Ninepoint International Small Cap Fund Market View

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Investment Team

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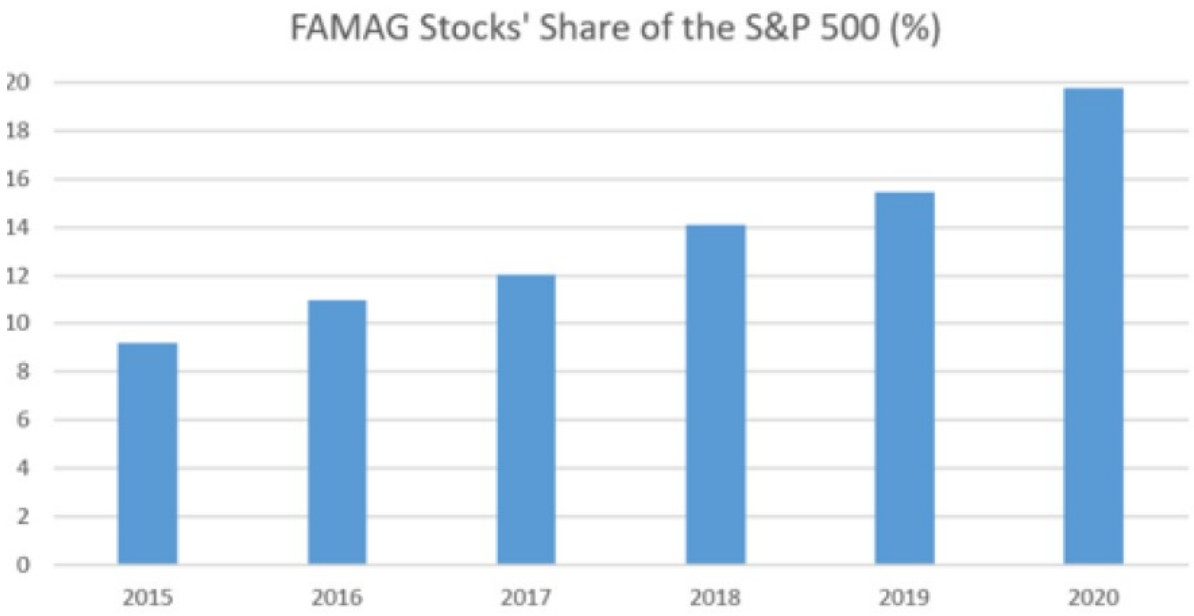
Dear Clients and Colleagues:

As we settle in to our new environment, many of you may find that working from home allows one's mind to wander more frequently. Lately, we have been giving thought to how markets are inefficient, despite all the research that argues otherwise, and the rise of ETFs, quantitative strategies and other financial products that unfortunately do not align with the purpose of stock markets – bringing together savers with companies that need those savings to fund their growth. Also lost is the purpose of investing in common stock of these companies, which is long-term capital appreciation, driven by earnings per share growth and increasing dividends to shareholders.

Presently, Netflix's valuation exceeds US$200 billion. The company is now viewed as a must have service in this age of confinement, however they have yet to generate free cash flow, pay a dividend and is selling at 87 times earnings. One could make any thesis on the future of that company. But with US$200 billion, you can buy not one but all of Colgate-Palmolive, Kimberly-Clark (yes toilet paper), Clorox (need some wipes?), and you can also have General Mills, Kellogg's and Campbell soup for good measure to top it up. All essentials, are they not? For our Canadian clients, US$200 billion allows you to buy the three largest Canadian banks, Royal Bank of Canada, TD Bank and Scotiabank, which last year declared over US$25 billion in profits and paid US$11.7 billion in dividends. Despite an estimated 25% of American households being unable to afford their rent or mortgage payments, and millions relying on food banks or stamps, Netflix is the last thing they will cut.

For legendary investor Warren Buffet, CEO of Berkshire Hathaway, 2019 was his worst year against the S&P500 Index since 1999. Buffet famously said, "The stock market is a device for transferring money from the impatient to the patient". Looking broadly at the United States (US) stock market, its dominance has continued in this correction and subsequent rebound. However, it has not been a broad rally; it has been driven by a few very large companies, an equal weighted index or small cap index where no companies have a big weight paints a very different picture with the median stock down around 30%.



We have rarely experienced such a disconnect between stock markets, particularly large cap technology shares and the state of the economy. Many investors have used the 2008 global financial crisis as a reference and see the rapid and unprecedented actions of central banks and government as support for the economy to experience a rapid V shape recovery. Therefore, the first half of 2020 is viewed as an outlier.

We have shared our views on the current environment over the past few weeks. We believe that the world will experience the worst recession since the 1930s – that is if we do not experience a depression, however that is not our forecast at this time. We believe the recession will last between two to three years. It will most likely be deeper for the US given the high debt levels of both households and corporations, compared to Asia and Europe, and also given the relatively smaller social safety net. Adding to the significantly reduced buyback activity coupled with an already lower dividend yield, we believe the era of outperformance for US large caps is coming to an end. The correction in the last few weeks has been brutal as shown in the following graph, deeper for small cap and non-US markets.

