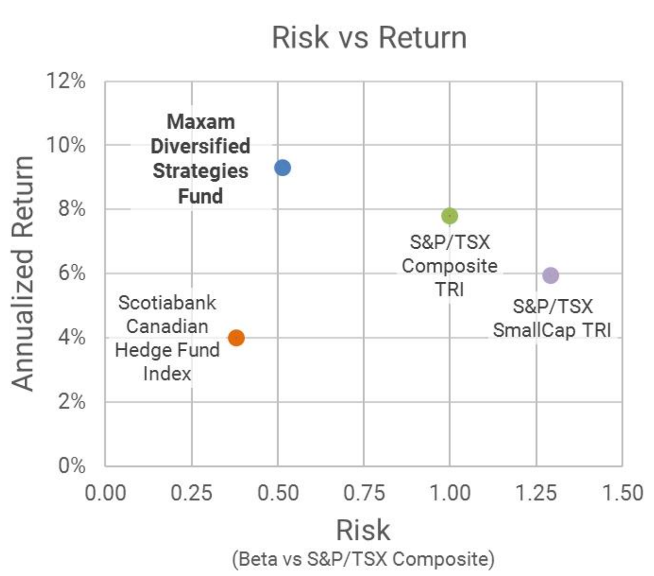
Maxam Diversified Strategies Fund – Q2 2019 Commentary

10 Years.

I'm pleased to share with you that the Maxam Diversified Strategies Fund reached a significant milestone at the end of June.

June 30, 2019 marked the ten-year anniversary of the launch of the Maxam Diversified Strategies Fund. I'm proud that we have built a track record of strong absolute performance and relative outperformance, delivered with approximately half the risk of the Canadian equity market (with risk measured by Beta).

Here's a snapshot of how we've done[1]:



We're proud of our long-term results and motivated and excited to deliver more in the years ahead.

What have you done for me lately?

The Maxam Diversified Strategies Fund gained +6.0% through the first six months of 2019[2] and was roughly flat during the second quarter (-0.6%). While our return this year is nicely positive, it has not kept pace with the Fed-fueled dovish pivot rally that we've seen across broad equity markets so far this year.

U.S. Federal Reserve chairman, Jerome Powell, ignited a risk-on rally for equities earlier this year when he shifted from a hawkish rate-raising stance, to a more dovish rate-lowering one. Low interest rates have led to higher stock market valuations as investors incorporate a lower discount rate on future earnings and cash flows.

At the same time, we've seen bond prices move higher as yields have moved lower. Declining long-term yields are typically a sign that investors are increasingly preferring safety over risk – some to the extent that they are willing to lend money to governments in Germany, France and Japan *at a loss*!

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In short – bad news, such as weakening or decelerating growth, has been good news for investors as it means central banks won't be taking away the punch bowl of low interest rates. The logic being that lower rates lead to increased borrowing, consumption and higher asset prices. This naturally can't continue indefinitely.

Many of our long positions have performed well so far in 2019, however our value-oriented style has recently trailed strategies that have focused on growth irrespective of traditional value and fundamentals. History has shown us that fundamentals and value are rewarded in the end.

Even bears gotta eat!

We don't consider ourselves to be bears, but our view is that economic growth is likely as good as it gets for this cycle. If that's true, then the days may be numbered for the *growth at any price* investor who has done so well of late.

That doesn't mean that select individual investments and certain investment strategies won't do well – on the contrary, some most certainly will.

We believe this market is transitioning from one where passive, beta-oriented strategies have worked, to one where active, alpha-driven strategies will shine – such as special-situation longs, merger arbitrage and targeted short exposure.

Longs.

The fund's long positions are focused on value-oriented special situations and companies where we believe we have identified a catalyst.

Hamilton Thorne was a strong performer for the fund in Q1 but was essentially flat in Q2, gaining +1.4%. We think the future is very bright for this company, which designs, manufactures and distributes precision laser devices and advanced image analysis systems to the Assisted Reproductive Technology sector and developmental biology research market. Capitalizing on attractive secular growth in a fragmented market, led by a strong management team, Hamilton Thorne should be able to keep growing even in a slowing economy.

