How we Invest at Cidel

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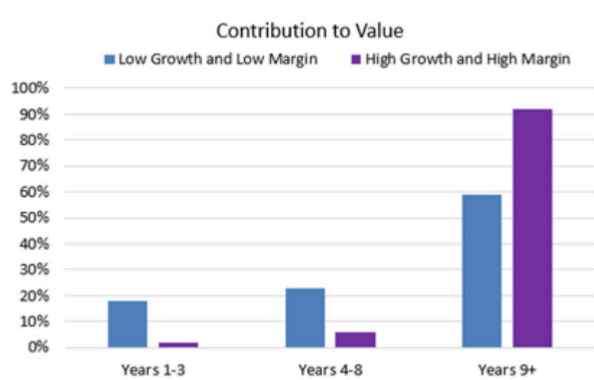
"If you can wait and not be tired of waiting" – Rudyard Kipling

Autumn reminds us of heading back to school. Therefore, with the back-to-school feeling in mind we are going back-to-basics about how we invest at Cidel. Perhaps a simple reminder will be a tonic given the daily geo-political and macro-economic turmoil that bombards us. First off, we have a rather old-fashioned framework for equity investing. We think like a long-term business owner. What matters to a long-term business owner, is the size and persistence of the cash flow that the business generates. As you are aware, there are many ways to value a business from 'short-hand' price-to-earnings ratios to elaborate discounted cash flow analysis. At Cidel, we employ many valuation techniques to be 'approximately' right rather than be flat out wrong by relying on only one measure. For this discussion, we will focus on the discounted cash flow analysis. We can already hear the chorus of objections – and yes, the discounted cash flow analysis (DCF) is not without its flaws. Nevertheless, if you believe, as we do, that equities are a long duration asset and cash flows matter, then it is easier to digest the use of a DCF with this analogy: think of the DCF model like democracy. To paraphrase Winston Churchill, the discounted cash flow model is the worst form of valuation, except for all other valuation methods that have been tried. A DCF model for any company will illustrate that most of the value of any business is in the long term. In fact, anywhere from 60-90% of the value is after 9 years. (To be clear, 'long-term' is not the portfolio manager's effective use of misdirection as any magician off Clifton Hill Niagara Falls might employ – feel free to open Excel and try it yourself).



Source: Cidel

The challenge is how de we capture the long-term 'prize'? Helping us assess the size and persistence of cash flows over long periods, we have built out investment process around four fundamental principles:

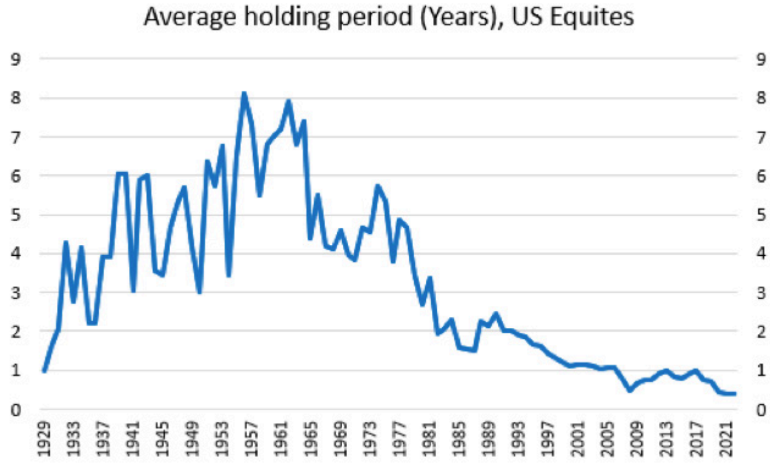
1. Sustainable Competitive Advantage: Capitalism means competition, and competition can be corrosive to margins and returns on capital. Therefore, we look for businesses with attributes that defend against these competitive forces.

2. Ability to Forecast: We use history as a starting point and we like to see a high degree of visibility in revenues, margins, and ultimately cash flows to narrow the range of potential outcomes. A wide range of outcomes not only makes valuation accuracy difficult, but it also makes assessing management's stewardship of capital difficult.

3. Attractive Return on Capital: Ideally, we are looking for businesses with durable, predictable and high free cash flow margins, which have sufficiently large opportunity sets to reinvest this cash flow back into the business at the same (or higher) rates of return. This creates a virtuous cycle that with time and repeated turns of the 'flywheel' results in a powerful compounding effect.

4. Financial Strength: A business can have all the above-mentioned attributes, which can be enough for investment success in most circumstances; however, during periods of macro distress, sometimes the only thing that matters is having an appropriate capital structure. Financial strength not only provides stability in economic downturns but also provides optionality to improve the business either through organic investment or inorganic acquisition to position the business for the eventual economic improvement.

Why does all this focus on the long-term matter? If everyone viewed equities as we do (as a long duration asset and with a focus cash flow) then our task of outperforming would be even more difficult. Why? There would be longer holding periods and less trading if investors shifted their focus to the long-term drivers of cash flow rather than over-reacting (either euphorically or pessimistically) to short-term noise. This would likely result in significantly fewer opportunities to deploy capital into mispriced securities. Is this the case? Clearly not. Studies of the average holding period of equities indicate that investors are doing just the opposite. That is, the average holding period of equities continues to fall and, by some estimates, the average holding period in 2022 is down to 4.5 months.



Source: Reuters, Refinitiv, CIBC

Months. Not years or even decades. This means investors, on average, have become even more fixated on the short-term. Whether it be speculating on short-term macro-economic indicators or positioning for short-term earnings 'beats' or 'misses'. Not only are these difficult to predict, but they matter little to the long-term value of the business (as noted in the charts above). Therein lies our competitive advantage. Patience. Along with a detailed investment process that gathers and assesses the relevant factors that form the 'large' value of cash flow beyond the next few years. We look to align ourselves with management teams that also share the same values: growing durable cash flows for the long term. In the end, the goal is to harness the power of compounding by constantly answering this question: "What are the best returns we can sustain for the longest period of time?"