Maxam Diversified Strategies Fund – Q1 2023 Commentary

Dear fellow investors,

The first quarter of 2023 started well with equity markets moving higher in January before giving back some gains through February. March was a particularly volatile month driven by concern that a regional banking crisis in the U.S. may be unfolding – however regulators acted swiftly to calm depositor and investor fears.

Against this backdrop, the Maxam Diversified Strategies Fund[1] was little changed in the first quarter at -0.2%.

Capital has a cost again.

Inflation has declined from high single-digits to mid-single digits following a series of rapid interest rate increases over the last ~14 months. Canada's central bank has now signaled that it is in 'pause' mode with respect to further hikes as it awaits more data. In the U.S., despite the Federal Reserve continuing to assert a more hawkish tone, markets are expecting a pause later this year, and perhaps even a pivot lower.

Constructively, we are encouraged that central bankers now have room to maneuver policy rates in response to any unforeseen developments – a luxury of flexibility that they did not enjoy a year ago. However, despite the relief that high multiple growth stocks and speculative companies have experienced of late thanks to shifting rate expectations, we continue to see many companies in that expensive cohort trading at valuation levels that will be difficult to sustain.

Even if we do get a pause that transitions into a pivot lower for interest rates, we do not see a return to the near nil levels that prevailed from late 2008 to early 2016, and for the two years following the onset of the COVID-19 pandemic. We have noted in recent commentaries that *capital has a cost again* – and this continues to shape our outlook and inform us where we see value, opportunity, and risk.

Most notably, we foresee the reality that capital has a cost again increasingly focusing investor attention on valuation and company-specific fundamentals.

We like growth, but we want to pay a reasonable price for it.

Everyone is talking about it.

It is no secret that a concentrated group of the largest and best-known companies have played a significant role in moving the bellwether equity indices ahead of late. In turn, investors have ignored other segments of the market, resulting in a fertile investment environment beneath the surface of the mega-caps.

The chart below compares the price-to-earnings ratio of large caps versus small caps over the last 10 years, and for fun we throw in the average P/E ratio for some familiar mega-cap companies.

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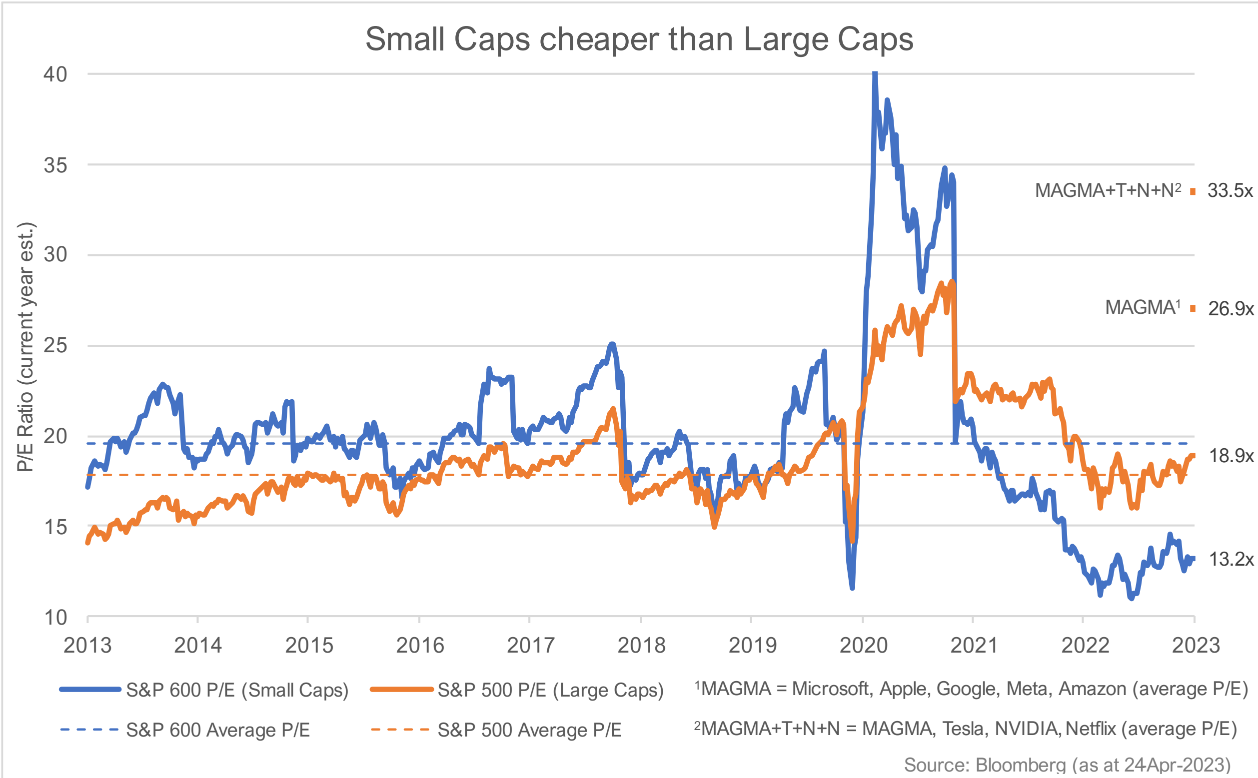

