What Drives Equity Prices: Headlines or Company Fundamentals?

The equity bull market continues after the Federal Reserve induced correction during the fourth quarter of 2018. Close to all time highs, North American markets seem more reactive than usual to the constant news stream relating to US-China trade negotiations, central bank policies, Brexit negotiations, the reduction in global economic growth rates as well as company specific developments.

In answer to our own title question, we would posit that headlines drive short-term market gyrations, but underlying economic and company fundamentals dictate the eventual direction of equity prices. Our best guess is that there will be an announced "trade deal" between the US and China within the next few months; one that can be trumpeted as a victory by both sides. The Federal Reserve, in spite of political pressure, will maintain its current policy stance, with no administered rate changes likely in 2019. Brexit is harder to call. We believe a sloppy solution is likely, with substantial economic costs already accruing to the financial services and auto industries.

Our time tested investment approach is not influenced by the constantly changing headlines mentioned above. Instead it seeks to identify mispriced companies that meet a strict set of quality criteria; those that allocate capital wisely, are managed in a shareholder friendly manner and have the balance sheet strength to withstand various growth scenarios.

Clearly global growth is slowing as demonstrated by the Purchasing Managers Indices in Chart 1. Of note, China has recently ticked up and much of the slowdown in Europe is likely Brexit related.

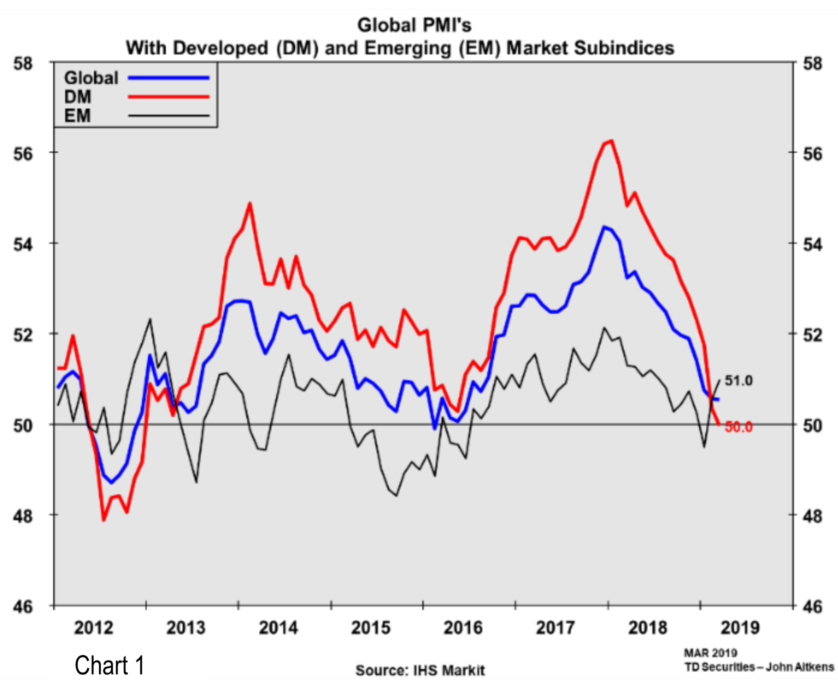

Chart 1

Measures of consumer and corporate confidence remain positive. In an environment of extremely low interest rates and rising wages as shown in Chart 2, a recession is unlikely. GDP growth of 1.8% in Canada and 2.5% in the US as well as subdued inflation will characterize 2019.

