THE CANADIAN FOCUSED EQUITY PORTFOLIO- FIVE YEARS IN

September 22, 2023

It doesn't seem like too long ago that we started the Canadian Focused Equity Portfolio. Michael Ballard and I had just formed our investment partnership and developing this portfolio seemed like the next logical step to efficiently manage my side of the business.

Since then a lot has changed. I went from having a toddler son and a baby girl to having a four and a half foot nearly hundred pound second grade boy and a six year old girl who seems to going on thirteen.

We have also seen the world abruptly change with the COVID pandemic and the work from home revolution.

Cumulative Results

We started the Ballard Mudge Financial Group's first discretionary portfolio in mid-2018 and the first client money went into our Canadian Focused Equity Portfolio August 3rd 2018. The goal was to make our life easier. Our business has been evolving and growing over time. It first became unruly to try to make individual trades in many accounts at the same time. Block trades could make that easier but even still there was a lot of work behind the scenes calculating the size of the position in each individual's account. A model segregated portfolio became the easiest solution to manage individual equity positions.

Our official results are tracked starting September 1st, 2018. These numbers are reflected on the portfolio fact sheet available on our website or in my email signature.

The official results are the sum total of all accounts and the results may be positively or negatively influenced by several external factors including individual investor decisions to add or remove capital, tax loss selling decisions, cash added in USD vs CAD etc. The official results also are provided by our firm and is provided monthly vs the daily monitoring I prefer in the management of the reference account.

I prefer to track the portfolio performance using our reference account starting the date that the first external money was invested. Viewing performance this was allows investors to view the returns and decisions as they are intended against the against the relevant total return indices.

With all that said the gross returns for the reference account has been **10.50%** annually through August 31, 2021 beating the benchmark[1] return by **1.5%** annually.

This result is behind our internal goal of compounding capital at rate of 15% annually.

An initial investment of $100,000 August 3rd 2018 would now be worth $171,700 on August 31st, 2023 vs the total return benchmark $157,666 over the same period.

[1] 70% S&P TSX Composite TR/ 30% S&P500 TR reported in CAD

Calendar Year Returns

Below are the calendar year returns of the reference account described above. These numbers will vary from the official numbers provided in prior commentary.

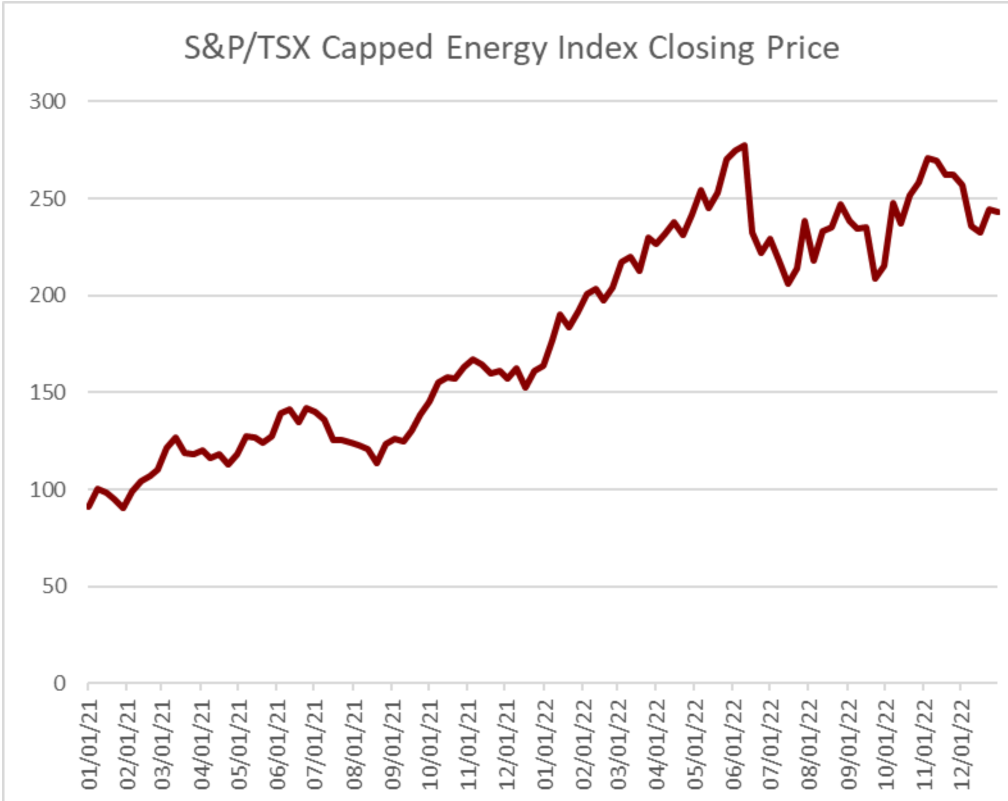
Period	Canadian Focused Equity Return	Benchmark Return[2]	Difference
YTD 2023 (Aug 31)	16.154%	8.99%	7.17%
2022	-13.55%	-7.74%	-5.81%
2021	11.91%	25.90%	-13.99%
2020	20.89%	8.77%	12.12%
2019	29.86%	23.53%	6.34%
2018 (Aug 3rd-)	-5.88%	-9.90%	4.02%

