DESAUTELS Capital Management
Gestion de capitaux

ALPHA SQUARED FUND
SRI FUND

MONTHLY NEWSLETTER
August 2018

Opening Remarks

As new students in the Masters of Management in Finance program, we are now settling into our equity analyst positions and managing the Desautels Alpha Squared and SRI Funds. We would like to take this opportunity to thank you, our investors, for your continued support. Your investments are providing us with an invaluable learning opportunity and we look forward to working with you this year.

Best regards,

Patrick Elliott, *SRI Strategist*
Louis Goulet, *Alpha Squared Strategist*

Also contributing to this issue:

Emilio Acosta, *Alpha Squared Equity Analyst*
Wissam El Khatib, *Chief Sustainability Officer*
Carl Kilajian, *Chief Economist*
Pierre-Louis Patault, *Chief Marketing Officer*
Corey Saxe, *Alpha Squared Equity Analyst*

Launching the Desautels SRI Fund

In 2010 DCM launched the Desautels Global Equity Fund as well as the Desautels Fixed Income Fund, and in 2017 we launched the Alpha Squared Equity Fund. We are now pleased to announce the launch of our fourth fund, the Desautels SRI Equity Fund, focused on Socially Responsible Investing. As always, investment decisions will be based on rigorous fundamental analysis and prudent risk management, but we will also focus on investing in companies that we consider to be socially responsible, promote sustainability, and are committed to best practices in ESG (Environmental, Social, and Governance). The goal is not only to provide our investors with superior risk adjusted returns, but also to raise awareness about socially responsible investing and at the same time encourage companies to act in a socially responsible and sustainable manner.

For a stock to be considered for the SRI Fund, the company must pass our negative screens, which eliminate firms that derive their revenue from certain industries, including tobacco, fossil fuels, and weapons manufacturing. While all stocks must pass the negative screen, we anticipate that about 50% of our holdings will also be leaders in sustainability and ESG. To identify companies with strong ESG practices, we consider ESG scores and rankings provided by ESG rating agencies, including Bloomberg Disclosure Scores, Sustainalytics Scores, and RobeccoSAM Rankings. The Sustainability Accounting Standards Board's *SASB Materiality Map* is another useful resource. This interactive tool allows analysts to assess intra-industry companies based on the most common impacts seen in their sectors.

The SRI portfolio is managed by student-analysts in Desautels' Masters of Management in Finance program. Analysts specialize by sector and the fund also has a dedicated Risk Management team and dedicated Sustainability team. Currently the SRI fund has $400,000 invested in an S&P 500 Fossil Fuel Free ETF. As the semester progresses we will continuously be transitioning out of the ETF and into individual names that we believe to be undervalued, and for which we have compelling investment theses. We are extremely excited to get started.

