DESAUTELS Capital Management
Gestion de capitaux

ALPHA SQUARED FUND
SRI FUND

MONTHLY NEWSLETTER
September 2018

Alpha Squared Fund

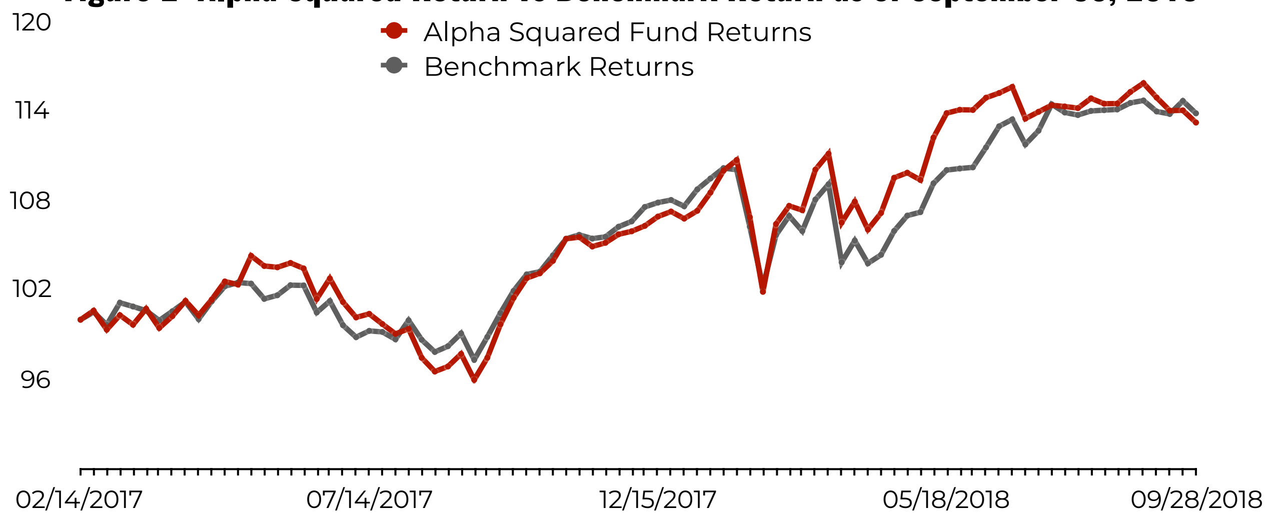
Dear Investors,

The S&P 500 edged slightly higher in September, but the S&P TSX shed 1.1% amid uncertainty on the US-Canada trade deal. The Alpha Squared Fund was also hit, down 2.3% gross of fees, vs. a loss of 0.75% for our blended benchmark. Year-to-September 30, the Alpha Squared Fund is up 6%, for a modest 0.2% outperformance (see Table below). As we detailed in our previous newsletter, the main risk factors for equity markets include trade tensions, stress in emerging markets, tight labour markets, monetary policy surprises, political risks, and high valuations. We continue to monitor each of these, and despite recent market turbulence, we retain a positive overall bias for equities, for now. One of the main concerns of the past months, the renegotiation of NAFTA, has been addressed on the last day of September with the proposal for the new USMCA trade deal, which could be favorable to the Canadian market as it was previously weighted down by uncertainty. Our biggest losers this month were discount retailer Dollarama, water heater manufacturer AO Smith, and bank holding company Zions Bancorporation. Outperformers included insurer Kinsale Capital Group and beauty products maker Estee Lauder. On September 21, we exited our position in Emergent Biosolutions with a holding period return of 39%. Details on selected holdings are provided further in the newsletter.