While the cumulative returns and annual returns in the partial year of 2018, 2019, 2020 and year to date 2023 outperformed.

There have been some periods of relative underperformance. I have mentioned before that I have no special ability to predict the ebbs and flows of commodity prices or the whims of foreign powers that control their moves.

Much of the underperformance in 2021 and 2022 was caused by the surge in the energy sector. The S&P TSX Capped Energy Index rallied 80% in 2021 and a further 48% in 2022.

[2] 70% S&P TSX TR & 30% S&P 500 TR in CAD



The energy sector steadily makes up roughly 18% of the Canadian index. Market weight exposure to the energy sector in 2021 would have contributed roughly 14.4% to the return in 2021 and a further 8.64% in 2022.

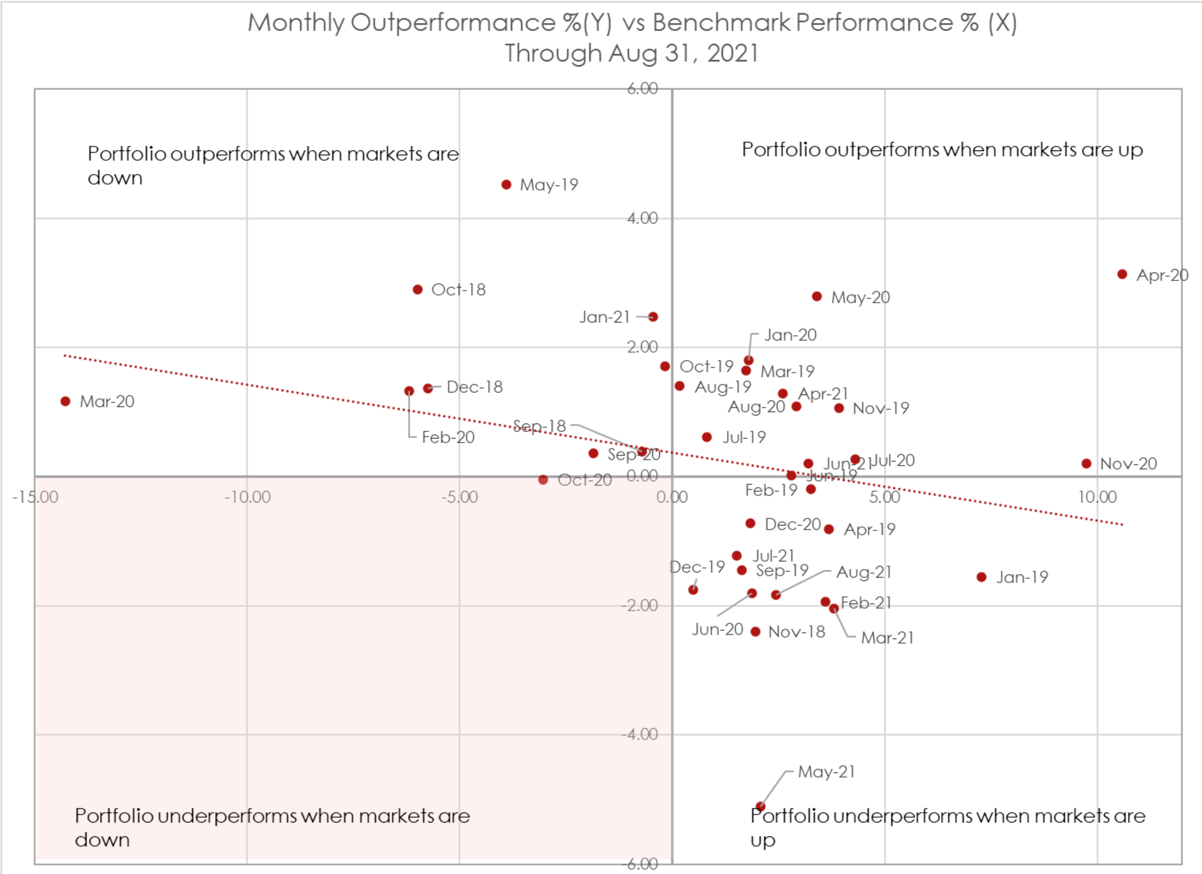
Our exposure to the energy prices is very modest by design. It has included one land owning royalty company in PrairieSky Royalty Ltd. From time to time we have also owned a few energy service companies most notably Pason Systems Inc.