It has been an active first six months of 2019 for Knight Therapeutics. On balance, Knight received a vote of confidence from shareholders when it defended itself against an activist campaign from a shareholder who wanted to reconstitute the board and move the company in a new, more aggressive direction.

Knight recently had two positive announcements: first that it has approved a normal course issuer bid under which it may buy back up to 10% of its public float over the next year, and second, that it has received approval from Health Canada for its Nerlynx product that treats early-stage breast cancer.

With an inexpensive price-to-book valuation of approximately 1.1, including $750 million dollars on its balance sheet (70% of its market cap), Knight is cashed up to pursue its business strategy of acquiring and commercializing pharmaceutical products. Founder and CEO Jonathan Goodman has proven to be a good steward of capital and a value creator. Goodman previously built and sold Paladin Labs to Endo International for $2.7 billion. We like the value here and perceive very limited downside, with the deployment of capital being the catalyst for gains.

We also see an attractive reward-to-risk profile for Westaim Inc. Westaim is a financial services company with two business lines: one, a specialty insurance business called Houston International Insurance Group and, two, an investment management firm called Arena Investors. The Westaim business today trades at approximately 0.8x book value. Catalysts that we think can drive the stock price much higher include the potential monetization of the insurance business, which has announced that it is considering strategic alternatives – and the Arena business continuing to grow very quickly.

From time to time, some of our longs can feel like value traps, but when our targeted catalysts occur we can benefit from substantial, value-creating, share price moves. And catalysts and events can occur in any market environment.

Merger Arbitrage.

Merger arbitrage is an investment strategy we've successfully employed since the inception of the fund. This market-neutral strategy has excellent reward-to-risk characteristics.

As discussed in the past, we like to hunt for merger arbitrage opportunities in the small-mid cap segment of the market because we find certain transactions can offer the optionality for additional upside. Such was the case with Crius Energy that was acquired by Vistra Energy for $659 million dollars. We established a position in Crius following Vistra's initial bid for the company; and we were rewarded two weeks later when Vistra was forced to increase their bid price when another suitor emerged.

We continue to view merger arbitrage as an attractive strategy in today's market environment and plan to add to our exposure – over 12% today – as we find compelling opportunities.

Shorts. Hedges.

Our fund exposure is typically net-long, but we do see opportunities to add value and manage risk through targeted short exposure. If the overall market declines, our short exposure will act to mitigate some of the downside. Regardless of overall market direction, we short select securities with the goal of adding absolute value in any market environment.

Our shorts are focused on companies where we think we have identified specific issues and negative catalysts. The fund's short exposure is diversified across seven sectors today, but focused on companies in the Financials, Consumer Discretionary and Industrials sectors. If growth is indeed slowing at this market juncture, then a number of our shorts will add value as their high-growth valuations come under pressure.

Overall, our fund exposures and positioning are differentiated from a traditional index or equity fund – and I believe reflect an attractive balance of reward-to-risk today.

The next 10.

Our investment approach remains consistent today with what has enabled us to generate strong risk-adjusted returns through our first 10 years. We invest in situations where we believe we have identified both value and a catalyst.

In the Maxam Diversified Strategies Fund's very first commentary 10 years ago I posed the question:

"Why should one invest in an environment where the near-term prospects are so uncertain?"

While clearly a different market environment back then versus now, my answer is similar today: With an active, flexible and opportunistic investment strategy we believe we can take advantage of the compelling investment opportunities that become available during periods of change and volatility. A more volatile environment means increased opportunities for our active strategy, which, in-turn, sows the seeds for future returns.

That is our opportunity as investors.

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Thank you for your investment and your continued trust.

Sincerely,

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

PS: follow us on Twitter for some retrospective thoughts on our first 10 years: @maxamcap

[1]Maxam Diversified Strategies Fund inception date was June 30, 2009; Series A units, net of fees and expenses. Beta is calculated relative to the S&P/TSX Composite Total Return Index. Scotiabank Canadian Hedge Fund Index, Equal Weighted data is as of May 31, 2019 because June 30, 2019 data was not available at time of publication.
[2]Maxam Diversified Strategies Fund Series F unit performance.