Ninepoint Enhanced Equity Strategy

July 2018 Commentary

Investment Team

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July saw a strong risk on equity market with cyclical sectors such as financials and industrials leading the U.S. equity market's 5% rally from June's trade-fear induced lows. As discussed in June's monthly commentary, we added upside calls to several individual industrial equities and the industrial ETF, on expectations of stronger than expected earnings and a potential relief rally. We also held upside calls on the SPY given cheap volatility, with general expectations that stronger than expected earnings would trump any near-term protectionist rumblings leading markets to climb a "wall of worry". We have since exited those options positions on the most recent rally and have added a more defensive positioning into Q3 with more hedging than we held coming into the quarter.

Not surprisingly, the 5% rally for the S&P 500 from the June lows mirrors the 4% positive estimate revisions that the S&P 500 has seen since late April. With 2019 S&P 500 earnings estimates moving higher, the forward P/E multiple of the S&P 500 is now just ~16X, a not particularly expensive to somewhat middling valuation. We see however a lower likelihood of further positive estimate revisions at this point given our sense that economic momentum is peaking and tax benefits are now properly modeled by the street. This diminishes one source of near-term upside for markets. The other, valuation upside, seems challenging given Chinese trade concerns are likely to incrementally worsen into September capping valuation driven upside. These factors have us running a tighter loss curve than we had entering summer.

Notable Movers and Changes in Positioning

Microsoft: Rallied >10% during July into earnings on expectations of very strong cloud growth, a dynamic which was confirmed during Q4 earnings. We continue to see our core thesis of DD revenue growth and stable margins playing out as cloud spending momentum continues.

CSX Corp: We increased our weight in CSX coming into earnings on the expectation that strong quarterly margin performance would lead to further estimates revisions for 2019. The company beat both our topline and operating margin expectations during the quarter. With strong margin performance in the quarter, it looks increasingly possible that 2020 operating ratio targets will be achieved as much as a year in advance. The stock has rallied 15% post earnings.

Canadian Pacific: We added a position in Canadian Pacific coming into earnings as we thought strike related earnings risk was well anticipated by investors and that the pullback offered an opportune time to add a position given we are bullish on the company's prospects for 2019 crude by rail volumes. This factor could offer investors peer leading volume growth and positive estimate revisions. We also see the upcoming analyst day as a positive catalyst for the company.

Northrop Grumman: After considerably pairing back the position into and after Q1, we exited our small remaining holdings after Q2. The company has failed to accelerate overall revenue growth to the degree we envisioned and valuation we feel no longer compensates us for the risk of not being able to meet street expectations for growth. We are happy with the return on our initial investment given the equity has rallied >100% since we initiated several years ago.

Facebook: We initiated a small position in Facebook during the Cambridge Analytica debacle with the thesis that valuation compensated us for the risks of slight downside to earnings growth assuming some fall-out from the negative publicity. The company rallied >40% off the lows on strong Q1 earnings, however Q2 saw weaker than expected guidance for 2019 sending the stock down 20 (although the stock has recovered about a third of that since). While the company's 2018 guidance for margins was in-line with prior comments, the guidance that 2019 margins implied a continuation of very high spending trends. We, like many, were surprised by the ramping spending expectations the company has announced, which if they prove conservative, would imply stronger than expected margins for 2019. We lowered our weight somewhat post earnings and continue to hold a profit on our initial position. We also used the most recent post earnings rally to hedge our position at low cost by selling out of the money calls to purchase a put spread into October. With the options wrapper we've left ourselves ~10% upside into October with ~10% downside protection, effectively hedging some of our gains. Meanwhile, we are waiting for early indications that "stories" monetization is running ahead of plan or that our initial margin expectations for 2019 numbers are indeed as achievable as we initially thought they were. Incremental data along these lines may lead us to consider exiting the entire position. At this juncture we are comfortable with the new risk profile given our hedge.

Parex Resources: Parex has been a stellar performer for our energy book over the past 3-4 quarters but ran into some tougher sledding in July. First the company announced a strategic review to look at selling its main producing assets while retaining a package of exploratory assets. We see this as positive given the company's stellar history of exploratory success and production growth combined with the fact that its current producing assets should sell for somewhere between $25 and $30 a share. The market though didn't like the uncertainty of not knowing when the producing assets would be sold or at what price and the stock sold off. The selloff was exacerbated a few weeks later when the company announced two exploratory wells had come up dry. Now, this is the oil industry and exploratory wells come up dry all the time (thus the word "exploratory") but it doesn't happen very often with Parex and on the back of the strategic review announcement, it spooked the market again. That said, we remain confident that asset value is well above $25 per share, that the current process is likely to realize a successful sale and that the strong record of exploratory success will continue.

The Enhanced Strategy Team

[1] All returns and fund details are a) based on Class/Series F shares/units; b) net of fees; c) annualized if period is greater than one year; d) as at July 31, 2018; e) inception date for Ninepoint Enhanced Equity Class is 04/16/12. The index for the Ninepoint Enhanced Equity Class; Ninepoint Enhanced Long Short; and Ninepoint Enhanced Long Short RSP is 50% TSX & 50% S&P 500 (CAD) Blended Index and is computed by Ninepoint Partners LP based on publicly available index information. The index for the Ninepoint Enhanced US Equity Class is S&P 500 TR USD and is computed by Ninepoint Partners LP based on publicly available index information.

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