We own Alimentation Couche Tard, a convenience store chain that sells gasoline at gas bars and is actually listed in the consumer discretionary sector. We also own Parkland Corp, an "oilier" convenience store company that also had a larger energy distribution network and refinery.

The underweight energy sector call severely hurt performance in 2021 and 2022.

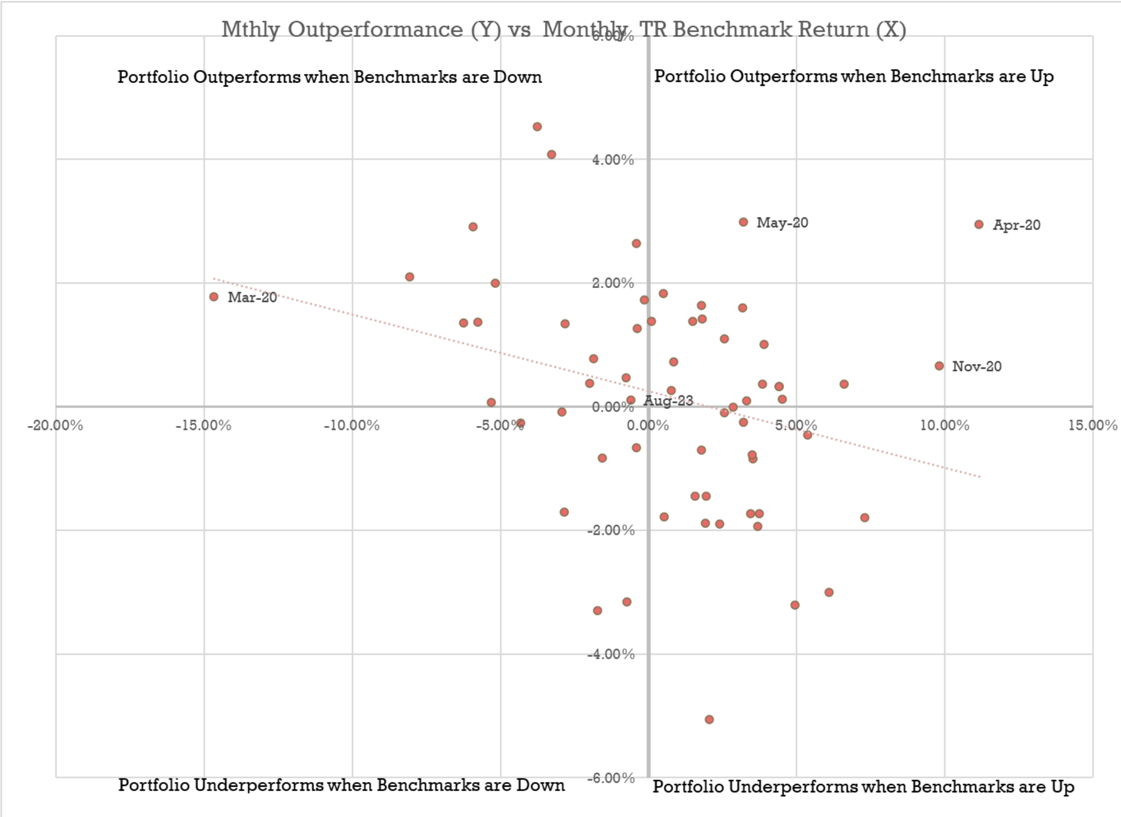
Historically, the portfolio has achieved its results by outperforming when markets are weak and catching most of the upside when markets are strong.

