MAXAM
CAPITAL MANAGEMENT

Maxam Diversified Strategies Fund – Q2 2020 Commentary

We hope that you and your families are safe and healthy during these extraordinary times.

The Maxam Diversified Strategies Fund[1] gained +12.7% in the second quarter of 2020.

The fund's gross exposure averaged ~20% across arbitrage, shorts and cash during the quarter. All else being equal, this segment of the fund's exposure is typically market neutral (arbitrage, cash) or negatively correlated (shorts) to equity markets. While this exposure can trail a rallying market in the short-term, it shows its value over time as the transactions we have arbitraged close successfully, our short theses play out on individual names, or as we opportunistically invest cash into new or existing holdings.

During the second quarter the fund exhibited low downside capture on the days when the major indices moved lower, i.e. the fund declined less than the market. In our view, the fund's low downside capture on the market's negative days was not only due to our aforementioned arbitrage, short and cash exposure, but also because our holdings are not the typical 'household' names that comprise a large weight in, and significant influence on, Canada's S&P/TSX Composite.

What pandemic?

Following the Coronavirus Crash that sent global equities plummeting in March, markets bounced higher through Q2. The move off the March lows has been fueled by unprecedented amounts of monetary stimulus and government aid, plus an investor that has so far been willing to *look through to the other side.*

There's an old saying, "Don't fight the Fed", which essentially means investors should align themselves with the actions of the Federal Reserve System, the central bank of the U.S.A. When the Fed is providing liquidity to the system, traditionally through reducing interest rates, it should be a positive for the stock market.

To be fair, if governments were going to essentially mandate the shuttering of the economy it would be remiss of them not to provide assistance to individuals and businesses given the foreseeable consequences (recession and spiking unemployment). Hence the unprecedented liquidity and stimulus which, it appears, may have in many cases gone directly into stocks and not the economy. *Case in point*:

E*TRADE, the self-proclaimed 'pioneer of online trading for retail investors', announced with their second quarter results that they "achieved levels of customer engagement that are without precedent in our nearly 40-year history". They "generated greater retail organic asset growth in the first half of this year alone than in the previous two years combined, and generated more retail organic account growth than the previous five years combined".

It is tough to imagine that the individuals responsible for 327,000 net new retail accounts opened at E*TRADE during the second quarter did so because they just received a raise or felt great about their job prospects.

While various factors have fueled this market of late, let's simplify and boil it down to a few things:

1. unprecedented liquidity and stimulus (some of it cash straight into individuals' bank accounts);
2. MOMO + FOMO: momentum and the fear of missing out (these go hand-in-hand, feeding each other);
3. a general feeling of optimism that we are beating the coronavirus, or at least that we will.

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Everyone is working from home in their lululemon leisure wear, day trading off the side of their desk (or couch), buying *work from home* and SaaS stocks at 1999 multiples. What could go wrong?

It's a bull market in expensive stocks.

One noteworthy aspect of this market has been how securities with higher valuations, "expensive" stocks, have materially outperformed securities with lower valuations, "cheap" stocks. The following tables illustrate this dynamic in both Canada and the U.S.:

Canadian Equities: S&P/TSX Composite Median Statistics by Price-to-Sales Multiple H1 2020

P/S Rank	Market Cap ($B)	P/E	P/S	P/B	YTD Return
1-50	$ 3.5B	21.7	6.8	2.6	3%
51-100	$ 3.5B	18.4	2.8	1.7	-4%
101-150	$ 4.6B	13.2	1.6	1.7	-15%
151-200	$ 3.3B	10.9	0.6	1.1	-23%
201-221	$ 1.8B	7.8	0.2	1.0	-14%

U.S. Equities: S&P 500 Median Statistics by Price-to-Sales Multiple H1 2020

P/S Rank	Market Cap ($B)	P/E	P/S	P/B	YTD Return
1-100	$ 31.6B	39.0	8.8	7.2	9%
101-200	$ 28.4B	24.8	4.1	5.4	-3%
201-300	$ 22.5B	18.5	2.3	2.4	-17%
301-400	$ 16.2B	14.9	1.3	2.2	-16%
401-505	$ 11.7B	11.7	0.6	1.4	-29%

We've ranked these tables by price-to-sales ratio, however, as you can see, whether you look at Canadian or U.S. equities, or measure valuation by price-to-sales (P/S), price-to-earnings (P/E) or price-to-book (P/B), the result is the same: expensive stocks outperformed cheap stocks by a large margin through the first six months of 2020.

For example, as ranked by P/S, the median return of the 50 most expensive companies in the S&P/TSX Composite (the "TSX") was 3%, whereas the median return of the 151-200th most expensive companies was -23%.

Hungry for growth in a growth-starved world, and at least partially justified by ultra-low interest rates, investors have aggressively bid up growth stocks, seemingly without a second thought as to valuation.

To be clear, we are not arguing that cheap stocks should outperform expensive stocks. There are a whole host of reasons why a company may deserve a superior relative valuation, such as: high growth rates, high margins, management quality, recurring revenues, and barriers to entry, to name a few.

However, the impact of expensive and large capitalization stocks on the major indices so far in 2020 has been nothing short of dominant. In the U.S. it has largely been Amazon, Microsoft, Apple, NVIDIA and a few other technology companies leading the way, while in Canada it has been a few technology and gold stocks.

