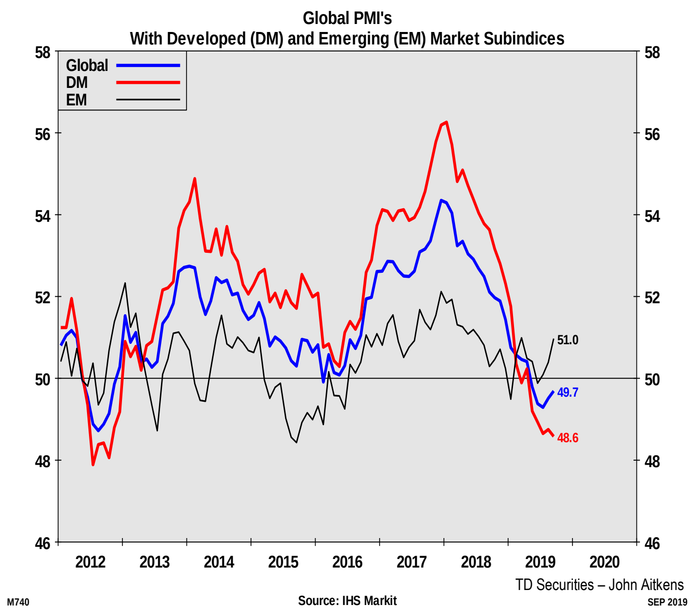
Manitou
Investment Management Ltd.

Quarterly Commentary
September 30, 2019

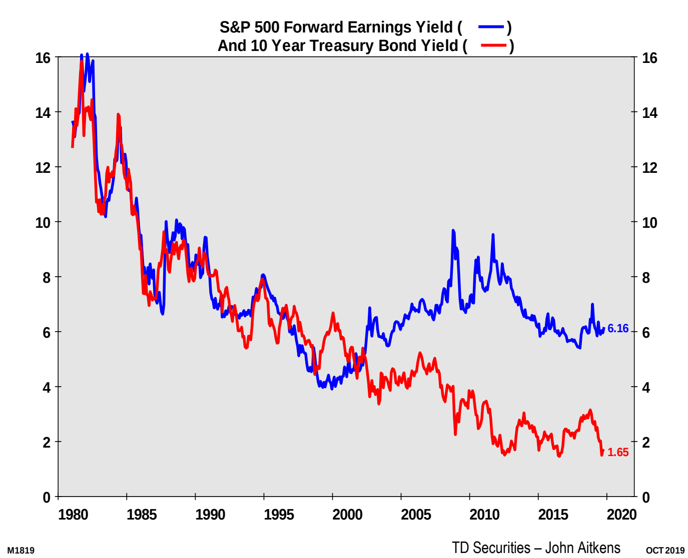
TINA Revisited

In our Q3-2016 commentary, we referred to the well known acronym TINA (There is No Alternative), to justify the relatively high valuation of equity markets vis-a-vis very low, or in some cases negative interest rates. We find ourselves revisiting TINA once again as equity markets have continued their upward trajectory.



Why has the market continued its ascent even though investor worries abound? Stock market performance thus far in 2019 has remained resilient in spite of the widespread uncertainty surrounding the US-China trade dispute, US$17 trillion in negative-yield sovereign debt, a chaotic Brexit, the possible impeachment of a sitting American President and riots in the streets of Hong Kong. Notably, the S&P 500 and S&P/TSX indices are up 16.9% and 19.1% respectively year to date through September 30th. These returns are even more surprising given the clear evidence that global growth is slowing, which is captured in the chart of the Purchasing Managers Indices to the right.

While the service sector is offsetting manufacturing weakness in North America, China is slowing to levels of growth not seen in the last decade. This is spilling over into the European industrial sector and the supply chain industries in South East Asia. In spite of these concerns, the fact remains that North American economic growth continues at a rate of 1.5-2.5% driven by such positive factors as near full employment, generationally low interest rates, improved home affordability, accommodative monetary policy and rapid innovation across many important industries. Furthermore, wages are rising modestly for an expanding workforce, and monetary policy seems unlikely to impede the economy. The US-China trade war and European negative interest rates remain the biggest of the *known* concerns in our view. In addition, while historically an inversion of the yield curve has been a near perfect indicator of a pending economic recession, its predictiveness in our view, seems lessened due to the absolute level of rates.



Clearly US$17 trillion in sovereign debt offering negative yields is an unrealistic and unsustainable situation that is in part a result of foreign exchange speculation. With a resolution to Brexit and an easing of German fiscal policy, European rates are likely to normalize to a modest positive level. However, rates would have to move materially higher in order for investment grade bonds to meaningfully draw capital away from equities. After all, a bond is merely a contractual obligation to repay the principal at maturity along with a contracted quarterly coupon. By contrast, quality stocks are part ownership in entities that pay dividends that can grow as the company expands organically or via acquisition. As the chart to the left demonstrates, S&P 500 companies offer an earnings yield that is 450 basis points above the 10-year treasury. This phenomenon is even more pronounced in Canada.

In our view, it is the yield gap between 'guaranteed' versus 'riskier' investments that is the most significant factor currently impacting stock market performance. The hyperfocus on every word from Fed Chairman Powell and the published minutes of the Federal Open Market Committee are a sign that stock valuations are generally high relative to their underlying growth prospects. The Fed emphasizes at every opportunity that its policy is data-driven, and a further reduction in the Fed funds rate, while likely, should be interpreted as precautionary and necessary only to offset the drag of trade talk uncertainty.

