1st QUARTER LETTER 2021

April 26, 2021

CANADIAN EQUITY

During the 1st quarter of 2021, the **LAM Canadian Equity Fund** rose **+8.5%** before fees versus +8.1% for the TSX Composite Total Return. We are particularly pleased with this performance given that we have low exposure to the Energy and Financial sectors which rose +28.3% and +12.7% respectively during the quarter. Our outperformance was attributable to strong returns from a diverse group of companies marching to their own beat, or what finance theory calls “securities selection”.

Our top contributors featured **Blackberry** whose share price skyrocketed on short covering and social media hype, **Ag Growth** which is benefitting from strong demand for farm equipment, **Pollard Banknote** whose iLottery and instant ticket business is booming, and **Savaria** which acquired Handicare to become the largest home accessibility and patient handling company in the world. We sold our entire position in Blackberry as its share price rose well beyond our target price thanks to the Reddit crowd, and we trimmed Pollard Banknote as its shares surpassed what we consider fair value.

Among detractors were many of our biggest winners of 2020. These include renewable power producers **Innergex, Boralex**, and **Algonquin**, as well as companies that have been benefitting from the pandemic such as e-commerce platform **MDF Commerce**, supply chain management solutions provider **Tecsys**, and meal-kit and online grocery company **Goodfood Market**. Despite continued strong growth in each of the above companies, a powerful rotation into more cyclical “re-opening trade” sectors caused these stocks to decline. We expect renewable energy producers to continue to benefit from the powerful trends towards reducing fossil fuel emissions and ESG investing, however valuations had become stretched in January and we trimmed our exposure. After a sharp correction in February and March, we have begun to add to these holdings again. Similarly, electronic commerce will continue to grow and our core investments in this sector should continue to do well.

Amidst the on-going pandemic, financial markets continue to defy gravity and logic with many bubbles having formed, yet many attractive investment opportunities have also been created. While most sectors have rallied sharply from the lows of last March, there are still areas where valuations are attractive such as energy infrastructure, asset managers, and telecom. While vaccinations are increasing, so are the rates of infection, and consequently, lockdowns in many parts of the country are stricter than ever before. This seems paradoxical and somewhat disconcerting and can be blamed on governments relaxing restrictions too early, irresponsible behaviour by a public losing patience, and the emergence of more contagious variants of the virus. We therefore continue to be cautious in our approach, not wanting to be a hero by playing the “re-opening trade”, but rather holding more stable companies and a larger cash balance even at the risk of lagging the broader market on the upside.

U.S. EQUITY

After a strong finish in 2020 when we returned +15.8% versus +12.2% for the S&P 500 in the 4th quarter, we expected some give back in relative performance. We got that in the 1st quarter of 2021 during which our U.S. portfolio was up **+4.5%** versus +6.2% for the S&P 500. Bond yields moved up swiftly as the "reflation trade" took hold and drove up the more cyclical sectors of the S&P 500 such as Energy, Financials, and Industrials. Higher interest rates are not good for high growth stocks such as those in the Technology sector which lagged the S&P 500 by 2.8%.

While we were underweight technology stocks which benefitted our portfolio, we were also underweight cyclicals and financials which contributed to our underperformance. The main detractors to our performance were Splunk (Technology), PG&E (Utility), T-Mobile (Telecom) and Mercado Libre (Consumer Discretionary in e-commerce). Viacom (Media & Communications), Crestwood (Energy), Williams (Energy) and JP Morgan (Financial) were the main contributors to our positive performance.

During the quarter, we increased our weighting in the Financial sector by adding **Arch Capital**, a commercial insurance company with good growth and an attractive valuation. We also added **Graco**, a manufacturer of fluid control systems in the Industrial sector. It is a company with a high Return on Invested Capital (ROIC) and a strong focus on this niche market. In the Consumer Discretionary sector, we added **Lowe's**, the home improvement giant which should benefit from several years of residential underbuilding in the U.S., and **O'Reilly Automotive**, a large auto parts distributor. These holdings are all high-quality companies that should benefit from a strong recovery in the economy. Meanwhile, we sold and took profits on Mercado Libre, Viacom, Crestwood, and PG&E which either reached our targets or no longer met our quality threshold.

FIXED INCOME

The 1st quarter of 2021 was marked by an impressive rise in interest rates, particularly 10-year Canada bond yields which rose from roughly 0.7% to 1.6%. The gradual reopening of economies and the roll-out of massive vaccination programs combined with accommodative measures by both governments and central banks, pushed up inflation expectations and consequently, bond yields as well. The upward movement in rates was accentuated when the Federal Reserve reiterated it was not concerned about inflation since, in its view, it would be transitory and, therefore, there was no need to control the interest rate curve. Canada is not at the same point as the U.S. in terms of reopening the economy or vaccinations, but we nevertheless "imported" the concerns about inflation and the increase in interest rates. The rapid rise in bond yields all along the curve caused the value of bonds to fall and also led to a widening of credit spreads on corporate bonds during the quarter.

