Q2 2023 | NEWSLETTER

VPI TOTAL EQUITY POOL

GROWTH THROUGH BUSINESS OWNERSHIP

UPDATE FROM PORTFOLIO MANAGER DIXON MITCHELL

"Optimism often sounds like a sales pitch, pessimism sounds like someone trying to help you."

- Morgan Housel

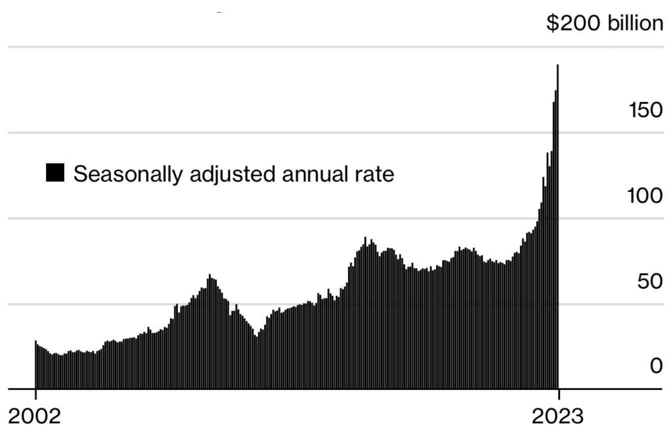
As 2023 began, there were plenty of reasons to be pessimistic: inflation was still uncomfortably high, with central bankers promising no end to their rate-hiking campaigns; almost all asset prices were being bludgeoned by the spike in rates; the economically important US housing sector was in a deep freeze; the long predicted recession was to arrive at any moment; stocks were limping out of a plunge that had passed the bear market threshold just weeks before; and, for good measure, the year began with a banking crisis south of the border. It's no wonder that most of the big strategy shops forecast that the S&P 500 would finish the year flat at best.

Trouble is, through the opening six months of 2023 the S&P has risen by as much as it would in a very strong full year and the NASDAQ Index has posted its best first half ... ever. What's also notable is that many of the predictions on which the bearish case was built have failed to materialize. Yes, we recently got another rate hike in Canada and the US Federal Reserve has forcefully reaffirmed that it's not done tightening, but many of the underlying drivers of consumer inflation have receded significantly and both the bond and equity markets seem to be taking note. For example, shelter is the largest component of CPI and, though this measure is still running at a 9% year-over-year rate by the US government's calculations, several private measures paint a much different picture. Rents monitored by Apartment List, for instance, show a semi-annual decline of 0.6% to the end of June and if the gap between these measures begins to close, headline inflation and the probability of additional rate hikes could dissipate rapidly.

Housing in the US is still challenged by higher mortgage costs and an accompanying lack of listings, but the industry has managed its way through, and expected layoffs haven't materialized. In fact, the homebuilder subset of the S&P is up by more than a third so far this year, another outcome which was not likely on the bingo cards of many forecasters six months ago!

As for recession, many remain adamant that it's still on its way, though it's difficult to imagine that we'll go into a steep slide anytime soon. In June, a slew of data was released in the US which appeared to be anything but recessionary: durable goods orders, business investment activity, new home sales, home prices, consumer confidence, and initial jobless claims all came in more favourably than expected, while first quarter GDP was revised upward by nearly 1%. As an example of how things are faring beneath the surface, the chart below shows construction spending by US manufacturers over the past two decades, a figure which has more than doubled in the past year alone. This activity is undoubtedly being helped by the push to "reshore" supply chains – and some may argue that the move away from Chinese production will carry its own negative implications in the long run – but it's difficult to square this level of business capital deployment with a near-term recessionary backdrop.

CONSTRUCTION BY MANUFACTURERS IN US



Source: *US Census Bureau*

Of course, the "not as bad as predicted" story described above only goes so far and doesn't explain the entirety of the market surge. The introduction of artificial

Source: Dixon Mitchell Investment Counsel intelligence into the public consciousness in Q1, first via Microsoft's collaboration with OpenAI to create ChatGPT and then with the release of Alphabet's Bard chatbot, led to talk of potential productivity gains similar to or in excess of those that followed the adoption of the mainframe computer, the desktop PC, the internet, and mobile telephony. This put a charge in the tech sector and provided a significant contribution to the NASDAQ's record start to the year, as strategists and investors contemplated and quantified a new source of long-term profit growth. (Microsoft and Alphabet have returned 43% and 36%, respectively, for our portfolios so far this year)

Since 1928, the broad stock market has risen about three out of every four years and fallen by 20% or more every six or so years. Predicting a market decline in any given session is always a low probability position, and even more so when stocks have suffered through a bear market just weeks before. With equities rallying now, sentiment improving, and the economy showing no sign of a significant slowdown, where does it leave the many who staked out bearish positions at the start of the year? Do they double down on their negative outlooks and hope that things take a sudden turn for the worse? Or do they throw in the towel and chalk up the missed opportunity of recent months to the cost of doing business? That's a tough call and one which we're very happy not to be facing!

As we look ahead to the balance of the year, the unusually long list of incorrect predictions made since the onset of covid-19 have only reaffirmed our conviction that the forecast game is one which we have no interest in playing. We're naturally pleased to have been fully invested in 2023 (as we always are) and equally glad that our equity team was patient with names that struggled for parts of last year, but which have made outsized contributions to performance through the past two quarters. We've recently made select equity trades to reallocate some gains toward better valued areas of our mandates. With these changes, we feel confident in the positioning of our portfolios, but will undoubtedly make further adjustments as conditions unfold.

