# Market Commentary
# Third Quarter 2020

## CI American Small Companies Fund

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| Class F returns (in %) as at September 30, 2020 | Year-to-date | 1 year | 3 year | 5 year | 10 year | Since inception (2000-08-08) |
|---|---|---|---|---|---|---|
| CI American Small Companies Fund | -6.9 | -2.0 | 1.8 | 4.4 | 11.0 | 4.0 |

Source: Epoch Investment Partners, Inc., as at September 30, 2020.

**Market Overview**

- Stocks had a strong quarter as the economy began to recover from the coronavirus lockdown, with workers trickling back to factories and offices. Global trade also rebounded. Ongoing support from central banks, resilient corporate earnings and optimism on progress toward a COVID-19 vaccine also helped lift equities. In July and August, markets were led by a handful of U.S. mega-cap stocks in the information technology, consumer discretionary and communication services sectors. Stocks cooled off in September as an additional coronavirus relief package in the United States remained bogged down in congressional gridlock. Nevertheless, stocks ended the period with solid gains. Growth indices beat value indexes and large-cap stocks outpaced small caps. The consumer discretionary sector had the best returns. Energy stocks provided the lowest returns by far, falling sharply as demand remained subdued.

- The U.S. dollar weakened against other major currencies after the U.S. Federal Reserve (Fed) announced a new inflation-targeting strategy, where it will tolerate periods of inflation above that target to compensate for spells when it undershoots that target. Many investors interpreted this as a promise to hold rates low indefinitely. Fed officials repeatedly stressed the need for additional fiscal support, highlighting the limits of monetary policy.

- The economy appeared to be reviving from its unprecedented 31.4% rate of decline in the second quarter. Home sales in the United States surged, helped by low mortgage rates. Purchasing Managers' Index data moved from contraction to expansion. Initial jobless claims, however, remained elevated.

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**Performance Summary**

- Over the third quarter of 2020, the CI American Small Companies Fund Class F (the Fund) returned 2.6%, while its benchmark, the S&P 1000 Total Return Index, returned 2.3%.

- Select holdings in the communication services, financials and information technology sectors detracted from results for the period.

**Contributors to Performance**

- In consumer discretionary, LGI Homes Inc. reported record-breaking June and second-quarter 2020 home closings. The company announced 760 home closings in June 2020, up from 651 home closings in June 2019, representing year-over-year growth of 16.7%. In addition, the company announced a record-breaking 2,005 quarterly home closings during the second quarter of 2020 compared to 1,944 home closings in the second quarter and finished the first six months of 2020 with a total of 3,840 home closings, 21.1% higher than the first six months of 2019. As of the end of June 2020, the company had 117 active selling communities.

- In health care, Charles River Laboratories Inc. reported second-quarter revenue and profits that significantly exceeded consensus expectations. The company also raised its forward guidance for full-year 2020 revenue and cash flow generation. In addition, the company also announced the acquisition of Celeron Corp., a provider of cellular products for cell-therapy developers and manufacturers. Cell and gene therapy are the fastest growing areas in biotech, and this helps round out the company's portfolio in this area after purchasing HemaCare Corp. in January. Charles River has a dominant market position in a growing industry being fuelled by biotech innovation. The company should continue to grow at a high single-digit rate, with margin expansion and upside from value added from merger-and-acquisition activity.

**Detractors from Performance**

- In energy, Texas Pacific Land Trust shares declined in concert with the sharp decline in the energy sector due to continued low oil prices. In addition, investors were disappointed that the company opted to delay its conversion from a land trust to a public corporation. Management cited a slow government approval process as the reason for the delay. Still, the business is performing reasonably well given the significant decline in oil and gas prices. Production on the Trust's properties was actually up on a year-to-date basis. The business remains profitable and has a fortress balance sheet with zero debt and over 7% of its market capitalization in cash. Once the enhanced governance framework is in place and consistent with the practices of publicly traded peer companies, it is expected that the new corporate structure would enable value creation over time and drive value for shareholders.

