Quarterly Commentaries for September 30, 2021

CDSPI

Canadian Small Cap Equity

During the third quarter, the excellent economic outlook and corporate profit growth led to new records being set on several stock markets. In September the markets were more volatile, enduring the biggest monthly loss since March 2020. In this environment, Canadian small cap stocks ended the quarter down. Materials fared the worst, driven down by gold stocks. On the flipside, small cap equities in the energy sector posted the best performances.

Despite the circumstances, our portfolio posted a positive return for the quarter. Several of its constituents are benefiting from the ripple effect of COVID-19. Contributors to the portfolio's returns included Tricon Residential, a real-estate company that owns and rents homes in the U.S. suburbs that is benefitting from the exodus of citizens from the city to the outskirts. Cargojet continues to benefit from the growth in online goods purchases. Canada is still behind other industrialized countries with respect to online buying, so the growth prospects are excellent. Moreover, since the start of the pandemic, many consumers have had much more disposable income for discretionary spending. This explains why the InMode company has the wind in its sails. The pandemic prompted an increase in cosmetic procedures and InMode provides state-of-the-art tools in this field. Similarly, the second ranking lender, GoEasy, reported results that exceeded expectations when it reduced its loan-loss provisions.

We added one stock during the quarter, specifically Mercury Systems, to the portfolio. This aerospace technology provider specializes in military aircraft detection systems. This is a key sector that is experiencing significant growth.

We were forced to divest from TFI International. We held a position in this company for several years and accompanied through its growth, where it has proceeded to become a large cap company and a key player in road transport in North America. We also eliminated a few minor positions in companies that no longer met our expectations in terms of outlook or valuation, namely WELL Health Technologies, Pivotree and Magnet Forensics. We note finally that we sold our holdings in InMode, considering that it had reached its target valuation.

The growth outlook and profit trends for the securities in our portfolio are excellent. The current environment calls for a cautious approach, considering the following risks: COVID-19 variant outbreaks, bond rate increases, supply problems and labour shortages. That's why we hold companies that are in a sound financial health, poised to make acquisitions.

Canadian Equity

We focus on owning high-quality businesses trading at attractive valuations, with a significant focus on capital preservation. We want to own good businesses that have demonstrated an ability to build intrinsic value over time for our investors. We have found that this approach has outperformed in the long run, and with lower risk.

After posting five consecutive quarterly gains (with each of the last three above 8%), the S&P/TSX Composite index took a breather in the three months ending in September, barely finishing in positive territory (+0.17%). Indeed, stagflation concerns are rising around the world on continued supply chains disruptions, talks of tapering from the Federal Reserve, increased Chinese regulation and the spread of the delta variant.

The defensive Consumer Staples was the best performing sector (+4.61%), followed by the Industrials (+3.94) and Energy (+2.82%) not too far behind. Consumer Discretionary (-6.53%), Materials (-5.62%) and Information Technology (-1.29%%) under-performed the broader market, while the heavyweight Financials ended the quarter in the middle of the pack (+1.14%).

The strategy delivered a total return of 2.05%, outperforming its benchmark for the quarter.

Our largest contributor this quarter was Thomson Reuters (+14.1%). The legal, tax and accounting software company benefits from sticky revenues like many software businesses. Indeed, its proprietary databases and best in class technology lead to a 90% retention rate. Backed by the Thomson family, a long-term shareholder, the business has delivered solid earnings growth and free cash flow generation over the years.

Constellation software was another strong contributor to performance (+10.6%) for Q3. The software it offers is narrowly focused on solving a problem for a specific market or industry and is typically core to an end customer's operations, making it utility-like and difficult to replicate. Constellation, a business we have long admired, has a number of strong attributes including one of the best decentralized business models we have come across, modest capex requirements, and an exceptional founder (and senior executives) with plenty of skin in the game.

Canadian Pacific Railway (-13.1%) was the largest negative contributor to performance this quarter. CP operates in an industry with high barriers to entry that offers a more affordable and environmentally friendly transportation service than trucking. The company has a strong balance sheet, a demonstrated resiliency over time through good cost control, and a proven track record of wealth redistribution to shareholders. On September 15, Canadian Pacific and Kansas City Southern executed an agreement to combine, creating the first single-line rail network, linking U.S., Mexico and Canada. The transaction has the unanimous support of both boards of directors and is expected to close in Q1 2022. CP's ultimate acquisition of control of KCS' U.S. railways is subject to the approval of the STB and its review is expected to be completed in the second half of 2022.

Quebecor (-6.6%) was a negative contributor to performance in Q3 as well. The company operates in the attractive Canadian Telecommunication industry structure and uniquely benefits from a strong brand and differentiated content in Quebec. Family-owned, with a strong track record of capital allocation, it operates a resilient business model, even in challenging periods, and has historically delivered superior return on equity for its shareholders.

We have eliminated our position in Rogers Communications. This durable company operates in an appealing market structure; however, we have opted to sell out of this investment and deploy proceeds in existing positions where we have higher conviction in quality and/or valuation.

We have also decided to exit our investment in Atco. The Alberta utility operates a monopoly position in certain markets of the province, offering electricity and natural gas transmission and distribution. It has delivered modest, but consistent earnings growth over the years. However, we have opted to eliminate this position and deploy proceeds in existing names where we have higher conviction in quality and/or valuation.

Our portfolio continues to be composed of high-quality businesses that can withstand tough times. Even after the market recovery, the portfolio is currently trading at an attractive discount to its intrinsic value. Both of these should position the portfolio well for long-term compounding of returns.

Active and Strategic Fixed Income — Short Term

The global economy continued to expand in the third quarter of 2021. Rising energy prices, supply-chain disruptions and labour shortages in a number of industries helped push the rate of inflation up. Investors and central banks are beginning to doubt whether the increase in inflation is transitory. Given the strength of the recovery and the substantial rise in inflation, the Bank of Canada further reduced its purchases of securities in the market. As for the U.S. Federal Reserve, it is expected to begin tapering in the fall. North American key rates should remain stable until the last quarter of 2022. The stock markets continued to advance during the summer, but September brought higher volatility, caused especially by higher bond yields.

In the third quarter, the 3-year Government of Canada bond yield increased from 0.65% to 0.68%.

During the quarter, we kept the portfolio's duration slightly longer than that of the index. This strategy did not contribute to the return.

After the curve flattened in the second quarter, we decreased our weighting of maturities greater than 5 years by taking profits.

In the third quarter, the slope of the yield curve from 2 to 30 years steepened by 6 basis points (bps). The segment from 10 to 30 years steepened by 1 bp, while the segment from 2 to 10 years steepened by 4 bps. Our positioning on the curve made a positive contribution to the portfolio's return.

Investors expect one or two increases in the key rate toward the end of 2022. This is the reason for the recent increase in bond yields.

During the quarter, corporate and provincial yield spreads narrowed by 5 bp for maturities of about 5 years. Demand for these securities continued to be strong. As for municipal spreads, they were stable at about 38 bps in relation to Quebec bonds. We maintained our weightings of these securities, which contributed significantly to the portfolio's return.

We think the stock and bond markets could become more volatile in the fourth quarter. Accordingly, we will keep the duration longer than that of the index with a positioning in the center of the curve. We may even increase this positioning if interest rates rise. Economic growth is slowing. As a result, we think that, despite the upsurge in inflation and expectations of a change in monetary policy, any increase in medium- and long-term bond yields will be temporary. In the short term, the risk of a stock market correction could cause yield spreads to widen; therefore, we will proceed cautiously.