Alpha Squared Fund

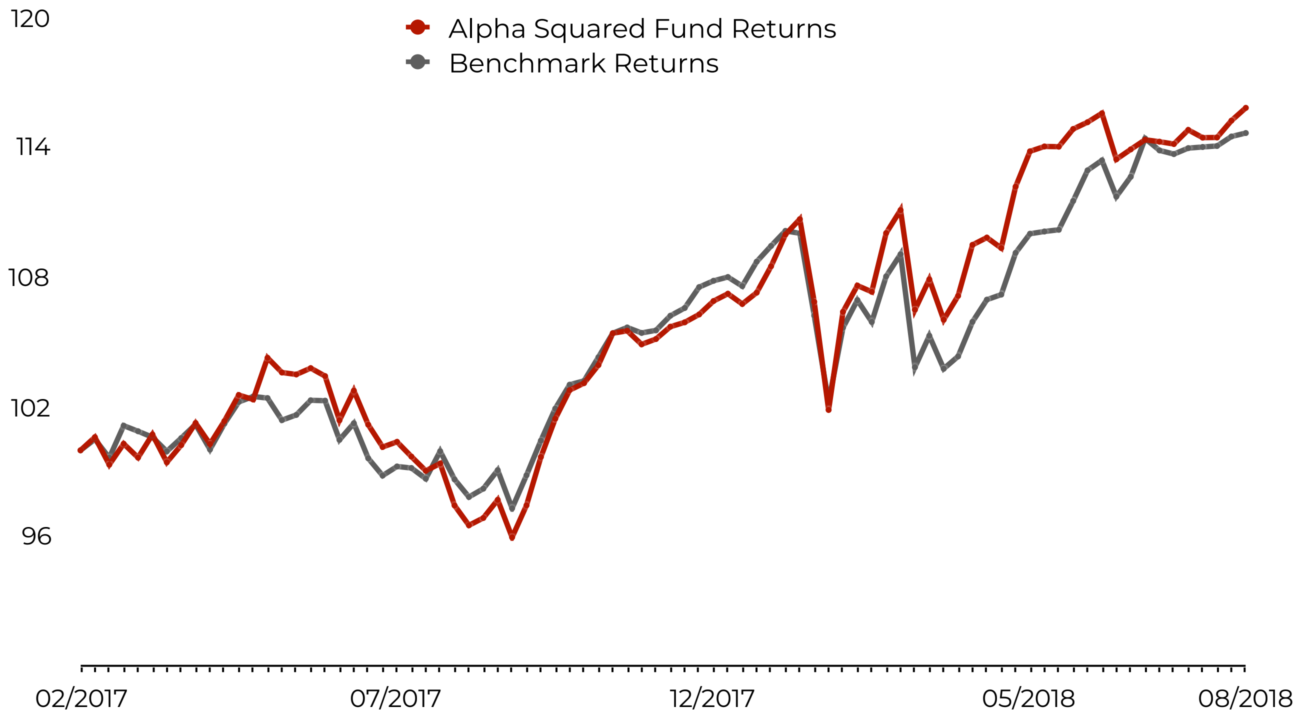
Dear Investors,

We are pleased to report that the Desautels Alpha Squared fund returned 8.51% gross of fees YTD, outperforming our benchmark by 1.92% (see Chart and Table below). The outperformance was primarily due to strong gains by CACI International, a leader in the IT security space, and Kinsale Capital, a specialty insurer, as our investment theses continued to play out. A couple of our holdings, AO Smith and Linamar, were negatively affected by trade fears and NAFTA negotiations, and we recently exited our position in Linamar as it was no longer satisfying our quant screen. Details on selected holdings are provided further below.

Figure 1: Alpha Squared Fund Returns

Time	Gross	Net	Benchmark
Since Inception	15.86%	13.18%	14.69%
YTD	8.51%	7.42%	6.59%
Q1 2018	1.07%	0.69%	-2.14%
Q2 2018	5.15%	4.76%	6.12%
H1 2018	6.27%	5.48%	3.85%

Figure 2: Alpha Squared Return vs Benchmark Return as of August 31, 2018



Note: Performance is calculated gross of fees. Benchmark is a blended 60% S&P TSX and 40% S&P 500 (measured in CAD). Inception date was February 14, 2017.

Alpha Squared Fund

Figure 3: Fund Holdings August 31, 2018

Company/ETF Name	Sector	Currency	Market Cap ($M)	Size	Shares	Local Price	Total Value (CAD)	Portfolio %
AO SMITH CORP	Industrials	USD	$10,156	LARGE	355	$58.08	$26,886	4.68%
CACI INTERNATIONAL INC	Information Technology	USD	$4,814	MID	130	$195.00	$33,056	5.75%
CAE INC	Industrials	CAD	$7,056	MID	985	$26.05	$25,659	4.47%
DOLLARAMA INC	Consumer Discretionary	CAD	$13,720	LARGE	480	$49.35	$23,688	4.12%
EMERGENT BIOSOLUTIONS INC	Healthcare	USD	$3,239	MID	283	$62.00	$22,880	3.98%
ENCANA CORPORATION	Energy	CAD	$14,927	LARGE	1,800	$17.28	$31,104	5.41%
ENERPLUS CORP	Energy	CAD	$3,672	MID	1,820	$16.14	$29,375	5.11%
ESTEE LAUDER COS INC/THE	Consumer Staples	USD	$51,437	LARGE	135	$140.12	$24,667	4.29%
FIRST BANCORP/ SOUTHERN PINES N	Financials	USD	$1,182	SMALL	450	$41.72	$24,481	4.26%
ISHARES S&P/TSX CAPPED	Financials	CAD	$1,126	ETF	1,630	$38.63	$62,967	10.96%
ISHARES S&P/TSX CAPPED	Materials	CAD	$103	ETF	2,270	$12.24	$27,785	4.84%
ISHARES S&P/TSX CAPPED	Utilities	CAD	$85	ETF	740	$21.10	$15,614	2.72%
ISHARES US FINANCIALS ETF	Financials	USD	$1,908	ETF	100	$124.35	$16,215	2.82%
ISHARES US TELECOMMUNICATION	Telecom	USD	$524	ETF	390	$29.68	$15,094	2.63%
ISHARES USTECHNOLOGY ETF	Information Technology	USD	$4,332	ETF	55	$195.84	$14,046	2.44%
KILLAM APT REAL ESTATE INVT TR	Real Estate	CAD	$1,407	SMALL	700	$15.87	$11,109	1.93%
KINSALE CAPITAL GROUP INC	Financials	USD	$1,279	SMALL	360	$60.77	$28,528	4.96%
LINAMAR CORP	Consumer Discretionary	CAD	$3,908	MID	315	$57.38	$18,075	3.15%
TERRENO REALTY CORP	Real Estate	USD	$2,196	MID	300	$38.41	$15,026	2.61%
VALERO ENERGY CORP	Energy	USD	$49,514	LARGE	220	$117.88	$33,817	5.89%
ZIONS BANCORPORATION	Financials	USD	$10,058	LARGE	290	$53.29	$20,152	3.51%
CAD Cash		CAD					$21,340	3.71%
USD Cash		USD					$33,056	5.75%

