PAPAU ARMSTRONG SCHMIDT FINANCIAL GROUP

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Adding More High-Quality Holdings in Q2

2022 has been a difficult year so far for North American equity and fixed income investors. Generally, our investment style is built to handle difficult markets, as we stick to high-quality holdings and attempt to avoid the most overvalued areas of the equity markets. So far this year, investors' focus has been on central bankers battling uncomfortably high inflation with higher interest rates. This market environment has started to create decent long-term opportunities in companies that we formerly viewed as too expensive. We have therefore recently added more holdings that fit our strategy of buying high-quality holdings at undervalued prices.

In this second quarter (Q2) edition of our Newsletter, we will highlight some of our recent purchases in our discretionary portfolios – the Balanced Portfolio, Total Return Portfolio and High Yield Portfolio. This should help illustrate where we are finding value in the markets.

Equity Market Commentary

Before we discuss specific transactions, we will note the wide divergence in performance among industry sectors this year. For example, there are sectors that have strongly outperformed, such as energy and utilities. The energy sector has rallied along with oil and natural gas prices. A supply and demand imbalance has pushed these commodity prices higher after a lengthy period of low exploration spending. It may take a combination of higher production and a slowing global economy to send energy prices significantly lower.

The utility sector has not been in a bull market like energy, but generally utility equities have held up well. The message of their outperformance seems to be that some investors are seeking safety in the stability and predictability of these businesses. The outperformance of the energy and utility sector has created some selling opportunities. We have gradually been trimming our energy positions for many months, but we have been reluctant to sell out of them entirely, as there is a chance energy prices could stay high for the medium term. We have trimmed utilities only modestly, as we do like the stability, high dividends and low volatility of these holdings.

While the energy and utilities sectors have outperformed, there are many industry sectors that have performed quite poorly. The technology and consumer discretionary sectors are good examples. This has created some buying opportunities, but we have to view these declines in context. For example, some of the worst performing technology equities of 2022 had multiple years of exceptional returns before this year began. This means we have to be careful about what we consider undervalued. To find real opportunities in technology that fit our strategy, we focus on the highest-quality holdings with good growth potential and strong current profitability. The more speculative companies are not candidates for our portfolios.

Looking beyond industry sectors, we can observe that investors have favored companies with strong near-term profitability so far in 2022. While this may seem like an obvious trait for investors to favor, in 2020, during the worst of the pandemic, we saw numerous unprofitable technology companies trading up to extreme levels due to a combination of future growth potential and irrational speculation. The current environment aligns better with our style of investing. Most of our holdings are expected to generate substantial near-term profits.

Selected Transactions

As mentioned above, we have been reducing our energy weightings in all three discretionary portfolios, but are reluctant to eliminate all holdings in the sector. On July 5 in the Total Return Portfolio we reduced our Suncor Energy Inc. (TSX:SU)[i] position at a price of $42.30. We reduced our Suncor position in the High Yield Portfolio on July 11 at a price of $41.33. The company remains a 2.6% position in the Total Return Portfolio and a 3.2% position in the High Yield Portfolio.

We have been debating the correct weighting in the energy sectors in our discretionary portfolios for many years. On one hand, there are global efforts to achieve a multi-decade transition towards renewable energy. On the other hand, the lack of exploration and drilling in recent years combined with the invasion of Ukraine have contributed to a current bull market in the sector. There are no easy answers regarding what to do next. In general, we do not want to be caught holding large energy weightings through the next major decline in oil prices. We do not want to be "buy and hold forever" investors in energy production. In recent years, we have done a fairly good job of adding to energy holdings when they have been priced pessimistically and reducing them at much higher levels.

On July 5 we added to our position in Amazon.com Inc. (US:AMZN) in the Total Return Portfolio at a price of US$108.51. The company now makes up 2.5% of that portfolio. We then purchased a new position in Amazon in the Balanced Portfolio on July 11 at US$113.02, creating a 1.3% weighting. In addition to a dominant online retail platform, the company offers on-demand cloud computing through its Amazon Web Services subsidiary and owns several other complimentary businesses. Despite the company's enormous size, it is expected to achieve substantial earnings growth in the coming years. Our Amazon purchases were an effort to take advantage of this year's substantial declines in high-quality, fast-growing equities. The company's shares were trading around US$170 at the start of the year.

We added to our position in Walt Disney Co. (US:DIS) in the Total Return Portfolio at a price of US$94.36 on July 11. Disney's share price performance has been weak this year, but we believe the company's long-term fundamental value is intact. Disney now has a 4.2% weighting in the Total Return Portfolio. The company has multiple lines of business, most notably media networks, Disneyland parks and resorts, movie studios and the Disney Plus streaming service. We expect earnings to rebound substantially in the coming years, and believe that our most recent purchase price was at undervalued levels.

