PENDER
CANADIAN OPPORTUNITIES FUND

MANAGERS COMMENTARY – Q4 2018 - AMAR PANDYA & DAVID BARR

A lost decade in the past could be a great setup for the future

2018 was a "terrible, horrible, no good, very bad" year for the S&P/TSX Composite Index which rung in the New Year capping off a 12% decline. To make matters even more disheartening, the TSX has barely moved in the past 10 years, delivering a frustrating lost decade for Canada's benchmark index. A large portion of that misery can be attributed to the resource-heavy weighting of the index with the Energy and Materials sectors still holding a combined 29% weight and both experiencing prolonged pricing slumps. But there was pain to go around in 2018 with all sectors beside Info Tech and Staples delivering a yearly decline.

One silver lining is the fact that in our view Canadian equities are really cheap, with multiples well below historical averages despite a substantial increase in their earnings power. Looking past the TSX index to the small and mid-cap part of the market where we tend to focus, the fundamentals of the businesses we own are positive, management teams are bullish, intrinsic value is growing and valuations are attractive. So, looking through the negative sentiment to the future, we are excited about the companies we own, the prices we are paying to invest in them and the new opportunities we are finding.

Canadian compounders are on sale!

In our never-ending quest to fill our portfolios with compounders we can buy and hold, we diligently monitor several high-quality companies via our watchlist. These are companies that we believe have the potential to compound returns for the long-term, but which have been trading at valuations beyond what we are prepared to pay. By determining a price which provides a sufficient margin of safety to our estimate of intrinsic value and being patient, we can opportunistically build positions in these companies. When they are being impacted by a short-term issue or when the "tide goes out" and indiscriminate selling puts downward pressure on the price, allowing us to buy a great company at a good price.

In the past couple of quarters, we have taken advantage of both kinds of opportunities in the Canadian market. As investors have fled Canadian equities, many high-quality businesses which we have wanted to own have been indiscriminately sold providing us with our target entry point. The market turmoil has further exacerbated the equity declines in several companies which are currently having problems we deem to be short-term or transient in nature. With quality wealth-creating businesses trading at attractive valuations, our opportunity set is currently wide and we will continue to increase our portfolio weighting in compounders.

Hey you Turkey! Get your hands off my jerky!

Premium Brand Holdings is a leading specialty food manufacture and distributer, with operations in Canada and the US. The company has a high-quality product portfolio of regional, niche and differentiated brands with sandwiches (think Starbucks), meat snacks (like jerky), baked goods and fresh seafood being key products. While the company can boast strong organic growth, acquisitions have also been a key driver of the company's success. Premium's acquisition strategy is unique as the company doesn't integrate acquired businesses, rather it operates as a decentralized capital allocator, providing access to capital, procurement, distribution and best practices. The company's target acquisitions are usually small, niche and regional entrepreneur-owned companies where founders are incentivised to continue growing the business as operators. The management team, led by CEO George Paleologou, has demonstrated a long-term track record of superior capital allocation and prudent long-term strategic decision making generating consistent growth, high returns on capital and strong free cash flow.

Concerns on retaliatory tariffs on US meats, combined with a tightening US labour force led to cost inflation, labour shortages and supply chain issues, culminating with the deferral of growth initiatives and a large pullback in the share price. We believe that many of these "problems" are temporary in nature and management is already taking steps to rectify them, giving us an attractive entry point to initiate a position in the company. While we are cognisant of Premium's currently elevated debt level, which will be reflected in our portfolio weighting, the company exhibits many of the characteristics we look for in a quality compounder. With food trends supporting locally sourced, healthy and high protein foods, we believe Premium's long-term growth outlook looks robust with a long runway in the heavily fragmented and fast changing specialty food sector.

Portfolio Updates

The Fund was fully invested at the end of the year with 36 holdings and the top 10 positions in the Fund making up 47% of the portfolio. As discussed above, the volatility at year end provided us the opportunity to initiate and increase our weightings in several high-quality compounders. In the current market environment, our investment preference is towards quality secular growth businesses as opposed to more cyclically exposed companies and we will continue to identify opportunities to increase our exposure to quality and understood compounders.

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