- In financials, Western Alliance Bancorp's stock price continues to come under pressure in concert with the decline in the banking sector due to the impact of the COVID-19 pandemic on banking activity and credit quality. In addition, the company set aside a large loan-loss provision of $93 million as compared to $51 million in the first quarter. While the company does not anticipate any need for additional liquidity, in response to the economic uncertainty the company has taken additional actions to ensure the strength of its liquidity position. These actions include issuing US$225 million in subordinated debt at the bank, establishing a U.S. Federal Reserve lending facility in connection with funding loans to small and medium-sized businesses, and temporarily suspending stock repurchases. The company's capital ratios remained strong as of June 30, 2020, with a tangible common equity to total assets ratio of 8.9%. Despite the increase in provisions, the company actually reported second-quarter revenue and profits that beat consensus expectations. Management expects to see a slight compression in its net interest margin as deposits have essentially hit a floor. Compression has been mitigated by substantial use of floors on variable-rate loans which give it positive asymmetric exposure to future interest rate swings. Loan growth will be muted until the fourth quarter, at which point Western expects a normalized loan growth rate of US$600-800 million per quarter (a 13% annualized rate), which makes the stock look attractive at current levels.

**Portfolio Activity**

- As mentioned in previous communications, we are focused on uncovering value in "epicentre stocks," or those most affected by COVID-19 based on the belief that their businesses will return to normal once we reach herd immunity or find a vaccine. A majority of these companies reported record sales, earnings, tangible book values and free cash flow in 2019. What they all have in common are business fundamentals significantly impacted by the COVID-19 pandemic and the subsequent collapses in economic activity, interest rates, and energy prices. Our focus list includes banks, travel and lodging companies, restaurant suppliers, hospitals and commercial real estate brokers. We are finding tremendous long-term opportunity in these names. The key to identifying these opportunities is deep dive fundamental analysis to ensure they have the balance sheet and liquidity to survive the tough times.

- One example of our epicentre stock is Marriott Vacations Worldwide Corp., which operates in the leisure industry. The company owns and manages a cluster of resorts and accommodation facilities under trademarks like Marriott Vacation Club, Grand Residencies and The Ritz-Carlton Destination Club predominantly in the United States. Some of its properties are also spread across Europe and Asia Pacific. Marriott's major revenue components include the sale of vacation ownership products, such as luxurious vacation packages. In addition, it offers purchase-money financing to the end users of its core services. Seventy percent of the company's sales centres have re-opened, which is a strong sign

of future potential business. Further, with increased occupancy in drive-to markets, the company expects its remaining sales centres to re-open this year. Stabilization in key markets, such as Florida, would provide additional positive momentum.

- Sensient Technologies Corp. manufactures and markets synthetic and natural colors, flavours and fragrances. The company has a widespread network of facilities around the globe, and its customers operate across a variety of end markets. Sensient's offerings are predominantly applied to consumer-facing products, including food and beverage, cosmetics and pharmaceuticals, and specialty inks and colours. Sensient has an enviable position in the colours market as the global #1 or #2 player. The company is also well positioned in flavours, specifically within natural ingredients, an area that is supported by increasing customer demand for natural products/focus on wellness. Their business also benefits from a high degree of recurring revenues and limited capital requirements. Sensient is in the last stages of turning around its business around following some missteps during a multi-year restructuring program. The company has been able to repair relationships with customers, evidenced by two sequential quarters of organic revenue growth. While current new business is on pause due to the pandemic, win rates have been improving and will show up in the numbers. Previous actions to remove costs from the model and prune the product portfolio with divestments will directly impact the business' margin profile. Additionally, a return to a more normal environment and a recovery in the purchase of colour cosmetics as employees return to the office will benefit.