Also in the Total Return Portfolio, we added to Aritzia Inc. (TSX:ATZ)[ii] on May 19 at a price of $38.00 per share. The company now has a weighting of 2.7%. Aritzia is becoming a notable Canadian success story. The apparel retailer and designer now has over 100 stores across North America and a fast-growing e-commerce business. Its opportunities for continued growth in U.S. are large. In December of 2021, we had reduced our Aritzia position at a price of $49.00. Our recent purchase price of $38.00 seemed like a decent opportunity given the company's continued exceptional quarterly results.

On July 11, we added to Chartwell Retirement Residences (TSX:CSH.un)[iii] in the High Yield Portfolio, making it a 3.0% weighting. Canadian senior housing equities seemed too expensive prior to the pandemic, but they are now priced significantly lower. The long-term outlook for senior housing demand is strong, with the number of age 80+ Canadians expected to increase rapidly in the coming decades. Chartwell is an ideal holding for the High Yield Portfolio with a high current dividend and some modest growth potential over time. The aftermath of the pandemic remains a risk, but the needs-based nature of senior housing works in favor of senior housing companies over the long-term. Most of their residents are unable to live independently at this stage of their lives, making senior housing a good option.

Finally, we will mention our small purchase of Canadian Western Bank (TSX:CWB)[iv] in the High Yield Portfolio on July 11 at a price of $25.50. With a market capitalization of around $2.3 billion, it is the seventh-largest Canadian bank by that measure. The company focuses on providing financial services to small- and medium-sized businesses and individuals, with operations primarily focused on the provinces of Alberta, British Columbia, and Ontario. Trading above $36 at the start of 2022, our entry point of $25.50 represents a discount to what we believe is fair value for the shares. The dividend yield is well above 4% at today's levels. The catalyst for share price gains will probably have to be better quarterly results in the coming year or two.

Inflation and Interest Rates

We will briefly revisit the topic of high inflation and rising interest rates. This has been the dominant focus of investors in 2022 so far, which is unsurprising given our highly-indebted North American economy. The Bank of Canada now expects inflation of 7.2% this year and 4.6% in 2023, having revised its consumer price index forecast higher several times.[v]

Based on this inflation forecast, the Bank of Canada will probably raise rates by at least another 50 to 100 basis points before the end of 2022. What happens after that will depend on whether inflation subsides as projected. We believe that at least a mild recession could begin within the next twelve months, and we are making investment decisions on that basis. Economic growth now appears to be slowing in Canada, the U.S. and other major countries. For example, Q1 Canadian GDP grew at an annualized rate of 3.1%, well below consensus expectations of 5.4%.[vi] Considering all of these headwinds, we will probably be making further changes to our discretionary portfolios before the end of 2022. We expect that more opportunities to purchase high-quality companies at discounted prices will arise.

Unfortunately there is no simplistic strategy to deal with a period of high inflation and rising rates without taking some risks. We need to think from multiple perspectives to successfully navigate this period. Some assets can be inflation beneficiaries but then fall as higher interest rates slow economic growth, such as oil producers and copper mining companies. Other assets are harmed by higher rates and inflation but then reach bargain levels for longer-term investors, including perhaps some of the faster-growing technology companies. We are fully engaged in the search for high-quality opportunities of all kinds.

Conclusion

Thank you for reading this Q2 edition of our Newsletter. The next several quarters will likely be interesting and full of volatility and opportunities. Our philosophy of buying high-quality businesses trading at undervalued prices remains the same through different market environments, but our candidates for purchase are constantly changing. We will continue to look for opportunities that fit that philosophy.

As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Newsletter, and thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORTFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[i] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. This company is a client for which a CIBC World

Markets company has performed non-investment banking, securities-related services in the past 12 months. CIBC World Markets Inc. has received compensation for non-investment banking, securities-related services from this company in the past 12 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.

[ii] The equity securities of this company are subordinate voting shares. CIBC WM Inc. makes a market in the securities of this company. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. This company is a client for which a CIBC World Markets company has performed non-investment banking, securities-related services in the past 12 months. CIBC World Markets Inc. has received compensation for non-investment banking, securities-related services from this company in the past 12 months.

[iii] CIBC WM Inc. makes a market in the securities of this company. This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.

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[v] https://www.theglobeandmail.com/business/article-canada-inflation-rate-june/

[vi] Source: tradingeconomics.com