As we mentioned in previous letters, rising bond yields are positive for certain types of preferred shares, like those with "rate-reset" features which allow for the dividend rate to be re-adjusted based on the 5-year Canada bond yield. A rise in yields therefore increases the expected future dividend rate and makes these preferred shares more valuable to investors. Also, issuers have started to redeem some of these shares by issuing hybrid bonds, contributing to a "scarcity effect" of this sub-asset class. As a result, the Preferred Shares Index again performed strongly, rising more than +12% in the quarter.

The rapid rise in yields has greatly affected returns for bond investors. For the 1st quarter of 2021, our newly launched **LAM Fixed Income Fund** was down only **-0.1%** versus -5.0% for the Canada Universe Bond Index and -2.3% for the Hybrid Bond Index. We are very proud of our performance, having successfully mitigated the risk of rising interest rates through a strategy of holding shorter duration and higher yielding corporate bonds, and having a large weighting to rate-reset preferred shares.

For the balance of 2021, it will be interesting to see how Canada positions itself for the reopening of the economy as vaccinations progress yet seriously lag our neighbors to the south. The Bank of Canada (BOC) announced the end of several bond buying programs, including provincial and corporate bonds for which markets are stable and functioning well. We do not expect any negative impact from this announcement; however, volatility could increase in the event of a more "risk off" tone.

It will also be interesting to see how the BOC reacts to inflation data, and whether it believes that inflation is transitory or higher than expected. Overall, we continue to expect bond yields to rise in the short to medium term as central banks let inflation overshoot their targets and are committed to not raise short term interest rates for at least another year. We remain positive on the corporate credit market, knowing that vaccinations are progressing and that the pandemic will eventually taper off with a global economic recovery that is leading to higher commodity prices, which is bullish for the Canadian economy. We therefore continue to favor a shorter duration (shorter maturities) and a larger weighting in higher yielding corporate bonds and instruments such as rate-reset preferred shares.

MACROECONOMIC OUTLOOK

The red-hot stock market in North America and in many other parts of the world continues to be driven by several extraordinary factors—massive monetary and fiscal stimulus, record liquidity, vaccine-induced positive economic expectations, negative real interest rates and a confluence of game changing technologies. The latter is a powerful long wave force, referred to frequently as the Fourth Industrial Revolution, that will continue to fundamentally change the world.

Another powerful positive change is the new reaction function of central banks, most notably the Federal Reserve. This has to do with how central banks view inflation and how their policies will deal with it. In the past, they have tried to be anticipatory, — reacting to their expectation of inflation increasing above their target by tightening early in order to not fall behind the curve. Since the Great Financial Crisis (GFC) in 2008-2009, the Fed has mistakenly tightened twice, rocking the economy and capital markets. Central banks don't seem to understand the inflation process and will now wait until inflation rises above the 2% target before tightening.

While markets are now expecting a pick-up in inflation in the near term, central banks are betting that it will be transitory and can be ignored. This expected pick-up in measured price increases has much to do with a rebound from the pandemic induced declines a year ago and demand induced temporary shortages due to a faster than expected economic recovery. A similar temporary rebound in measured inflation occurred after the GFC.

This is important for investors to bear in mind because there is unlikely to be an early central bank tightening of policy which would lead to a squeeze on liquidity. That is what ends all bull markets. Therefore, global equity markets are likely to continue being supported by forces which remain intact. Market breadth (Advance/Decline ratio of stock prices) is very strong, and corporate profits, driven by a resurgence in world-wide demand, should continue to rebound.

While the recent rise in interest rates has rattled bond markets, it should be seen as a return toward a more normal level. Government bond yields in the U.S. and Canada could overshoot during an inflation scare and surge in economic growth, but by 2022 we should see the end of pandemic-related price increases, a moderation in the recovery of the global economy, and a significant easing in fiscal stimulus. Inflation expectations should thus soften as a result.

A powerful bull market, surging economy, cheap money, and rising house prices, however, create their own set of risks due to a contagious optimism and animal spirits. There is clear evidence of a gambling mindset among investors, speculative excesses, and rising debt, particularly margin debt. In this environment, players emerge who try to 'game the system' or worse. Recent examples are Gamestop and the Archegos hedge fund blow-up. Clearly the market has become frothy with excessive exuberance in certain areas such as crypto currencies. Volatility will likely rise and there will be needed corrections to periodically weed out excesses. Sound risk management in a frothy market is always prudent, even if it leads to a temporary lag in returns. Canada has experienced less hype compared to the U.S. where regulation had eroded sharply under Trump. This seems set to change under the Biden Administration which would be helpful in containing excesses and sustaining healthy capital markets.

In Canada, the equity market still offers excellent opportunities. While it has underperformed relative to the U.S. market over the past decade, the Canadian stock market has performed well lately, bolstered by higher commodity prices, particularly a strong rebound in the price of oil, as well as a strong loonie. Valuations are still reasonable and foreign fund flows have become positive again, making Canada an attractive investment environment among global markets.

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