share in the face of higher input costs. Part of the proceeds of this exit were used to increase our position in Procter & Gamble, a conceptually similar stock which we believe has better pricing power. Finally we also exited our position in Medtronic. After a period of being significantly undervalued vs. peers in the late 2010's, the the shares had appreciated to the point where they were trading inline with our valuation, and given our significant weight in health care (and in particular medical devices due to our investments in Olympus and Johnson & Johnson), we opted to use our Medtronic position to fund the purchases of Paypal and MercadoLibre.

The economic growth outlook – which is the ultimate driver of public market equity profit growth – was already decelerating even prior to the start of the war. Reuters poll of 2022 U.S. GDP growth estimates have fallen from a rosy 4.2% last September to a much more pedestrian 3.3% presently; the 2023 growth estimate has fallen to just 2.2%. While economic forecasts are infamous for their inconsistent accuracy, but the direction of travel matters. By contrast, we can see from the chart below that S&P 500 EPS forecasts (currently expecting $230 over the next 12 months) have continued to rise at a nice clip in 2022. With the April earnings season just getting underway it will be interesting to see if estimates can maintain this strong run. By contrast earnings estimates outside the U.S. (specifically the MSCI World ex U.S. Index) have clearly started to flatten.

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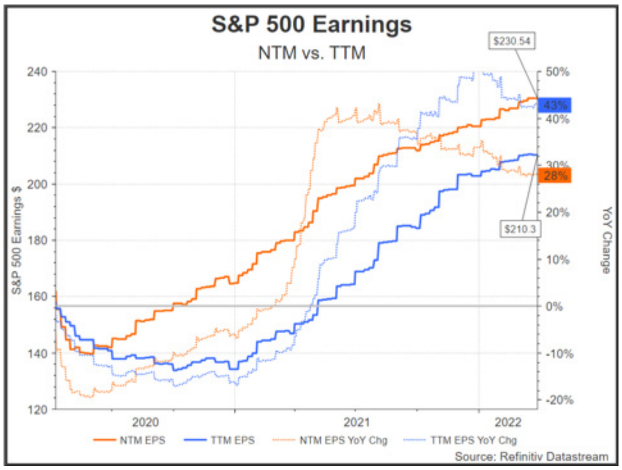

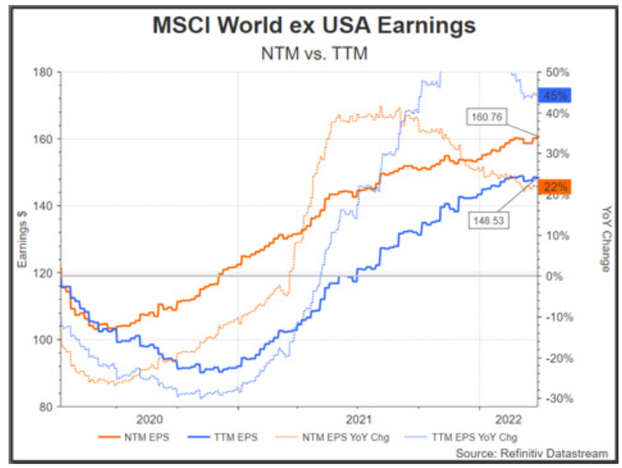

Central banks were slow to acknowledge the persistence of rising inflationary pressures in 2020 and 2021, and as we enter 2022 they are now in a position of having to increase interest rates aggressively this year and possibly beyond. For equity markets this threatens a set up of decelerating earnings growth and rising investment hurdle rates (via higher interest rates). In our prior quarterly commentary we noted that while we retained a generally favourable medium term outlook we were somewhat concerned for 2022's prospects. Not only must equities overcome earnings growth deceleration and tighter liquidity, they are also at risk of needing to take a proverbial "breather" after three extraordinary calendar years of returns between 2019- 21 (wherein annual USD returns for the MSCI World Index ranged between 15% to 27%).

But long term investors should be able to see the silver lining that accompanies weak or volatile markets, namely the opportunity to add in high quality businesses to the portfolio. The businesses we invest in have excellent balance sheets, often with no net debt at all, and will be able to not only navigate through tighter liquidity and a slowdown, but can capitalize upon it. We expect the vast majority of our holdings to increase dividends this year, and while dividend growth has been a relatively poor performing "factor" in recent years we are confident that it can recover for a couple of reasons. First and foremost dividends (and re-investment) are a huge component of long term equity returns (as much as half depending upon the time period and the market in question). Long term stock market investors ignore dividends at their peril. Secondly in an environment of rising economic and geopolitical uncertainty we think that company's that can prove their consistency and cash flow visibility to investors by increasing their dividends – on a sustained basis – will stand out even more so than normal.

April 2022