Total Securities/Cash: $574,620.43 | 100%

Alpha Squared Fund

Figure 4: Sector Allocation

Sector	Fund	Benchmark Weighting	Over/Underweighting
Energy	17.51%	13.69%	3.81%
Financials	29.68%	26.22%	3.46%
Real Estate	5.05%	2.92%	2.12%
Industrials	10.38%	10.24%	0.14%
Consumer Staples	4.79%	4.83%	-0.04%
Consumer Discretionary	8.03%	8.41%	-0.38%
Utilities	3.04%	3.45%	-0.41%
Telecom	2.92%	3.48%	-0.56%
Materials	5.25%	7.04%	-1.79%
Healthcare	4.17%	6.92%	-2.75%
Information Technology	9.19%	12.79%	-3.61%

Figure 5: Fund Size Allocation

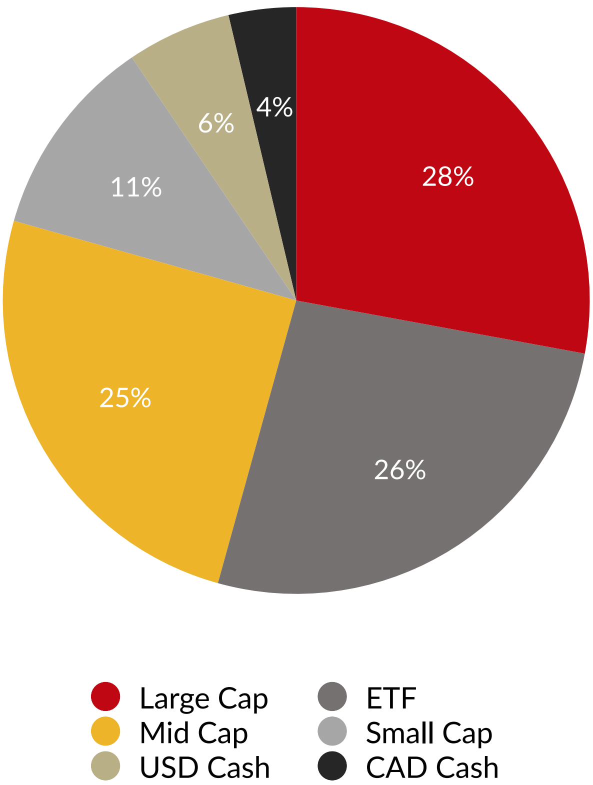
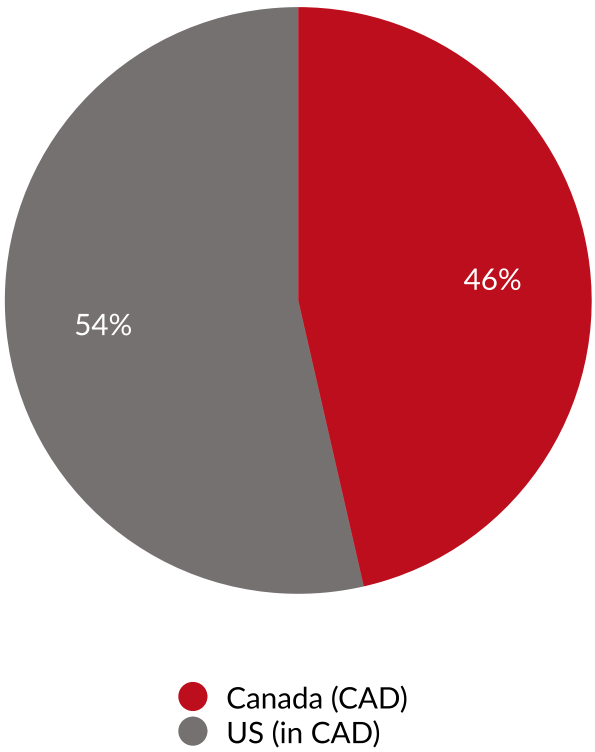


