Ninepoint Enhanced Equity Strategy

October 2018

Investment Team

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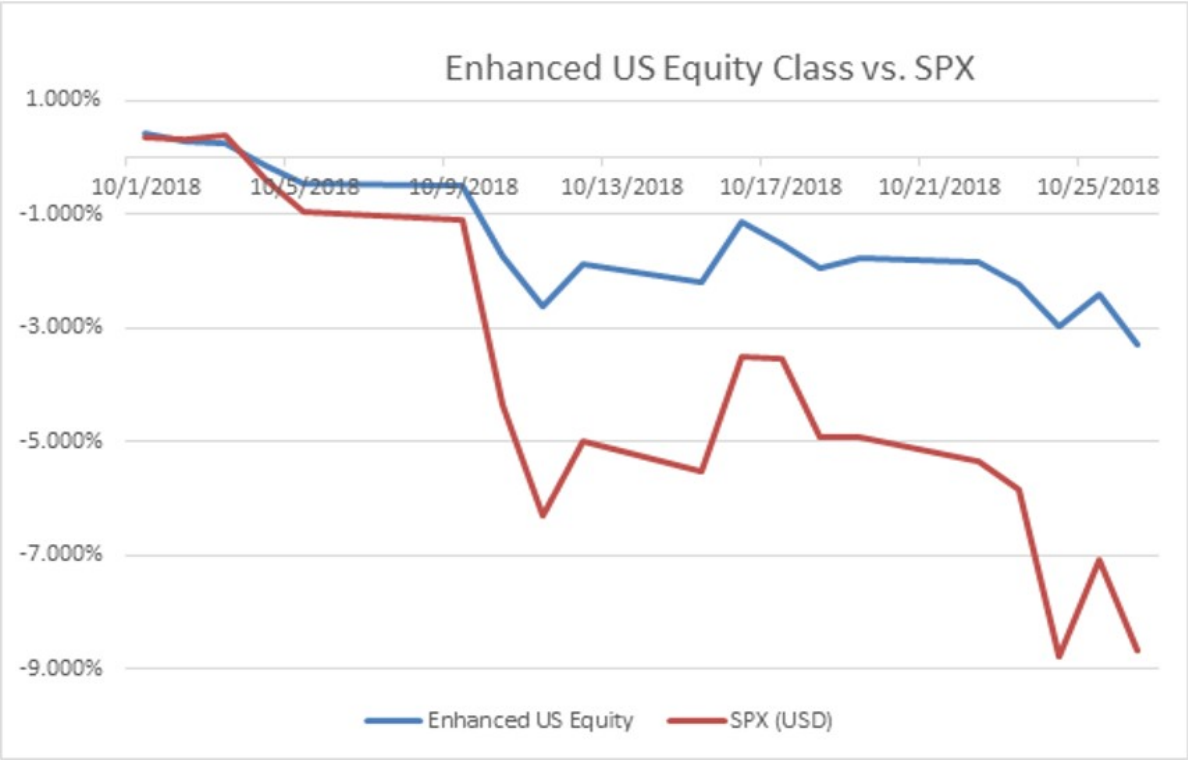
This October lived up to its historical reputation as the worst performing month of the calendar year as financial markets sold off across the board with U.S. and Canadian equity markets as well as commodities suffering material declines over the course of the month. Possible explanations abound: rising rates, China slowing, Trump's tariffs, weakening U.S. economic data particularly housing, Brexit, stress in emerging markets, $110 billion of GE debt possibly getting downgraded to junk, Italy's political and fiscal woes…the list can go on and on. In the end, our best view of what is weighing on risk assets is an overarching blend of most of these: growth. We are now ten years into a positive economic cycle and investors naturally worry that it must end soon. Slowing global economies, especially China, combined with rising rates and the potential for further tariffs provide a basis for believing that the inevitable end to the good times must be approaching, Worries on growth create uncertainty (to the downside) on 2019 earnings estimates and require a higher equity risk premium (meaning a lower market multiple).

While we agree that this cycle will end eventually and resulting recession will usher in a bear market for equities (as it always does) the current frenzy feels somewhat premature to us. While it is of course possible that we are on the doorstep of the next recession, there is still very little to indicate that is what is about to happen. Growth in the U.S. is slowing as the fiscal tailwind from the tax cuts laps itself but unemployment and wage growth are their best in decades and while the cost of credit is rising, it remains widely available on historically generous terms. In fact, were the tariff threat to go away (alas, unlikely in our view), we believe global growth could accelerate meaningfully from current levels. We have significant index hedging in place across our portfolios given we expect current volatility to continue for some time but we are also adding upside exposure in order to benefit from an expected recovery from current levels.

