Maxam Diversified Strategies Fund – Q1 2020 Commentary

First and foremost, we hope that you and your families are well and staying safe and healthy during these surreal times. The entire Maxam team and our families are doing well. Our team has successfully transitioned to working remotely and we are able to efficiently perform our essential work functions – allowing us to focus on navigating the challenges and opportunities of this environment for our clients.

The Maxam Diversified Strategies Fund[1] declined -26% in the first quarter of 2020. Placing our fund's decline within the context of the broader equity markets, large and small caps in Canada and the U.S. declined -20 to -39% in the first quarter[2].

Where were you during the Coronavirus Pandemic of 2020?

This will be a period in time that necessitates more than merely a footnote in the history books. The COVID-19 coronavirus pandemic has affected all of us, impacting everything from our daily routines and occupations, to our collective psyche and our health.

COVID-19 had a materially negative impact on capital markets and the security prices of all asset classes in the first quarter of 2020, most significantly during March. The magnitude of the decline in equity markets was notable itself, however what differentiated it from historical crashes, was both the speed and depth of the decline.

Canada's S&P/TSX Composite Index (the "TSX") declined -37% from its pre-pandemic peak to its recent low in only 22 market sessions. Putting this in context, the TSX declined -31% in 52 trading days during the 1987 crash which is itself remembered for its speed and depth.

Similar to previous market crashes and corrections, correlations between securities prices moved quickly towards one. A high correlation means that security prices are moving together in the same direction, up or down, at the same time. Correlations of securities prices on the TSX index spiked towards 0.90 during March, up from pre-pandemic levels in the low to mid 0.70's.

This means investors were treating the vast majority of securities the same, as something to sell and turn into cash. Company fundamentals, balance sheets, business prospects – good or bad – didn't matter. This leads to opportunities, more on that later.

A brief synopsis of what has transpired over the past few months:

- Rise and spread of COVID-19 leads to a global health and economic crisis;
- Social distancing, lockdowns and non-essential business closures;
- Uncertainty leads to fear and panic – investors sell first and ask questions later;
- Equity markets move materially lower in a very short period of time;
- Governments and central banks announce a variety of assistance programs and policy moves;
- Signs emerge that the growth rate of cases is slowing, and the curve is beginning to flatten;
- Equity markets have rebounded somewhat off their recent lows…

Beyond the eye of the storm.

While equity markets have broadly moved off of their recent lows, there is still much that we don't know. We cannot predict the extent nor the duration of this pandemic, but we do know that the impact on many businesses and industries will be significant, at least over the next few months ahead of us.

We also know that it has been the large cap leaders of the previous cycle that have led this market off its lows, whereas many other companies remain significantly lower than their prices of just a few months ago.

Today, investors are increasingly looking beyond the eye of the storm (generally a good thing), however we think their mettle will be tested as the realities and unknowns of this unprecedented economic break continue to unfold.

In the short-term we expect market volatility to remain elevated as investors are whipsawed between massive fiscal and monetary stimulus, signs of a return to normal and the regular reporting of economic statistics (think low growth and high unemployment) and earnings (think none for some) which will undoubtedly serve as harsh doses of reality.

Hello Normal. Meet New.

Investor attention has initially focused on the solvency and liquidity of businesses in order to assess their available runway to get through the current environment. Subsequent effort has shifted towards assessing what the *new normal*, post-pandemic, will look like – and notably which businesses and industries will thrive in it and which will not.

We envision that aspects of the new normal will look similar to the old normal, just in fast forward. Certain trends that were already in place will remain in place and even accelerate. For example, some trends likely to accelerate include: the growth of online shopping over physical; remote or work from home flexibility; online education; e-health and tele-health; the growth in demand for internet connectivity and increased bandwidth; a decline in non-essential business travel (and perhaps reduced travel in general); greater focus on personal health and wellness.

And some new trends are likely to emerge. For example: the reshoring to North America of the manufacturing of certain essential items like pharmaceuticals and health care products; an increased savings rate by individuals after too many found themselves unprepared for a crisis; and perhaps even a reversal of the migration from rural to urban centres as people seek out more distance from their neighbours?

These trends and changes will of course have both positive and negative implications for certain businesses and industries. I also suspect that many aspects of the old normal will return in the fullness of time – humans are creatures of habit after all. And I think it would be unwise to bet against us solving this crisis.

Consider the impact of the current environment on Boyd Group, one of the largest auto-collision repair companies in North America. With large parts of the economy shut down and various social distancing measures in place, driving and traffic volumes are of course dramatically lower. On March 27th Boyd announced that they were seeing a decline in demand of 40-50% despite being open in all locations.

While we had reduced our position in Boyd Group during the first couple of months of 2020, it is looking more attractive to us following its recent decline. In our view, demand levels for Boyd's services should return to pre-pandemic levels once the economy begins ramping back up – i.e. we believe people will get in car accidents with the same frequency that they used to (unfortunately). And with its solid balance sheet, Boyd looks like it will be in a position of strength relative to peers, putting it in good stead for future acquisitions. We will look to opportunistically increase our weight in Boyd when market volatility offers us the chance to do so at attractive levels.