- UniFirst Corp. provides workplace uniforms, protective clothing and other workplace products and services to businesses in the United States, Canada and Europe. The rental and cleaning segment accounts for the majority of company sales. That segment rents and sells clothing and non-garment items, and offers a cleaning service that delivers clean uniforms when it picks up dirty or contaminated ones. The specialty garments rental-and-cleaning segment provides specialty garments, non-garments and cleaning services for nuclear and classroom applications. The company's first-aid segment provides safety supplies and pill packaging. UniFirst manufactures most of its products at its plants in Mexico and Nicaragua. UniFirst is a high-quality business with lengthy customer contracts. While the business has experienced disruption due to shutdowns resulting from the pandemic, we expect it will recover as the countries normalizes. Generally speaking, this should be a steady compounder in the Fund, with growth expected slightly ahead of gross domestic product. Further consolidation in the market could result in increased scale and margin improvements for UniFirst.

**Outlook**

- The macro outlook continues to improve, although the pace of recovery has slowed. Since March we've expected the economic recovery to trace out the Nike swoosh. However, no single letter or shape fully encapsulates the complex recovery taking place. While a few sectors are experiencing a

"V" (e.g., housing), the Fed worries that some industries face an "L" (e.g., commercial real estate). Moreover, we believe "K" in many ways has become an apt metaphor for this cycle, with college-educated workers in digital industries thriving, while less-educated workers in some services sectors still struggling.

- Overall, we expect a 90% economy to emerge, with an exceptionally long road back to normal. The COVID-19 recession has hit the service sector particularly hard, and we believe consumers and employees will only gradually return to malls, restaurants, cinemas, offices and airports. This is particularly true for work and other activities where public transit is required. Further, even a month after Labour Day, there remains much debate and uncertainty regarding schools and universities.

- Further, the COVID-19 shock has accelerated several long-standing trends. One is lower-for-even-longer interest rates and a world of yield starvation. The Fed has made it clear that it is "not even thinking about thinking" about hiking rates. The COVID-19 shock has also acted as an accelerant for technology and the digitization/virtualization of the economy. This is being reflected in the shift to working-from-home, EdTech, e-fitness, telehealth, e-commerce, and so on.

- Market volatility typically rises ahead of elections, and the period before this year's U.S. presidential election is proving to be no exception. Moreover, if the election is close, it is possible that the period of elevated uncertainty will last well beyond November 3. During the contested period in 2000, the S&P 500 Index declined by 8% and the 10-year bond yield plummeted by 80 basis points. During periods of rising volatility, high-quality companies with strong earnings visibility and sustainable free cash flow, typically outperform.

- Given this challenging backdrop, the consensus expects S&P 500 Index earnings per share to decline by 20% this year, and then to rise by 28% in 2021 and 15% in 2022. For the MSCI World Index, the consensus expects earnings per share to decline by 19% this year, and then to rise by 30% in 2021 and 16% in 2022. Valuations imbed aggressive earnings growth expectations, and lower-for-longer interest rates, leaving little room for error. This is especially important as we begin the third-quarter earnings season. Last quarter, the vast majority of companies announced above consensus, but most also emphasized the elevated level of uncertainty, a perspective that was reflected in the relative lack of guidance for the remainder of the year and into 2021.

- Looking forward we continue to expect fat and flat returns. That is significant volatility and a relatively wide range across sectors, with overall upside of 6% to 10% over the next 12 months.

- Finally, it is especially crucial in this environment to identify companies that have sustainable cash flows and are focused on maintaining their dividends. Moreover, the yield from equities is likely to be

far superior to that attainable in fixed income markets. As a result of the above points, we believe the best-positioned companies are those that have a demonstrated ability to produce sustainable free cash flow and to allocate that cash flow effectively between return of capital options and reinvestment/acquisition opportunities.

Source: Bloomberg Finance L.P.; Morningstar Direct; and Epoch Investment Partners, Inc.

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