While small capitalization companies have historically traded at premium valuations to large caps due to their faster growth rates, on average they trade at a material discount today.

Investors have sought safety in the largest capitalization companies and likely shied away from smaller caps as a group because of the perception that these businesses are more sensitive to higher interest rates (they are *growth* companies) and at greater risk during recessionary environments. While that perception may be true on average, the averages obscure specific opportunities.

While many of our holdings are not your typical household names, they are businesses where we have identified attractive value and growth, or an upcoming event or catalyst that we believe will drive future gains. And in many cases, market concerns over slowing growth and recession are more than reflected in their current share prices.

In addition to attractive growth prospects and valuations, our holdings largely reflect our preference for solid balance sheets and stable business models. In an environment where interest rates have risen dramatically from levels experienced in recent years, a business with low debt levels, or perhaps no debt at all, is much less likely to face financial stress from a need to refinance at higher prevailing rates.

While it has been a particularly challenging period for small and mid-caps recently, we are encouraged by the discounted valuations and significant opportunities we are invested in and deploying capital into today.

Exposures.

The fund was invested across all 11 industry sectors with the top ten positions accounting for 28% of net exposure as at the end of the first quarter. From a strategy perspective, fund exposures include 67% in fundamental longs, 21% in special situations, 4% in convertible debentures, 15% in arbitrage, and approximately 2% of gross exposure in short positions.

As noted above, the fund's exposure to arbitrage was approximately 15% at the end of the first quarter. This is down from 31% at the end of 2022 as a result of tactically re-allocating capital to select fundamental longs and special situations where we see compelling risk/reward attributes.

Select positive contributors to fund performance during the first quarter included Vecima Networks, Ag Growth International and Guardian Capital Group. Individual holdings detracting from results in the quarter included Knight Therapeutics, Chemtrade Logistics and Tidewater Midstream & Infrastructure.

Hindsight has a perfect track-record.

Looking backwards it is easy to explain what happened – and it makes perfect sense that it did. Looking forward is the hard part.

We often ask ourselves: "*looking backwards two years from today, what will seem obvious in hindsight?*"

Today we observe a market environment that has, at times, seemed solely focused on top-down, macroeconomic concerns. We believe the market is fairly efficient at discounting these factors as they become understood and well known. However, in our experience the market tends to be much less efficient with respect to discounting both risk and opportunity for individual companies – especially in the less well-covered arena of small and mid-caps.

In our Q4 2022 commentary we outlined that we have historically delivered some of our best performance after periods of elevated market volatility and market declines (review that detail here). With many security prices still down significantly over the last 18 months, it has most certainly become a more fertile investment environment for our investment style and strategy.

When we look back a couple of years from now, *with the benefit of hindsight*, I think it will make sense that we were investing in businesses with strong fundamentals and attractive valuations that were being largely ignored by the market. And I think we'll be quite pleased.

While there are no straight lines, we are excited about the prospects for the remainder 2023 and beyond – as much as we have been in several years.

Thank you for your trust and confidence. Please don't hesitate to reach out with any questions.

Sincerely,

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

[1] Maxam Diversified Strategies Fund, Series F, net of fees and expenses. Please contact us regarding other classes of fund units or visit our website www.maxamcm.com

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