Shown visually, the next graph shows that when markets are weak (the left side of the graph) the portfolio rarely underperforms (lower half of the graph). There are almost no data points in the lower left of the graph.



This first graph was dated Aug 31st 2021 on the 3 year anniversary of the portfolio and means that we had never underperformed in a negative month but the impact of the strong energy rally changes things.

Subsequently we have added several more months of underperformance during down markets as energy was the only positive sector for much of 2022 (lower left corner).



Regardless, our trend continues to show that we tend to outperform in negative months and underperform when markets are sharply higher.

Process

We have written before about our process but it is good to refresh the core ideas of what we are doing.

We are looking for companies that have a sustainable competitive advantage. These companies have less competition and can charge higher prices for their products or services and earn greater economic profits. We then try to estimate the growth of their net assets (BV/S Growth) and how much they should be able to earn based on those assets (Future ROE). We also estimate what future investors should be willing to pay for those earnings five years in the future.

The longer term nature of our estimates precludes us from investing in a lot of commodity companies. End product price fluctuation makes longer term profit estimates difficult and unreliable.

We then make assumptions of what we can pay for the company to achieve our targeted 15% annual rate of return on the investments plus a margin of safety.

We will also consider companies that would not necessarily fit the above criteria but are extraordinarily inexpensive for one reason or another if we have faith that the discount will disappear over time.

We tend to hold companies for a long time period and try to keep portfolio turnover as low as possible.

The cash balance in the portfolio will vary due to the prevailing economic climate and available opportunities to deploy capital.

Portfolio Behaviour

Over the last five years, we have observed the following idiosyncratic ways that our investment style tends to operate in different market conditions.

a) **Energy and Mining stocks**- As mentioned above we have missed much of the boom in these sectors. We also have missed much of the pain in past years as the end markets for commodities collapsed. Our investors also tend to favour more ESG conscience investments wherever possible. Historically we have been underweight commodity businesses.

b) **Technology Companies-** The giants of yesterday tended to be early movers into a field with huge amounts of capital tied up in Property Plant and Equipment. They would use their first mover advantage and size to beat competition on price eventually dominating a market.

   Today the giants of industry tend to have not invested in capital assets but who have build a wealth of engineering talent and invested millions (billions?) in intellectual property (IP) that allows them to dominate an industry. These IP investment once made tend to have the potential to add revenues and profits in a new non-linear way making the surviving businesses truly economic giants.

   We will tend to be overweight profitable technology companies where valuation and portfolio weighting permits.

c) **Capital Allocator CEOs-** Not to whine or complain but allocating capital is a difficult task. This is how we spend our time. If we can find successful business owners who are skilled at allocating capital and growing their own business it makes our job somewhat easier.

   Over the years we have owned several businesses run by strong capital allocators like Constellation Software, Fairfax Financial and to a lesser more debt fueled extent CI Financial.

   We will continue to look out for companies with management that has a strong ability for capital allocation.

d) **Niche Businesses**- We like to find businesses that are very good at what they do and do not stray out of that niche. We aim to find very profitable niches and companies that know where their own boundaries are. Some of these companies may be smaller and off the radar of larger investors.

e) **Cash drag**- Our goal is to find companies that can compound capital 15% annually and hold them for the long term. At times not all of our capital is deployed. We also try to balance the risk of owning equities with having cash reserves when markets look poised to fall over the shorter period. Cash has also built up in the portfolio when new money is added to the portfolio and it has not been fully invested yet.

   These cash reserves helped preserve capital in the early stages of the pandemic selling in 2020 but can be a drag on performance strongly positive years.

Lessons

There have been several lessons learned over the past 5 years.

Patience

Several times over the last 5 years I have acted where being more patient would have been more beneficial to investors. There are several ways this can occur and below are a few examples.

In the COVID panic selling of March 2020, I was actively buying on the 10th and 13th while waiting to get closer to the market low of March 23rd would have added much more value for investors.

I have also purchased companies which have been falling when the clear correct decision would have been to wait a few quarters to have the validation of the investment thesis available in the financial statements.

I have also sold companies too early where I had become frustrated in one facet of the business and not waited for the company to change course or management.