Not just survivors.

We've been busy. First and foremost, we are sticking to our process and core principles – a value-oriented, opportunistic and company-specific approach.

While we have always had an affinity for solid balance sheets and durable business models, our first action, as discussed above, was to review the balance sheets, liquidity and the short-term impact of the current environment on our holdings. Focus then quickly shifted towards assessing the medium and long-term impact of the current environment, and the new normal, on both our current holdings and on our watchlist of opportunities.

We're not interested in companies that will merely survive the pandemic, but those who will thrive on the other side of it. As mentioned above, companies like Boyd Group fit that bill.

During market corrections, when volatility is high and correlations move to one, we believe our opportunity set as investors is greatly enhanced. This is because highly correlated price declines have the effect of moving all securities prices lower together – all companies are treated the same despite their underlying fundamentals, and their future prospects, potentially being materially different. Correlated declines can materially shift risk/reward levels of securities, resulting in relative and absolute opportunities.

We have taken some action based on both the relative opportunities and risks we see. We have exited some holdings and opportunistically added to both existing and new positions.

Some names and exposure.

Canadian health care company HLS Therapeutics remains a core position for the fund and is a great example of the type of investment we are attracted to, especially in the current market environment. While the stock price of HLS is ~25% below its pre-pandemic highs, our thesis and estimate of future value remains unchanged. We believe that a material portion of HLS' current stock price is supported by its existing commercial drug portfolio, demand for which is not economically sensitive. The catalyst for HLS to move significantly higher is its recently approved cardiovascular drug Vascepa. HLS owns the Canadian rights to this CV drug which was fast-tracked through approval by Health Canada because it meets a "large unmet" need for patients. In our view an investment in HLS represents an asymmetric reward-to-risk profile – lots more upside than downside from current levels.

Hamilton Thorne is another core holding for the fund in the health care sector. We believe that this provider of laboratory instruments, consumables, software and services to the assisted reproductive technology market not only has the balance sheet to make it through the pandemic, but is positioned to thrive on the other side. The company, which sells its products and services in North America, Asia and Europe, recently commented that while sales in China were lower in Q1 it was beginning to see a "U" shaped rebound – perhaps giving us a window to how sales will trend in other countries.

With respect to adding new positions we have been able to take advantage of some of the market carnage and indiscriminate selling. We first looked to our watchlist of names we were actively following and familiar with. We have also begun to uncover and invest in some unique opportunities that have arisen because of the pandemic or dynamics relating to it. We expect there will be more of these investment opportunities over the months and quarters ahead and we look forward to taking advantage of them and sharing the details with you.

In our Q4 2019 commentary we discussed the value we saw in our holdings and the catalysts we saw for them on the horizon. We still see that value today for our core holdings, moreso in most cases, and the catalysts are still on the horizon.

The fund's gross exposure today, in late April, includes approximately 23% allocated to arbitrage, shorts and cash – with cash at just over 13%. The balance of our exposure is in long positions comprised of companies where we have identified both value and a catalyst, and special situations where we believe we are exposed to asymmetric reward-to-risk profiles.

This is where we do our best work.

As noted above, equity markets have rebounded somewhat off their March lows with the largest caps and the leaders of the previous cycle having led the way. While some securities seem to be ignoring that there is a pandemic led recession underway at all, other companies, primarily beneath the surface of the largest caps, are still significantly lower than their pre-pandemic levels, with many off 30-60% or more.

This dichotomy in performance and valuation between companies suggests substantial opportunities to us, both long and short.

I believe we have entered a market environment where careful and astute security selection holds the opportunity for strong return generation and is also key for risk management. It was a similar environment when we launched our fund in mid-2009 coming out of the Financial Crisis, namely broken financial markets, a recession with no end in sight and zero investor confidence. No one wanted to invest in anything at that time, which history has shown is precisely the right time to invest – patiently, but opportunistically.

Some of our fund's best returns were generated during the first several years of our fund's existence. I believe that we have entered a similar market environment today – an environment where we do our best work.

We won't try to pick or call the bottom of this market (we'll only know that well after it has passed) – but I believe we will make great investments during this turmoil, investments that will do extremely well as we get through this.

Thank you for your investment and your continued trust. Please take the opportunity to call us if you have any questions. We can even do a video call and you can see how badly I need a haircut!

Sincerely,

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

Please note that the Maxam Diversified Strategies Fund did not incur a taxable distribution for 2019 and therefore we will not be distributing tax slips.

[1] Maxam Diversified Strategies Fund, Series F units, net of fees and expenses.
[2] Some major equity index performance in Q1 2020: S&P/TSX Composite -21.6%, S&P/TSX Small Caps -38.6%, S&P500 -20.0%, Russell 2000 -30.9%.