Canadian technology darling Shopify, now the largest company in Canada, contributed +576 points itself to the TSX during the first six months of 2020, with the index losing a cumulative 1,548 points. Clearly Shopify has had a massive influence on TSX index performance this year (*37% of TSX points if you're cool dividing a positive number by a negative*[2]).

Outside of Shopify, the next four biggest contributors to the S&P/TSX Composite accounted for +342 points through the first half of 2020[3]. Including Shopify, the top five points contributors to the TSX added +918

points relative to the index losing 1,548 points overall. Said another way, the TSX would be down an additional 5.4% this year absent these heavy lifters. It has been a small group of companies driving a significant portion of the TSX move so far this year, especially since the March lows.

As we've witnessed during this volatile market, investors have flocked to the obvious growth themes, pushing some already expensive valuations even higher. Shopify is a quality company and it is benefitting from a few obvious themes right now – notably e-commerce and *work from home*.

With a P/S ratio of ~40x and a P/E ratio over 1,400[4], Shopify repeating its first half performance of +150% might be a tall order. It is a great company but, considering risk and reward, we have no position in Shopify today.

We don't know how long this bull market in expensive growth stocks will last. Our focus is on where we see compelling risk/reward opportunities today.

Where do we see opportunities today?

There is another old saying worth noting today, "This time is different". Those words, through the fullness of time, have inevitably been proven wrong with respect to investing. We believe those words will also be proven wrong with regards to investors disregarding valuations when deciding where to invest their capital.

Our focus is on investing in companies where we believe we have identified attractive fundamental or hidden value, plus a catalyst or event that we believe will drive or unlock value.

We see extreme inefficiencies across the market capitalization spectrum and, because of some of the dynamics discussed above, we see significant opportunity.

We classify the majority of our holdings into these broad categories today:

1. Special situations where we see asymmetric risk/reward profiles, with an investment thesis independent of the current environment;
2. Companies that we believe may actually benefit from current environment;
3. Companies that we believe have been thrown out with the bathwater and are undeservedly cheap.

Some holdings and exposures.

Hamilton Thorne is a core holding for the fund in the health care sector. This provider of laboratory instruments, consumables, software and services to the assisted reproductive technology (ART) market has several characteristics we are attracted to. Operating in an industry with secular growth trends and high barriers to entry, Hamilton Thorne is led by a strong management team and board that is aligned through material share ownership. In addition to solid organic growth, company management has a history of successful and accretive M&A in this fragmented industry.

HLS Therapeutics is another example of a core holding in the health care sector where we see attractive value and catalysts on the horizon that we believe will materialize independent of the economic environment. As we've covered in previous commentaries, HLS owns the Canadian rights to the Health Canada approved cardiovascular drug Vascepa. Following some recently received positive news regarding pricing for Vascepa, HLS management re-iterated its peak-year sales forecast of $200-300 million "with upside potential". We expect they are being somewhat cautious with their forecast.

Superior Plus is a new holding for the fund and is an example of a name that we think is both undeservedly cheap and well suited for the current environment. Superior Plus is a propane distributor and marketer with operations in Canada and the U.S., and is also one of North America's largest producers and distributors of specialty chemicals. Not only is propane a recession resistant business (essential for cooking and heating

in remote and rural communities) but we believe Superior Plus may actually benefit from the current environment as people stay closer to home, firing up those BBQs.

Bolstered by a recent strategic investment from Brookfield Asset Management we expect Superior Plus to be active on the M&A front, consolidating a fragmented industry. In the meantime, the company pays a 6% yield with a 40% payout ratio.

At the time of writing, our fund exposure remains predominantly long, plus approximately 16% of gross exposure allocated across arbitrage, shorts and cash. Our cash position is at just over 7% today, down from our last report following opportunistic deployment into companies that meet our risk/reward criteria.

Value rises to the surface.

While pondering an environment where expensive, and in some cases unprofitable, companies have significantly outperformed attractively valued and profitable companies, I was reminded of one of my favourite quotes:

"If you're not confused, you're not paying attention."

- Tom Peters, in his book "Thriving on Chaos: Handbook for a Management Revolution" (1987).

We continue to see tremendous value and opportunity beneath the surface of the largest cap and most expensive companies that have been driving index returns. Encouragingly, we are seeing incremental signs that the market is beginning to care about fundamentals and value again. We believe that bodes well for our holdings and not as well for some of the very expensive names that have been driving the market higher.

While being different can be relatively uncomfortable in the short run, our conviction remains grounded in sound fundamentals and value. We look forward to some material catalysts on the horizon for several of our core positions through the balance of 2020.

Thank you for your investment and your continued trust. Please take the opportunity to call us if you have any questions.

Sincerely,

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

[1] Maxam Diversified Strategies Fund, Series F units, net of fees and expenses.
[2] Can you even do that? Shopify added +576 points to the TSX in H1 2020, whereas the index was *down* 1,548 points. ((576) / (-1,548)) = 37%.
[3] Barrick Gold, Franco Nevada, Wheaton Precious Metals and Constellation Software contributed a cumulative +342 points to the S&P/TSX Composite index in H1 2020 (+918 points including Shopify) whereas the index was down 1,548 points. 918 / 1,548 = 59%.
[4] On June 30 Shopify's share price was C$1,289.77 its market cap $154 billion. Per Bloomberg, 2021 consensus sales and earnings per share forecasts are $3.9 billion and $0.92 respectively.