Not acting boldly enough

Position sizing is a never ending challenge. It always comes down to a thought like "I think x is a good value but how big of a position should it be?" Nobody naturally thinks in terms of "I like it but do I like it for a 1%, 3% or 5% weighting?" It is much easier to be binary. I like it or I don't. A nuanced relational approach is more difficult.

The easy answer is to do less than you think your eventual ideal size would be in case it falls and you can add more at a better price.

This has often been wrong and you are left with smaller positions in winning companies that clearly should have been larger.

Knowing when to bend our own rules

It doesn't take a genius to realize that the post COVID market panic world was not going to stop moving forever and that negative oil prices weren't sustainable. Yet somehow this dummy sat on the sidelines. This wasn't the way I knew to invest. Any blindfolded throw of the dart at nearly any energy company over a 6 month period in 2020 would have produced substantial returns.

The worst part was that I knew the companies were undervalued but that I chose not to invest anyways. Part of me was soothed by "sticking to core principals" idea and the other to the way that the portfolio would look better through an ESG lens.

YTD 2023 Update

Outperformance in 2023 has been driven primarily by the resurgence in the technology space after 2022's challenging year. Amazon.Com, Real Matters, Alphabet Inc, Apple Inc, Fairfax Financial Holdings Ltd, Microsoft Corp and Constellation Software are all up more than 30% YTD through August 31st.

There has also been strong performance from Parkland Corp, Accenture, Moodys Corp, PrairieSky Royalty Ltd, new purchase TJX Co, Alimentation Couche Tard, Mastercard Inc, S&P Global and Boyd Group Services each earning more than our 15% annual target.

2023 has not all been giggles and sunshine. We are challenged by the Canadian financials (National Bank, Definity and TD bank), the corporate changes at Walt Disney co and by a few of our niche businesses primarily Park Lawn Corp and Richard's Packaging Income Fund.

We also did well in a shorter term trade. Again shorter term trades are not really what we are about. In this case we got lucky with our timing. We purchased Tucows Inc, who has several business lines including domain registration services, a value added software platform that services the telecom industry and a digital fiber to the home internet provider. We were interested because we liked the business and felt that the shares were undervalued due to a recent punitive financing that they completed (13-17% interest. Ouch!). Our initial purchase was in April for $27.35 per share. We trimmed the position mid-May at $40 and again mid-June at $43.60 per share. For this portfolio I sold the last of the positions at $32.32 on August 4th. I believe that the shares likely remain undervalued for long terms investors but I lack some clarity regarding the prepayment plans of their onerous debt.

This portfolio also sold our position in CI Financial. We began purchasing the shares in September of 2022 and made several purchases mainly between $13.78 and $14.50. We sold the shares this summer in the $16.55 to $16.75 range. I believe the shares are still undervalued whenever they complete the IPO of their US division but I became concerned with a potential drop in market values and the impact on CI's fee driven business.

Constellation Software has presented equity investors a unique opportunity to buy some of the debt the company would like to raise. Usually opportunities like these are reserved for larger institutional investors and pension fund managers. Wherever possible, on your behalf I will be executing your rights to buy the floating rate debt then moving the new debt holdings out of the portfolio into another of your accounts. This will show a small drop in the value of the portfolio holdings but I believe it is in your best interest to take part in the transaction.

Outlook

We have said in the past that we have no crystal ball and don't value forecasts. To us, It seems like market participants who were very cautious in the fall of 2022 have reversed course and now feel that we can get inflation under control without triggering a recession.

We see risks with that narrative. We have become concerned about the impact of inflation remaining stubbornly high and central banks needing to raise rates higher than previously expected. Central bank action impacts the economy "with long and variable lags". Once Canadians are forced to refinance their mortgages from the 2020 Covid low rates on their primary (or secondary!) residence we will likely see more signs of difficulty from the Canadian consumer.

We have raised the cash holdings in the portfolio from a recent low of 4.7% to 22.5% at the end of August. We would like to remain cautious as we look for new opportunities.

We will be here to steer the ship.

Sincerely

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David Mudge is a Portfolio Manager with CIBC Wood Gundy in Montreal. He/ and his clients may own securities mentioned in this column. The views of David Mudge do not necessarily reflect those of CIBC World Markets Inc.

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Granite REIT	2a,2c,2e,2g,7
National Bank Of Canada	2a,2c,2e,2g,3a,3c,7
PrairieSky Royalty Ltd.	2g
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