As your portfolio valuation indicates, we are currently maintaining relatively high cash weightings. This reflects our concern about valuations being driven more by the extremely low level of interest rates than the growth rates of even our most admired companies. Yet despite our concerns about valuations, stock markets have powered upward thus far in 2019. Once again, this underscores the difficulty in predicting overall markets in the presence of such unprecedented conditions. We are much better equipped to understand businesses and assess their valuations in light of their longer-term prospects.

Portfolio Performance

Manitou portfolios performed well in Q3 and year to date. For the 12-month period ending September 30th, 2019, all mandates exceeded their absolute and relative benchmarks. In fact, they have consistently outperformed their absolute benchmark of CPI+7% since their respective inception dates. Our record of strong performance is the result of the consistent application of our process, namely, concentrated investing in high-quality companies at attractive valuations.

A few of the significant outperformers and detractors held broadly across our equity mandates are as follows:

Constellation Software continues to be our largest holding across all eligible mandates. The company outperformed this quarter and year to date as a result of management's systematic deployment of capital on bolt-on acquisitions across its operating groups. The company spent C$263 million during Q3 and C$438 million year to date. Furthermore, the pace of acquisitions has accelerated in spite of an increasingly competitive environment. The focused management team, decentralized structure and exceptional discipline to its target hurdle rates are reflected in the share price improvement over the quarter. Although we periodically trim back our position when the weighting drifts above our allowable target, we continue to believe in the enduring competitive advantages of this "serial compounder".

During Q2 of 2019, **Apple's** share price declined due to concerns over iPhone demand saturation. Its share price subsequently recovered during Q3 as a result of management's decision to reverse the significant price increase on its 2017/2018 model X phones, in addition to successfully driving growth through services and wearable devices; namely watches and AirPods. Apple bolstered its service offerings by delving deeper into media with Apple News and Apple TV+ subscription services, as well as into financial services through the Apple Card which serves to complement its Apple Pay service. We continue to support the thesis that Apple will remain a highly profitable company due to its sticky ecosystem, loyal consumer following, and innovative leadership team.

Jardine Strategic Holdings is held in both the Global and International Funds. As mentioned in previous quarterly letters, Jardine is a Hong Kong-based holding company founded in 1832. Since its inception the company has amassed interests spanning property development and management, retail, auto dealerships, hotel management, and infrastructure, spread over a vast geographic area. A large part of Jardine's success is due to its owner-operator culture which is emphasized amongst current management, many of whom are direct descendants of the founders. The Keswick family retains a stake of over 10% in the company.

Unfortunately, given the location of operations and its direct exposure to Hong Kong, Jardine's share price has been negatively impacted by the ongoing protests. As an example, according to the latest data from Hong Kong's Census and Statistics Department, sales of jewellery and watches plunged by 47% in August compared to the same month in 2018. This was on top of a 24% decline in July, 2019. As the largest landlord of Grade A luxury retail and commercial space in the city, Jardine has been adversely impacted. We will continue to monitor the situation and its effects on the company's business operations, but at present, we remain confident in Jardine's ability to withstand this temporary shock as it successfully did when Hong Kong was transitioned from British to Chinese rule in 1997.

Manitou Income Fund's performance over Q3 and year to date has been strong, significantly exceeding its benchmark. This reflects the Bank of Canada's continued accommodations given the further slowdown in global growth, weak oil prices and well-publicized trade uncertainties. Canada's 3-year average bond yields were flat quarter-over-quarter at 145 basis points, but are still down 47 basis points since the beginning of the year. Given the Income Fund's higher proportion of corporate versus government bonds, we were able to benefit from this additional yield. With the current flattish yield curve, we continue to maintain a relatively short fund duration of approximately 3 years.

Manitou Total Return Yield Fund (TRY) is currently generating a running cash yield of 5.5%, slightly lower than our targeted cash yield of 6%. This is primarily a result of two larger investments (Arch and Fundata) which together represent approximately 22% of the Fund's assets, and *currently* offer little to no yield. This is temporary, as both companies are anticipated to contribute more meaningfully to the Fund's cash flows in 2020, while possessing significant upside capital appreciation potential over time. We have continued to cull highly market sensitive investments in favour of more predictable yield contributors and this process will progress throughout Q4 of 2019. During Q3, we allocated funds to Grafton Partners LP and Flow Capital. We also topped up our investment in Easy Legal Financial. Each of these investments pays a coupon of 10% or better. Overall, TRY is performing well and continues to be a viable option for clients wishing to diversify a portion of their capital into investments that are less correlated with the market.

Conclusion

Years ago we wrote about the adaptability of good companies being able to safely navigate, and often prosper, through difficult macro economic conditions. Together with innovation and continuous improvement, these factors are essential to the longevity of a business. Most of the revenue of today's largest tech companies derive from products and services that did not exist ten years ago. Apple sells tens of millions of iPhones each year and garners an ever-increasing proportion of profits from service revenues. Google touches many aspects of one's life, dominating "search" which has taken on a new meaning in the 21st century. Visa and MasterCard process millions of financial transactions every day as governments worldwide attempt to phase out the use of cash. Airbus builds efficient, increasingly eco-friendly planes that transport millions of travelers annually and Diageo produces spirits, many of which were created well over 100 years ago. While valuation is critical to our process and is key to protecting client capital, investing in dynamic businesses that are profitable, financially sound, and possess enduring franchise qualities is at the core of our investment discipline.