FROM THE DESK OF

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MOVING UP THE QUALITY SCALE

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As fundamental bottom-up managers with a focus on value and quality, the years leading up to the COVID-19 pandemic had been particularly challenging. Not because risk (equity and credit) markets were falling, but quite the opposite actually. With risk markets generally in a strong and prolonged bull market, equity and corporate bond valuations in the highest quality companies were particularly demanding. There were many companies and their bond issues we would have loved to own or increase in our portfolios, but prices were just too high in our view.

That situation quickly changed in February and into March of this year. Risk markets forcefully retreated as the COVID-19 virus continued to spread across the globe and developed countries locked down populations and businesses were forced to close. This provided opportunities (in some cases, a once in a generation opportunity) to add some of these higher quality companies to our portfolios at valuations we believed to be more acceptable.

Before I get into some examples of securities the team added to the portfolios, I'd like to define what we mean by quality and how it is determined. There are both quantitative and qualitative factors that we rely on to assess quality. From a quantitative point of view, we consider metrics such as ROIC[1] relative to industry peers, free cash flow generation/conversion, and consistency and/or level of revenue/EBITDA[2] growth relative to industry peers. These indicators are generally more readily accessible and identified, and therefore more quickly priced into valuations as they become available.

In many cases, however, we believe it is the qualitative factors that are most helpful when assessing quality , particularly when taking a longer term view. This may involve following a company for quarters and sometimes years to deeply understand and get comfort around these factors. Some of these are: sustainability of competitive advantages, management's ability to allocate capital and grow the business, and management emphasizing a conservative capital structure. Additionally, these indicators will likely maintain some of the quantitative metrics mentioned above.

High quality characteristics also apply in the fixed income space. Characteristics of higher quality corporate bonds are securities with higher credit ratings, secured bonds collateralized by high quality assets, companies with highly recurring revenues that are less exposed to a COVID-19 related decline in economic activity, and market leaders or companies with scale.

Concluding that a company possesses hiqh quality attributes through both qualitative and quantitative factors will ultimately provide us with the conviction to buy when a stock or corporate bond comes under pressure to levels that seem overdone when taking a longer term view.

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In our Canadian large cap equity mandates, Restaurant Brands International (QSR) is one example. QSR is the owner of three very strong quick service restaurant brands – Tim Hortons, Burger King and Popeyes. Some of the attributes we like about this business include its strong brands which create a wide economic moat around its business; its franchise model which results in both strong free cash flow generation and low operating leverage; and the company's strong financial position supported by ample liquidity. Additionally, while growth in the short term will be under pressure from the COVID-19 related lockdown, longer term in a more normal environment, we anticipate that the business can grow revenue organically in the high single digit range. During February and March of 2020, the share price of QSR came under significant pressure which pushed valuation on a trailing twelve-month basis from ~25x earnings to ~11x earnings. On average, we bought the shares at the lower end of the aforementioned valuation range which represented a material discount to our fair value estimate.

In our international equity mandate, two examples of moving up in quality are Nihon M&A Center and Legrand. Nihon is a Japanese M&A (mergers and acquisitions) boutique company that we have been following for several years and were able to buy because of the market drawdown. Over multiple years the company has built up a database of buyers and sellers, which together with their highly trained and aligned employees has created a strong niche in this growth market. The company has maintained high and consistent levels of ROIC while continually capitalizing on the growth in this attractive market.

Legrand is a French designer and manufacturer of switches and other electrical components that are used in both the residential and nonresidential construction markets. The company has global reach and is a consolidator in the highly fragmented space. Their portfolio of products alongside highly effective R&D both contribute to Legrand's strong pricing power. We were able to buy Legrand due to the drawdown and short term impact COVID-19 is having on end markets.

Meanwhile, on the credit side we have also been moving up in quality by investing in bonds that recently sold off that are either issued by companies with highly recurring revenue and earnings that are less impacted by the impacts of COVID-19 or market leaders that are well-positioned post-COVID. In the investment grade universe, these include bonds issued by Clorox, Disney and Verizon, while in the high yield universe, these include bonds issued by Quebecor Media and T-Mobile.

Lastly, I want to re-emphasize the importance of following these companies for an extended period of time and having a high level of comfort in the names. This allowed us to act quickly and capitalize on the opportunities in February and March. As of today many of these opportunities have disappeared as unprecedented levels of government stimulus has propelled all markets higher. In summary, having our research done ahead of time has been very beneficial to our investors.

Thank you for your ongoing support.

[1] ROIC = return on invested capital (a measure of profitability)

[2] EBITDA = earnings before interest, taxes, depreciation and amortization

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