Figure 6: Fund Currency Allocation



Market Outlook

With this record bull market now near its 10th year and indices at or near their all-time highs, investors are asking themselves the same question they've been asking themselves for many years now: how much longer can this last? Currently the main risk factors include: trade tensions, turbulence in emerging markets, tight labour markets, monetary policy surprises, a nearly inverted yield curve, political risks, and high valuations. Below we explain why, despite these risks, we maintain a moderately bullish outlook for equity markets.

Starting with trade, the conflict between the U.S. and China ramped up recently, when $16B of additional tariffs applied to Chinese imports went into effect. The total now stands at $50B, with China matching tariffs dollar for dollar. While the White House cites unfair trade practices and intellectual property theft, China has also retaliated by initiating an official complaint at the World Trade Organization. A big factor is that the U.S. trade balance with China continues to deteriorate, having now reached a $36.8B deficit, prompting the Trump administration to threaten another round of 25% tariffs on $200B of Chinese goods. China's economy is starting to feel the sting, with markets there in correction territory. Furthermore, If the U.S. goes forward with these tariffs, China would no longer be able to respond in full due to the trade imbalance between the two countries. However, in our view and in the view of a lot of American businesses and consumers, the main loser of this new escalation would be the U.S. Until now, the bulk of the tariffs has impacted industrial supplies and components, with a variable pass-through rate and impact. The next wave will include $44B of tariffs on finished consumer products, and we believe those would start to affect the American shopper directly, on top of an even greater impact on the business sector's input prices. This also has a high potential of feeding directly into inflation data (especially CPI), raising questions and fear about how the Fed would respond. We believe that if tariff-induced inflation were to materialize, the Fed would recognize its transitory nature and not respond too aggressively. We are keeping a close eye on China as some of our holdings, like A.O. Smith, are directly affected by the country's economic outlook. Staying within emerging markets, several countries are seeing moderate to severe turbulence, including Turkey, Argentina, South Africa and arguably a few others. Beyond country-specific risks and fears of contagion, a good part of the problem resides in the recent USD appreciation, which puts a lot of pressure on EM countries' ability to repay their USD-denominated debt. Overall, we view the recent price divergence in EM and DM as a fair reflection of contrasting fundamentals. Most importantly, we view the risk of EM contagion to DM as small for now.

Trade tensions also continue to generate headlines closer to home. Since a new trade deal was signed between the U.S. and Mexico, and with President Trump taking to Twitter to threaten the end of NAFTA, focus is now on Canada as negotiations are underway. According to the new schedule, the deadline now stands at the end of September. Until then, uncertainties remain, and fear of a no-deal outcome will continue to negatively impact companies that depend on cross-border commerce, particularly in the automobile and auto parts sectors. In the worst-case scenario of a 25% U.S. tariff, the entire industry would of course be hit very hard. On the other hand, a reasonable trade deal would lead to a significant rally in the sector as trade fears get priced out. We remain cautiously optimistic on the negotiations. The issues still standing in the way of a new deal mostly concern a few specific points, like supply management in the dairy sector that should be surmountable. More importantly, the U.S. Congress have indicated their strong preference for a trilateral trade deal. The Bank of Canada is also keeping a close eye on U.S. trade negotiations. While they acknowledge the threat, they remain optimistic on the Canadian economy and are expected to announce a rate hike at their upcoming October meeting.

Speaking of rates, investors' attention is squarely focused on the risk of a yield curve inversion in both Canada and the U.S., a phenomenon that is often viewed as a leading indicator of recessions. Standard term-structure theory tells us that the 10-year yield is equal to the expected average value of the short-term rate over the next 10 years (plus a risk premium adjustment). An inverted yield curve could thus reflect the bond market's expectation that short-term rates will eventually start dropping in the future, something that would typically occur in a recession.

