Maxam Diversified Strategies Fund – Q4 2018 Commentary

Carnage. And Opportunity.

2018 was a weak and volatile year for Canadian and global stock markets. Here's a snapshot of how select developed and emerging equity markets performed in 2018:

2018 Return ($ USD)			
ARGENTINA	-51.7%	JAPAN	-14.5%
AUSTRALIA	-15.8%	KOREA	-22.6%
AUSTRIA	-29.3%	MEXICO	-17.4%
BELGIUM	-28.6%	NETHERLANDS	-15.1%
BRAZIL	-3.9%	NEW ZEALAND	-6.6%
CANADA	-19.1%	NORWAY	-11.6%
CHINA	-20.4%	PORTUGAL	-14.1%
DENMARK	-16.9%	RUSSIA	-5.6%
FINLAND	-6.2%	SINGAPORE	-13.3%
FRANCE	-14.6%	SOUTH AFRICA	-26.5%
GERMANY	-23.9%	SPAIN	-18.3%
GREECE	-37.8%	SWEDEN	-16.1%
HONG KONG	-10.5%	SWITZERLAND	-11.2%
INDIA	-8.8%	TURKEY	-43.6%
IRELAND	-26.4%	UNITED KINGDOM	-17.7%
ISRAEL	-6.4%	USA	-6.3%
ITALY	-20.0%	*Average*	***-18.2%***

Source: MSCI.com

Not pretty.

The table below details the Maxam Diversified Strategies Fund's short and long term performance[1].

As at December 31, 2018	1M	3M	1 Yr	5 Yr*	SI*	Cumulative
Maxam Diversified Strategies Fund	-2.6%	-11.4%	-16.8%	6.4%	9.2%	130.7%
S&P/TSX Composite Index	-5.8%	-10.9%	-11.6%	1.0%	3.5%	38.1%
S&P/TSX Small Cap Index	-3.9%	-15.0%	-20.1%	-2.9%	2.3%	24.5%
S&P/TSX Venture Index	-5.5%	-21.4%	-34.5%	-9.8%	-6.8%	-49.0%

We've been here before.

Despite there being almost nowhere to hide in 2018, we're not happy with the fund's performance. However, we've been here before – and we've historically done some of our best work during periods of notable market volatility like this.

One could argue, and many recently have, that it's different this time. While there is no denying the significant challenges facing economies and markets today, we believe it is very important to remind investors – and ourselves – that the world has faced significant challenges and crises many times throughout history: world wars, oil spikes, 20% interest rates, technology and real estate bubbles, sovereign debt defaults, double digit unemployment, corporate scandals and multiple bear markets. One thing all crises have in common is that they end. We don't want to diminish today's challenges, but we're mindful that throughout history successful investors have prospered through opportunistic buying during panics, not selling. When this crisis is broadly recognized as having ended, security prices will already be higher.

We're smart enough to know that we can't predict where the broad markets will finish 2019. And while we won't make a market performance prediction for 2019, we do believe that volatility will remain elevated and investors will remain cautious – we think that is a recipe for opportunity. This is precisely because fear and negative macro headlines cause investors to fixate on price movement instead of value relative to price.

Does that sound familiar?

If it does it's because it is an excerpt from our Q4 2011 commentary – all we changed was the year from 2012 to 2019.

In many ways 2018 reminded us a lot of 2011, both in terms of the market environment and our fund's performance. Much like the latter few months of 2018, market weakness in 2011 was driven by macroeconomic and geopolitical issues that promoted a very risk-off environment. In 2011 it was the European debt crisis, questions regarding growth and the effectiveness (or not) of quantitative easing. In 2018 it was trade uncertainty (USA, Mexico, Canada, China, etc.), pipelines, rising interest rates and questions regarding growth.

The numbers are very similar:

	2018	2011	*The next 3 years* (2012-2014)
S&P/TSX Composite Index	-12%	-11%	+22%
S&P/TSX Small Cap Index	-20%	-18%	-6%
S&P/TSX Venture Index	-35%	-34%	-53%
Maxam Diversified Strategies Fund	-17%	-15%	**+67%**

History doesn't always repeat, but it often rhymes. In the three years following 2011 the Maxam Diversified Strategies Fund gained +67%, or +18.6% annualized.