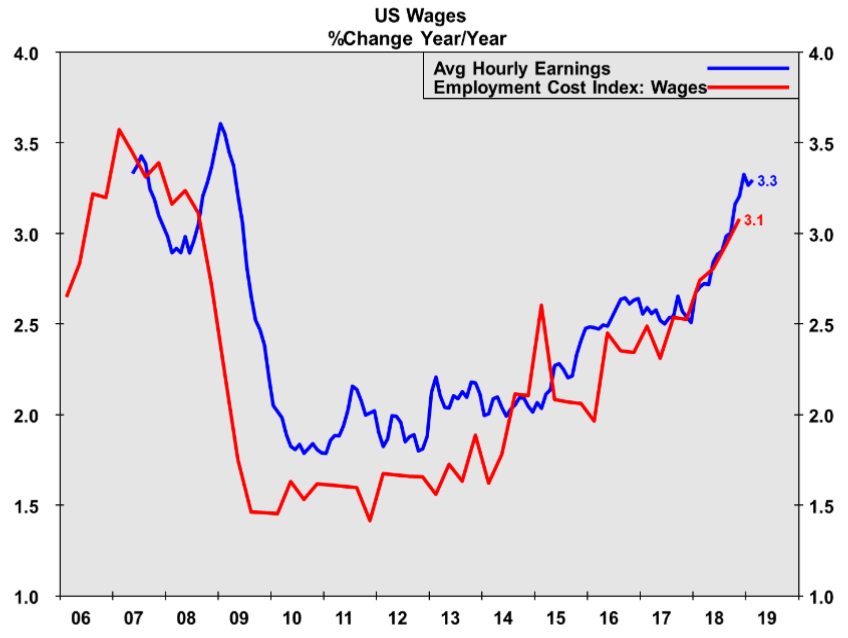

Chart 2

A market phenomenon that bears close attention is the rush to go public by a spate of "unicorns"; private companies with valuations in excess of $1 billion. If valuations do not hold up when detailed disclosures are provided, a market correction similar to the tech bubble of 2000 could have a mildly negative impact on global equity markets.

Returning to the title line of this report, history seems to indicate that the global uncertainties which dominate the headlines do not in fact have much impact on equity market performance. We cannot control the headlines, but we can continue to do in-depth research on quality companies to combine into sensibly diversified portfolios.

The Importance of Management

In its most rudimentary form, successful investing is about evaluating three elements of a company: its people, business model and price. Gaining access to information that provides insights into a firm's outer workings (e.g. industry, competition, financials and valuation metrics) is quite easy, compared to understanding the complexity of its inner workings. During the Annual General Meeting of Constellation Software, the company's President Mark Leonard generally acts as a facilitator of a fireside chat. He encourages shareholders to question the company's divisional leaders about "all that murky stuff like culture that they don't teach you about at business school because it is near impossible to measure".

In 2009 we embarked on a project that we code named the Grade ‘A’ Manitou System. The impetus behind developing our own grading system was to foster a “best ideas win” approach to analyzing and valuing potential investment opportunities. To remove as much subjectivity as possible, and most importantly to provide an objective definition of Manitou Grade ‘A’ quality, we established a scoring system tied to the five key criteria listed below.

1. LONG & CONSISTENT TRACK RECORD OF PROFITABILITY
   - Profitability Over 10 Years+
2. SUSTAINABLE COMPETITIVE ADVANTAGES
   - A Wide & Defensible Moat
3. FINANCIAL STRENGTH
   - A Strong Balance Sheet Derived From Free Cash Flow Generation
4. GROWTH
   - Organic & Acquisition
5. MANAGEMENT
   - Honest, Long-Term Shareholder Orientated & Skilled

As highlighted during our last Investor Day, ‘A+’ companies that meet the first four criteria tend to be run by high functioning management teams.

Based on our experience there is no magic formula or set of attributes that guarantees a successful investment. Even when the “special sauce” is recognizable, it can diminish over time due to the complacency of those leading the company. It is therefore imperative that we stay on top of “the stuff that goes well beyond the numbers”. While commonsensical, some of the healthiest signs of a successful business include a passionate focus on delighting customers. Other traits we look for are a clearly understood sense of mission and a fair and equitable compensation scheme. The easier to understand, the more closely tied to the longer-term success of the company and the broader the distributed benefits throughout the enterprise the better. Conservative accounting practices with minimal restatements, decentralized decision-making, and a high degree of autonomy amongst customer-facing employees are also traits of well-managed companies. In addition, being cost-conscious and savvy capital allocators with a return on invested capital mindset are indispensable characteristics of highly successful management teams.

Good managers will sometimes make bad calls or encounter bad luck and distinguishing between the two can be a tricky equation to interpret. We have found that management teams that communicate openly and honestly are not only confident enough to admit when they make mistakes, they are resourceful in finding quick solutions that oftentimes result in positive learning experiences.

Quite simply, the best run companies that succeed over the long-term tend to be a bit cultish or tribal. They foster a culture of attracting and retaining the best employees, shareholders, suppliers and customers. They adhere to the Golden Rule and go to great lengths to ensure an alignment of interests between the company's employees, owners and communities. Garnering this information is vital to understanding a business and is generally not found in the companies' financial reports. It is the "art" versus the "science" of investing. Furthermore, its importance should not be overlooked because in the end, our judgement of the quality of the *people* makes all the difference between poor, fair and superior investment results.

Manitou Mandates
For Q1 2019

In stark contrast to the volatility of 2018 and the fourth quarter of last year in particular, markets were downright robust in the first quarter of 2019. On top of buoyant markets, the returns of most Manitou Mandates in our opinion were due in large part to our concentrated approach to owning high quality companies. Literally all mandates are on track to out-perform our absolute return objective of CPI+7%, and as highlighted below virtually all performed exceptionally well relative to their benchmarks.