There are, however, other potential explanations for the yield curve's current relative flatness. We tend to agree with Governor Poloz, who attributes the shape of the yield curve to high demand for long term bonds in an environment of relatively low interest rates. This, together with the Fed's outsized balance sheet, and the hunt for a safe, relatively higher yield (compared to other developed market bonds), could also be driving demand for longer-term bonds and thus putting downward pressure on longer term yields.

In terms of monetary policy, the main risk is that the Fed overreacts to inflation or labor market data and hikes rates too aggressively. This would certainly be a drag on the economy, possibly even tipping it into a full recession. As of now, however, we view that risk as small. In the U.S., for example, the tightening labor market still hasn't fed significantly into wage growth. While the August print for 12-month wage growth did come in at 2.9%, vs 2.7% expected, this figure is not as alarming as some headlines would suggest. While the 2.9% figure is the highest in close to 10 years, it's not by much. For example, 12-month wage growth hit 2.8% on both Sep 1, 2017 and July 1, 2016. In Canada, things are a bit less complicated, as unemployment recently rose a bit to 6% and wage growth slowed.

Finally, a quick word on S&P 500 earnings and valuation. In Q2 2018, a record-high 80% of S&P500-listed firms beat earnings expectations. It should come as no surprise then that US equities continued to rally. In terms of valuation, multiples may appear stretched at first glance. The S&P 500 trailing twelve-month PE ratio now stands at 25, quite a bit higher than its post WW2 average of 18. The high multiple, however, is a reflection of high earnings growth expectations, which in our view is justified. For Q3 2018, the aggregate earnings growth rate is expected to be 20%, and barring a recession earnings growth should remain robust in the medium-term as well. The index's forward PE ratio of 17 seems quite reasonable to us. As discussed above, there are several risk factors that could finally derail this bull market, but in our view those risks are contained. Thus, we remain cautiously optimistic and certainly believe there are great investment opportunities in this market.

Selected Holdings

- **Top Performer: CACI International (48.2% YTD)**
- **Kinsale Capital Group Lifted by Robust Operations (40.4% YTD)**
- **AO Smith Corp (-3.6% YTD) Hits a Snag with its Expansion**
- **Trade Difficulties Continue to Plague Linamar (–24.2% YTD)**

Top Performer: CACI International (48.21% YTD)

Increasing **demand for IT security**, especially from the government, has brought CACI a lot of significant deals, including a 9-year contract with a ceiling value of $184M to support the Deputy Chief of Naval Operations, representing both new and continuing work in Business Systems market. We remain bullish on the IT security space believe CACI is well positioned to cash in on that growth.

Kinsale Capital Group Lifted by Robust Operations (40.4% YTD)

Kinsale's impressive YTD performance can be attributed to its stellar **operational performance**, mainly: its focus on excess & supply (E&S) insurance, efficient underwriting expense structure, and emphasis on small accounts. The company boasted an annualised ROE of 14.9% for the most recent quarter and a historical combined ratio of 80.4%, outperforming its peers' average by more than 1,000 bps. The company is positioned for expansion as it develops new product offerings and invests strongly in technological infrastructures for risk assessment and cost-cutting. Despite the recent gains, we see further upside potential for the stock.

AO Smith Hits a Snag with its Expansion (–3.57% YTD)

While **AO Smith** produces most of what it sells in the same country it's being sold in, it has been unable to fully avoid higher input costs due to the **U.S.-China Trade War**. Higher input costs and slowing housing growth in China has resulted in AO Smith taking a major hit. However, a strong performance in its most recent earnings call and growing demand for U.S. residential water heaters and water treatment, and the company's expansion into India leaves room for potential upside.

Trade Difficulties Continue to Plague Linamar (–24.23% YTD)

Ongoing **NAFTA uncertainty** has brought a lot volatility and negative sentiment into the auto components industry, with **Linamar** suffering as a result. That being said, recent developments suggest the company is not in that bad of a spot: impressive recent performances coupled with the Canadian Government's reimbursement program has given Linamar newfound confidence. Further, ongoing Canada-U.S. negotiations may result in considerable potential upside. From a fundamentals point of view we like Linamar, and if we were a pure fundamentals-based fund we would likely continue to hold the position. The Alpha Squared Fund, however, is a quant/fundamentals hybrid, whereby we exit positions that no longer satisfy our quant strategy screens. In this case, Linamar is no longer satisfying our momentum signal. Relying on a quant signal to exit positions imposes a disciplined structure on our investment process and helps alleviate well-known behavioural biases such as the disposition effect where analysts find it difficult to exit positions at a substantial loss.