Hedge Book: In the U.S. Enhanced Fund we were able to operate with a roughly 1/3 downside capture during the worst parts of the October sell off. This was largely in line with our expectations. We were able to book hedging profits of ~120bps during the month while continuing to operate comparable downside capture expectations. The Enhanced Equity Fund however underperformed our downside capture expectations largely due to underperformance of several Canadian companies specifically Altagas and several energy equities.



Source: Factset, Ninepoint

Earnings Moves

We were largely happy with earnings for the companies in our portfolios. We saw a tendency for market reaction to fade better than expected to neutral numbers as investors are broadly more worried about whether 2019 S&P 500 earnings expectations of 10% growth are achievable.

Microsoft: The quarter largely confirmed our core thesis that revenue momentum and margin expansion are likely to come in better than expected over the next several years leading the stock to rally after the quarter. While the third cornerstone of our thesis, that free cashflow should materially accelerate has yet to come to fruition, we still think there is good chance that this occurs next year, in which case the company is trading at a material discount to peers on a free cashflow basis while growing in-line with them.

UnitedHealth: Management "blessed" the streets earnings growth expectations for 2019 leading to continued strong performance from the stock. We have lowered our exposure given rising valuation and initiated a position in Anthem, please see below for details.

Financials: Most U.S. financials traded poorly on Q3 earnings as concerns about 2019 net Interest margins (NIMs) continue to weight on banks, combined with broad based risk off market behavior. We have and continue to hold considerable positions in Citibank and Bank of America. We see the core retail franchises as undervalued for both, especially when compared to regional banks. Bank of America has done a stellar job at improving efficiency and put up almost 40% earnings growth during the quarter. While that momentum will slow next year, at <10x earnings, with a well provisioned balance sheet and very muted expectations we think earnings growth in-line with current expectations is likely baring a recession. Indeed, relative forward valuations of U.S. Financials are trading at decade lows, a dynamic that might be justified in a scenario coming into a

recession, a factor we don't consider a likely event in anytime soon.

Energy Performance: Our Energy equities were a large than anticipated detractor from performance during November and while our strategy outperformed markets during the October sell-off, it do not perform as well as we would have anticipated largely due to the performance of our energy equities. Crude oil prices have declined sharply on the U.S. decision to grant waivers to China, India and a few others to allow them to continue importing Iranian oil despite the U.S. sanctions. Worries over higher Iranian exports combined with worries over global growth and resulting demand for oil have driven both Brent and WTI down by over 25%. We believe the crude selloff is overdone and energy names which were very cheap to start with are now in many cases at all-time lows.

Notable Additions and Dispositions

Anthem: We sold a portion of our United Health position to purchase shares of Health insurer Anthem. Anthem is one of the largest health benefits companies in the U.S. serving over 40 million medical members as an independent licensee for the Blue Cross and Blue Shield Association. Anthem's sales growth has slowed to a 2-3% pace in 2018 as the company has reduced its public exchange exposure and declines in their commercial insurance business. Anthem is also currently in the process of internalizing its PBM (pharmacy benefits manager) relationship away from Express Scripts. We feel that revenue growth is likely to accelerate in 2019 as headwinds from the exchanges dissipate at a time when several states increase their Managed Medicaid programs. We also think the management team is being too conservative about the earnings benefits from internalizing their PBM relationship in 2020. We think this alone could boost 2020/2021 earnings estimates by 10% vs. current expectations creating a company with an almost 20% earnings growth rate in that time frame vs. peers at low-mid teens. Under our estimates the company is trading at ~12X 2020 estimates and a >7% FCF Yield vs. UnitedHealth at 16X 2020 Earnings ~5% FCF Yield. While we continue to hold and like the strong competitive moats and consistent revenue growth that UnitedHealth has, we feel the discount that Anthem currently trades at is likely to close as their revenue growth accelerates closer to the UnitedHealth growth rate. This is likely to occur at a time when earnings growth should accelerate to a faster rate than peers as the benefits from internalizing the PBM start to be realized. Management has noted that 2019 street estimates seemed somewhat conservative reinforcing our confidence that our thesis is on track.

Fiserv: We have been trimming our position in Fiserv for several months now and ultimately exited the position after the most recent quarter. Our core thesis that organic revenue growth could accelerate later this year has not come to fruition at a time when the company is trading at its largest premium to S&P 500 and technology sector in several years. Management highlighted they are only 69% of quota for sales currently and while their historic track record of execution is strong, we feel the current valuation doesn't compensate us for the risk of miss execution at this point in time.

In summary, recent market declines reflect growing uncertainty over future growth. Uncertainty is not unusual in financial markets and is the underlying reason we believe in always being hedged. That said, our current view is that we are not entering recession and that markets can recover over the coming months. We believe owning cheap companies with strong financial performance and balance sheets should drive substantial upside.

Until next month,

The Enhanced 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 October 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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