The pool continued to perform well in the second quarter with F class shares up 3.5% versus the benchmark and category returning 2.9% and 3.0% respectively.

On a year-to-date basis performance of Canadian Equities, has been driven by our holdings in Stella Jones, Dollarama, and Alimentation Couche Tard, up 42%, 13.5% and 14.4% respectively. Canadian National Railway Company (up 4%) and not owning Constellation Software (up 33%) were drags on relative performance on a YTD basis.

US Equities continued their strong performance in the quarter and on a year-to-date basis. Oracle, Alphabet, Microsoft, and Visa were all positive contributors with returns of 43%, 32.5%, 39.3%, and 12% respectively. Thermo Fisher and CVS were the largest drags in the portfolio, while not having exposure to Amazon, Telsa, Meta Platforms and Nvidia hurt our relative performance.

Considering where we sat a year ago, when a sharp spike in inflation had imparted substantial pain across asset classes, we are pleased with our absolute and relative performance since that point in time. Nevertheless, as we did in mid-year 2022, we reiterate our commitment to process over emotions. This strict adherence has served us and our clients well over the passage of time. However, we are mindful that the long run includes many interim periods where we may see unfavourable relative performance, and the true markers of success come from staying true to our investment philosophy and process during challenging periods such as the first half of 2022. We continue to adhere to our principles while being open-minded about our mistakes and successes. Looking ahead, we remain committed to continuous improvement while maintaining our discipline as we navigate the post-pandemic era.

Note: YTD returns as of June 30, 2023. Benchmark is 65% S&P/TSX Total Return and 35% S&P 500 Total Return CAD. The benchmark provided is the custom benchmark, created by Value Partners Investments Inc. Category is North American Equity. Source: Bloomberg, Morningstar, Dixon Mitchell Investment Counsel, Value Partners Investments.

(204) 949-0059
valuepartnersinvestments.ca
300-175 Hargrave St.
info@vpinvestments.ca

PORTFOLIO ACTIVITY

Portfolio activity was muted in the quarter; however, we did add a new position, Aritzia, the Vancouver based fashion retailer. We exited our position in Gildan Activewear to fund the buy of Aritzia and on the US side we again added to CVS HealthCorp, using proceeds from trimming Microsoft.

After adding to CVS in Q1, the stock declined further in Q2 as investors continued to assess the integration and ultimate success of its two value-based care acquisitions. Additionally, a competitor projected a higher medical loss ratio for the year as elective surgeries return, signaling a potential for higher costs in CVS' health insurance subsidiary. This negative sentiment has led to a stock priced for an extremely adverse situation, providing us with a favourable and asymmetric risk/reward.

In the quarter we added a new position in Aritzia, which we have owned as a firm since the 2016 IPO. After a recent sell off we took the opportunity to add to the position in the Canadian Balanced Pool and the Total Equity Pool.

As we reflect on our original investment thesis, we have renewed confidence in the business, namely in the company's ability to grow in the US. Some reasons for this conviction are:

- ATZ's unit economics on new stores have improved since the IPO, as stores are generating higher sales with its improved brand recognition in the US;
- New stores are also aiding the eCommerce business, which has grown at a 40% CAGR since the IPO;
- The company continues to execute well on its multi-brand, everyday luxury product strategy, having added three distinct brands since the IPO.

Expectations of a slowdown in growth and lower margins clearly spooked investors, with shares falling over 40% from their highs in November of last year and now being valued at the lows of its historical trading range. But after 160% growth in the past two years, a slowdown is not entirely surprising. In the near term, the company's margins will be under pressure due to investments in a new company-owned distribution center, new store opening expenses, and product pricing decisions. As we assess the decisions driving the near-term outlook, the company is staying true to its strategy of investing in its brands, infrastructure, and internal culture and over a longer time horizon, these decisions are more likely to strengthen the business than damage it.

OUTLOOK & PERSPECTIVE

Over time, other companies may find their way into our portfolio. In some cases, these migrations occur because of an attractive entry point driven by market conditions, while other times the business matures and we gain greater confidence in the runway for future growth, and thus the business 'graduates' into our all-cap mandate. ATZ meets both these criteria. As we look back at positions graduating from our small cap portfolios, we see clear benefits for our clients:

- Expansion of our opportunity set with deep research and relationships with the businesses; and
- Further diversification of our portfolio, as at times small cap stocks diverge from their large-cap peers.

Given our history with these businesses and strong insight into the management teams that run these companies, we can often take meaningful positions (i.e. currently TFI International has a 3.3% weight, Element Fleet Management at 2.7%, and Stella Jones at 2.6%). As we continue to adhere to our process, we anticipate more such examples ahead. We look forward to highlighting similar instances in the future.

Source: Dixon Mitchell Investment Counsel

VPI TOTAL EQUITY POOL

GROWTH THROUGH BUSINESS OWNERSHIP

STANDARD PERFORMANCE DATA

	1 YEAR	SINCE INCEPTION
SERIES A	18.0%	5.9%
SERIES F	19.1%	6.9%

Note: Performance of series A and series F are different primarily because of different management fees. Annualized returns as of June 30, 2023.
Source: Value Partners Investments Inc.

Date of Publication: July 2023

(204) 949-0059
valuepartnersinvestments.ca
300-175 Hargrave St.
info@vpinvestments.ca