INVESTMENT FUNDS

NORTH AMERICAN EQUITY

QUARTERLY COMMENTARY

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The past year was a memorable one for investors, with most asset classes generating positive performance. Only bonds, gold, and Chinese stocks delivered negative returns in 2021. However, markets have a rough start for 2022 with interest rates on the rise. The benchmark 10-year Treasury yield stands at 1.80%, its highest level since the start of the pandemic. The Federal Reserve (Fed) is expected to hike rates three to four times in 2022, signaling that the central bank is getting aggressive in an attempt to curb inflation. The Fed could raise short-term interest rates in March and begin to shrink its holdings of bonds and other assets soon afterward.

The rapidly spreading Omicron variant of COVID-19 is also throwing a wrench in early 2022 stock debut timing. In the short-term, the Omicron wave should exacerbate labour supply issues and support inflation. Still, a profound bear market does not occur unless recession is on the horizon, which is not forecasted.

For the Canadian part of the mandate, we continue to favour the energy and financial sectors. E&Ps continue to focus on shareholder returns, and we expect very modest production growth across the industry, which should support oil prices. Also, financials should benefit alongside rising rates.

Within the Fund, we recently added a defensive company with several catalysts over the coming months, Maple Leaf Foods. As we look to 2022, a substantial reduction in capital expenditures by mid-year should lead to meaningful free-cash-flow generation for the first time since 2017-2018. The new bacon facility and the London poultry plant should also boost the run-rate meat EBITDA margin over the next two years.

A few big themes were top of mind this year. First, the broadening impact of the digital revolution, as it transforms non-tech industries, was a big factor in helping companies better execute in this environment. Second, the energy transition and its long tail of CAPEX-heavy decarbonization opportunities are becoming more and more of a reality and also have the potential to introduce significant volatilities in the commodity complex. We see opportunities spanning decades around the technologies enabling the energy transition. Lastly, the emergence of Web 3.0 (e.g. digital assets) and the eventual next computing platform (e.g. metaverses) are still quite early but with promises of changing the status quo and unleashing disruption along the way.

As we move into 2022, we also see opportunities revolving around the upcoming enterprise spending boom. We already have good visibility in a record level of CAPEX from the semiconductors industry, the public cloud buildout, and the telecom sector. We continue to favour cybersecurity as well, as the critical nature of digital infrastructure justifies massive investments on that front. Automation should also be favoured in this environment, either from a software perspective or from the need to modernize outdated equipment. As usual, we like to balance these opportunities with positions that have good potential as well but also reduce the overall risk of the portfolio. Speaking of which, we like the traditionally defensive Health Care sector, which has underperformed significantly since mid-2020. We think an environment of declining fiscal and monetary supports, reduced political pressures and historical discount to the rest of the market bodes relatively well for the sector.

Over the medium term, if inflation settles at a slightly higher level, it will mostly be positive for the equity market, as many companies would be able to execute with a higher pricing power level. There is a risk of an overshoot in the near term, especially if the winter is colder than usual and commodity prices rises further. Productivity could be accelerating as well as intellectual property product investments, patent applications and new business formations, which have all been accelerating since last year.

Market valuation is also elevated on a historical basis when looking at price-to-earnings ratios. Having said this, it's important to remember that the equity market valuation is inversely correlated to the interest rate level on a non-linear basis. That makes the multiple very sensitive to any significant move in interest rates. So far, the great retirement in the labour force seems to be contributing to a reduction in the equilibrium rate of interest offsetting reflationary pressures. In this environment, the surprise of positive earnings growth is a key driver of returns and we think that U.S. companies benefit greatly from the digital revolution, which results in an increased ability to convert earnings into free cash flow, which enables a higher level of capital returns and ability to invest for growth.

We construct the portfolio using a barbell strategy. On one side, we like to have exposure to innovators and keep between 5% and 15% in small- and mid-capitalisation. Each position here needs to make sense from a risk and return point of view. We currently see overvaluation pockets in some themes, like electric vehicles and artificial intelligence hardware, for example, and think our active approach of avoiding these deteriorating return propositions could result in alpha. On the other side, we go with dominant firms where we currently see more opportunities in some defensive sectors, like health care, and in companies that have historically showcased a higher level of pricing power.

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Main funds managed by the team

✓	Canadian Equity Growth
✓	Real Estate Income
✓	Global True Conviction
✓	Canadian Equity Growth Hybrid 75/25
✓	Global True Conviction Hybrid 75/25
✓	IA Clarington Canadian Leaders Class

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— Manages $97 billion in general portfolios and segregated and mutual funds
— A team of 184 people, including 108 investment professionals (including 44 CFA charterholders)
— Composed of experienced managers who emphasize fundamental analysis, identification of value and long-term investing

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