Global Equity returned +11.38% versus the benchmark of +9.97%, Manitou Equity (North America) +10.79% versus the benchmark of +12.26%, Canadian Equity +13.53% versus the benchmark of +13.30%, US Equity +11.84% versus the benchmark of +11.16%, Focus 5+ +17.17% versus the benchmark of +12.26%, International Equity +5.70% versus the benchmark of +7.46% and Income Fund +2.48% versus the benchmark of +2.28%. As a reminder, the valuation of the Total Return Yield Fund (TRY) lags by one quarter. The Q1 performance will be discussed in the Q2 report. Performance for the year ended December 31, 2018 was +6.00%.

Please note that all returns stated above are gross of fees.

For the Global Equity Mandate the principal contributor to this quarter's returns was Airbus +35.12% and the largest detractor was Uni-Select -28.11%.

For the Manitou Equity (North America) Mandate the principal contributor was Constellation Software +32.81% and the most significant detractor for this fund was again Uni-Select -28.11%.

The top performer in the Canadian Equity Mandate was Constellation Software +32.85% and the bottom contributor was Uni-Select -28.11%.

For the US Equity Mandate the top performer was Airbus ADR +35.11%, with CME the bottom performer at -13.93%.

For the Focus 5+ Mandate the top performer was Constellation Software +32.87 and the largest detractor was Walgreens -8.90%.

The International Fund's top performer was Airbus +34.48% and the bottom detractor was BMW -6.25%.

Given the significant overlap in top and bottom performers across mandates this quarter, we felt it might be helpful to highlight some of the issues that impacted their stock prices.

In the case of Airbus, our initial thesis has begun to play out in earnest. In our opinion, Airbus is a well-managed firm with a favourable duopoly structure operating in the aerospace industry. The company has a clear strategy to manage its backlog and production as it ramps up deliveries of new aircraft over the next decade. We continue to believe in the company's return potential, derived from timely execution, margin expansion, increasing free cash flow, foreign exchange capture and positive sentiment. In addition, the smooth management transition as well as the forward looking, positive impact of the C-series deal with Bombardier have also contributed to Airbus' outperformance.

Constellation Software which represents the largest weighting in our Global Equity, Manitou Equity and Canadian Equity mandates in addition to being a significant weighting in F5+ outperformed on positive full-year results. The software platform consolidator saw an increase in organic growth while continuing to participate in opportunistic acquisitions. CSU has a reputation of having a truly unique culture and is known to consistently allocate capital in a highly disciplined manner. The company's strong balance sheet, record of profitability and continued growth trajectory have strengthened our positive stance on this unique firm. In addition to its regular dividend, the company also paid a special dividend of $20 per share during the quarter.

Uni-Select was our bottom performer across three mandates. The stock price fell post the announcement of Q4/2018 full-year results due to four "misses": 1) there was no update provided with respect to the firm's previously announced strategic review, 2) the Board has yet to announce a new CEO having relieved the previous one shortly after Q3 results, 3) the continued issues at Finish Master, Uni-Select's US-based paint supplier and 4) a sober outlook for 2019. Needless to say, we are disappointed with management's contradictory actions relative to their previous statements delivered during several face-to-face meetings over the past two years. As a result, we have revised our assumptions and are reviewing our investment thesis which includes re-assessing the management team, its strategy going forward, as well as the Board of Directors. However, we are cautiously optimistic due to the actions taken by the new Chairperson that are designed to improve governance and thereby enhance shareholder value.

For the Income Fund, bond prices increased over the period as expectations regarding what was thought to be an imminent interest rate hike dissipated. As in the past, we continued to favour short duration bonds in the current environment. Overall, the fund benefitted from the contribution of high yielding securities contained within its basket clause.

The Total Return Yield Fund (TRY) benefitted from the positive impact of the Federal Reserve Chairman Powell's dovish posture on interest rates. In particular, the limited partnerships having the most direct exposure to marketable securities performed well. On the back of these gains, we sold out of both Northstream and Phoenix, which will reduce TRY's exposure to interest rate sensitive holdings. The timing was perfect, as the proceeds from these sales helped to fund our April 2019 purchase of shares in privately owned Fundata Canada, Inc. Fundata is one of Canada's premiere data and analytics providers to banks, insurance companies and money managers. We have considerable knowledge of this company and industry. We look forward to it being a core holding within TRY for years to come.

Conclusion:

The deep dive taken by the S&P 500 during the fourth quarter of 2018 was the first time ever that this bellwether index was down for the full year after having been positive the previous three quarters. As well, the decline in December was the worst recorded since the Great Depression of the 1930's. As discussed during our 'Year in Review' conference call in January, we are proud of the risk-adjusted returns we produced during extreme periods in the markets. The fact that we experienced relatively less pain during the fourth quarter and have captured most of the upside is a testament to the Manitou process and our research team.

As always, we will continue to strive to deliver excellence in all that we do.