Today, like 2011, we believe we have very attractive value in our current holdings, and we are excited about the opportunities we are taking advantage of.

Q4 Review.

It was an ugly final three months to finish the year. For Canadian equities it was the worst Q4, and the worst December, in 10 years. Market breadth was terrible with over three quarters of S&P/TSX Composite constituents in the red.

The price performance of our holdings, on average, followed that of the Canadian market. The business performance of the companies we own in the fund was certainly much better, and definitely less volatile, than their prices were. As we've discussed in previous commentaries, intrinsic company value, which is based on fundamentals and prospects, is generally not as volatile as stock prices are in the short-run. In the long-run, fundamentals win.

During the quarter we added to some of our favorite positions at attractive prices.

We had the opportunity to catch-up with the CEO of Medicure, Dr. Friesen, in early December. He provided us with a fulsome update on this pharmaceutical company focused on the commercialization and sale of drugs in the cardiovascular space. Medicure sells three drugs to U.S. hospitals and doctors today, and should add at least another two by mid-2020 as they work on other opportunities in their pipeline. In the meantime, the company's balance sheet is rock solid with net cash amounting to approximately 90% of its year-end market cap.

With a substantial cash balance providing both excellent downside protection and optionality, plus new product launches on the horizon, we think Medicure has a very attractive reward-to-risk set-up. We took advantage of the market carnage during the fourth quarter to increase our position.

We also met with Baylin Technologies during the quarter. Baylin finished 2018 with a gain of about 10%, after being up more than 20% before the markets melted in Q4. Things are going well for this antennae and wireless technology company. A couple of key acquisitions in 2018 will enable Baylin to capitalize on the coming 5G network build-out globally. We took advantage of recent market volatility to add to our position at attractive prices.

In addition to opportunistically adding to some existing holdings, we were able to initiate some new positions at prices that we believe were significantly below even reasonable company value.

For example, we started a new position in a technology company whose share price had declined more than 65% from its mid-2018 highs. While it has now rebounded slightly off the lows it set in the depths of December, it still trades at a very compelling valuation, generates strong free cash flow, and net cash accounts for over 1/3 of its market cap. We continue to buy shares in this company at levels that we believe will reward us handsomely in the future.

Investor fear and emotion also allowed us to buy a company trading at a negative enterprise value (i.e. trading below the net cash on their balance sheet... yes that means we bought a dollar for less than a dollar and acquired the operating business for 'free').

We didn't just add long positions during the fourth quarter. We also took advantage of the plunging equity markets to cover some short positions in our favour. While our short exposure is somewhat modest today, it is focused on companies with fundamentals and business performance that we believe will deteriorate due to both economic and company-specific factors.

We do foresee adding incremental short exposure in the current market environment and will do so in the same measured manner that we do with long positions – opportunistically.

We were also active in the quarter adding some additional merger arbitrage exposure. We like the merger arbitrage strategy for its attractive reward-to-risk and market neutral characteristics. And, unlike our larger peers who find it difficult to invest in transactions involving smaller companies, we are able to take advantage of small and mid-cap M&A opportunities where the returns can be higher without an incremental increase in risk. We think that the recent market carnage and increasing shareholder activism will bring us more transactions to take advantage of.

Where to from here.

We don't believe it will be all smooth sailing ahead for the markets. The prices of securities can be materially impacted by sentiment and emotion in the short-term, but whether it's your favourite fund, stock or strategy, we are proponents of using market volatility, and certainly corrections, to selectively add exposure. Buying fear, and conversely selling exuberance, is hard to do, but history has shown us time and again that it is the best long-term approach.

We are being both opportunistic and patient with respect to deploying capital. We are holding some cash and using the market volatility to selectively add to some long positions, and to increase some short exposure. Selectively taking advantage of times like this (both us and investors) is when we sow the seeds for future returns.

We're excited about the value inherent in our holdings today and the catalysts ahead.

Thank you for your investment and your continued trust.

Sincerely,

Travis Dowle, CFA
President & Fund Manager
Maxam Capital Management Ltd.

[1]Returns are for Series A Units and are net of fees and expenses; * Annualized; SI = Since Inception June 30, 2009;