This situation is not dissimilar to what happened in the fall of 2008. The market had corrected from

the Lehman bankruptcy on September 15 until the end of October, before rebounding strongly until year end. Then as now, the US and large caps outperformed. We then had a second correction at the beginning of 2009 and markets finally bottomed on March 6, 2009, around six months after Lehman. In that second correction, small caps started outperforming and finished the year much ahead of larg cap and never looked back until about 2015, as the relentless bull market marched on. A similar story happened in 2000, during the tech crash. We are confident we will see a similar scenario unfold this time.

Let's have a look at the following table:

Market Characteristics at March 31, 2020

Indice	P/E 2019	P/E 2020	EV/Sales	EV/EBITDA 19	EV/EBITDA 20	Yield	Net Debt/EBITDA Trailing
S&P 500	21.2	15.8	2.2	13.4	11.6	2.4	1.8
Russell 2000	18.5	11.7	1.5	19.9	8.0	2.2	7.4
MSCI World	20.7	15.3	2.2	12.3	10.6	2.4	2.2
MSCI World Small Cap	17.5	12.8	1.4	13.0	10.3	2.9	3.8
MSCI EAFE	19.4	13.3	1.3	10.1	8.6	3.4	2.4
MSCI EAFE Small Cap	16.4	12.8	1.1	11.1	8.8	3.6	1.7

Source Global Alpha & Bloomberg

Although earnings and sales are anyone's guess at the moment, one can see that small cap are generally cheaper and have a higher yield than large companies, a yield that is less at risk that larger companies. In addition, larger companies' profit margins reached an all-time high, and had much lower tax rates than smaller companies. Two characteristics that will most likely be greatly diminished going forward.

So how are we navigating this market, incorporating our belief that the economy will experience a deep recession?

Our first step was to stress test all of our holdings assuming a worse-case scenario. Our investment process has always been to choose companies with better profitability and stronger balance sheets than their industry competitors, but it was important to verify it given the crisis. We then classified the market into four types of companies:

1. Companies not affected by the virus:

Some companies saw a very limited impact from the virus or even saw an increase in sales. Names like Amazon or Costco spring to mind. Our portfolio holds a number of companies, like Internet Initiative Japan and Norway Royal Salmon that fall in that category. As their relative performance increased their weight in the portfolio, we took some profits. However, some companies in that category were not immune from the market correction and provided us an opportunity to increase our position, including Raffles Medical Group, Kerry Logistics, Konami, and Farmland Partners.

2. Companies that will not see a destruction of demand, rather a postponement in the demand:

Some companies like medical technology companies, funeral homes, imaging clinics, hospitals, long-term care, recycling equipment or agricultural equipment may experience a deferral of demand but not a change in the essential nature of their product. We believe that demand will accumulate in the backlog. When the price did not reflect the resiliency of their business, we increased our

position. Radnet, CVS Group, Globus Medical, Titan Machinery and Bucher Industries are examples.

3. Companies that will experience a rapid recovery and will likely gain market share in a post- COVID world:

We believe that some industries will be changed for a long time, if not permanently. Airlines, cinemas, events and exhibitions fall into that category and it will also impact their suppliers. Highticket, highly discretionary consumer durables like RVs, boats, motorcycles, even cars, may see a much lower end demand and slow recovery ahead. Capital expenditures will most likely be lower and experience a subdued recovery as companies will adjust to the new level of demand as well as repair balance sheets. However, some companies, like Biffa, a leading waste management company in the United Kingdom, are much less affected. Its residential waste and energy from waste segments allow the company to be resilient in the crisis. Post-crisis, Biffa will likely gain market share in its fast growing industrial, commercial and construction waste business.

4. Companies that were in the middle of corporate actions to surface value:

Companies like Verint Systems which was in the mist of separating its customer interaction and cyber intelligence businesses saw the share price correct more that its peers; we increased our position. Other companies like Kerry Logistics, Melia Hotels or IWG that were selling some real estate assets to free capital and be more comparable than peers are other examples. We believe that many companies will look to demonstrate to the market the value of their assets by those restructuring.

5. Companies that are directly hit by the virus and will probably not survive or do so at such dilution to existing shareholders that there will be no future upside for existing shareholders:

We do not own any companies in this category at the moment, we sold Vista Group which had to resort to a share issue. It is noteworthy that Citigroup issued so many shares during the 2008 - 2009 period that its share price is still 80% lower today that it was in early 2008.

Our portfolio has been positioned for the next 18 months, not the next two weeks. Our expected value-add should also be viewed over that period. Many of the companies in our portfolio have been profiled in our weekly commentaries in recent weeks or even years. Past commentaries are available on our website in the commentary section and we invite you to read them again. Also, on our website is our latest webcast which provides further details on our view on the economy and markets.

We wish you excellent health and courage during this trying and uncertain period.

Have a great week ahead!

The Global Alpha team

MONTHLY RETURNS (%) AS AT MARCH 31, 2020, SERIES F

	1M	YTD	3M	6M	1YR	INCEPTION
Fund	-13.8%	-22.5%	-22.5%	-14.2%	-14.4%	-7.9%
Index	-12.3%	-20.4%	-20.4%	-13.1%	-12.8%	-9.5%

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at March 31, 2020; e) since inception (March 15, 2018). The index is 100% MSCI EAFE Small Cap NR USD (CAD) and is computed by Ninepoint Partners LP based on publicly available index information.

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