Figure 1: Alpha Squared Fund Returns

Time	Gross	Net	Benchmark
Since Inception	13.21%	10.47%	13.83%
YTD	6.03%	4.84%	5.79%
Q1 2018	1.07%	0.69%	-2.14%
Q2 2018	5.15%	4.76%	6.12%
H1 2018	6.27%	5.48%	3.85%
Q3 2018	-0.23%	-0.60%	1.86%
September 2018	-2.28%	-2.39%	-0.75%

Figure 2: Alpha Squared Return vs Benchmark Return as of September 30, 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 September 30, 2018

Company/ETF Name	Sector	Currency	Market Cap ($M)	Size	Shares	Local Price	Total Value (CAD)	Portfolio Weight
AO SMITH CORP	Industrials	USD	7,841.08	MID	355	$53.37	24,490.05	4.35%
CACI INTERNATIONAL INC	Information Technology	USD	4,515.36	MID	130	$184.15	30,944.20	5.50%
CAE INC	Industrials	CAD	6,536.67	MID	985	$26.22	25,826.70	4.59%
DOLLARAMA INC	Consumer Discretionary	CAD	13,053.45	LARGE	480	$40.69	19,531.20	3.47%
ISHARES US HEALTHCARE ETF	Healthcare	USD	2,465.10	ETF	95	$202.90	24,915.51	4.43%
ENCANA CORPORATION	Energy	CAD	14,131.79	LARGE	1,800	$16.93	30,474.00	5.42%
ENERPLUS CORP	Energy	CAD	3,467.23	MID	1,820	$15.95	29,029.00	5.16%
ESTEE LAUDER COS INC/THE	Consumer Staples	USD	46,662.35	LARGE	135	$145.32	25,358.49	4.51%
FIRST BANCORP/ SOUTHERN PINES N	Financials	USD	1,178.61	SMALL	450	$40.51	23,563.45	4.19%
ISHARES S&P/TSX CAPPED	Financials	CAD	1,067.82	ETF	1,630	$38.44	62,657.20	11.14%
ISHARES S&P/TSX CAPPED	Materials	CAD	102.09	ETF	2,270	$12.06	27,376.20	4.87%
ISHARES S&P/TSX CAPPED	Utilities	CAD	76.66	ETF	740	$20.84	15,421.60	2.74%
ISHARES US FINANCIALS ETF	Financials	USD	1,780.22	ETF	100	$121.47	15,701.21	2.79%
ISHARES US TELECOMMUNICATION	Telecom	USD	485.20	ETF	390	$29.74	14,992.35	2.67%
ISHARES US TECHNOLOGY ETF	Information Technology	USD	4,047.14	ETF	55	$194.02	13,793.46	2.45%
KILLAM APT REAL ESTATE INVT TR	Real Estate	CAD	1,350.42	SMALL	700	$16.13	11,291.00	2.01%
KINSALE CAPITAL GROUP INC	Financials	USD	1,288.02	SMALL	360	$63.86	29,716.36	5.28%
TERRENO REALTY CORP	Real Estate	USD	2,105.34	MID	300	$37.70	14,619.31	2.60%
VALERO ENERGY CORP	Energy	USD	40,899.85	LARGE	220	$113.75	32,347.32	5.75%
ZIONS BANCORPORATION	Financials	USD	9,286.62	MID	290	$50.15	18,798.93	3.34%
CAD Cash		CAD					39,208.15	6.97%
USD Cash		USD					32,410.01	5.76%

Total Securities/Cash: $562,465.69 | 100%

Alpha Squared Fund

Figure 4: Sector Allocation as of September 30, 2018

Sector	Fund Weights	Benchmark Weight	Over/Underweighting
Energy	18.96%	14.16%	4.80%
Financials	30.67%	25.88%	4.79%
Real Estate	5.19%	2.84%	2.35%
Consumer Staples	4.99%	4.68%	0.30%
Utilities	3.12%	3.40%	-0.27%
Industrials	10.10%	10.39%	-0.29%
Information Technology	9.20%	10.61%	-1.41%
Materials	5.68%	7.13%	-1.44%
Healthcare	5.09%	7.22%	-2.13%
Consumer Discretionary	3.92%	6.58%	-2.66%
Communication Services	3.06%	7.11%	-4.05%

Figure 5: Fund Size Allocation as of September 30, 2018

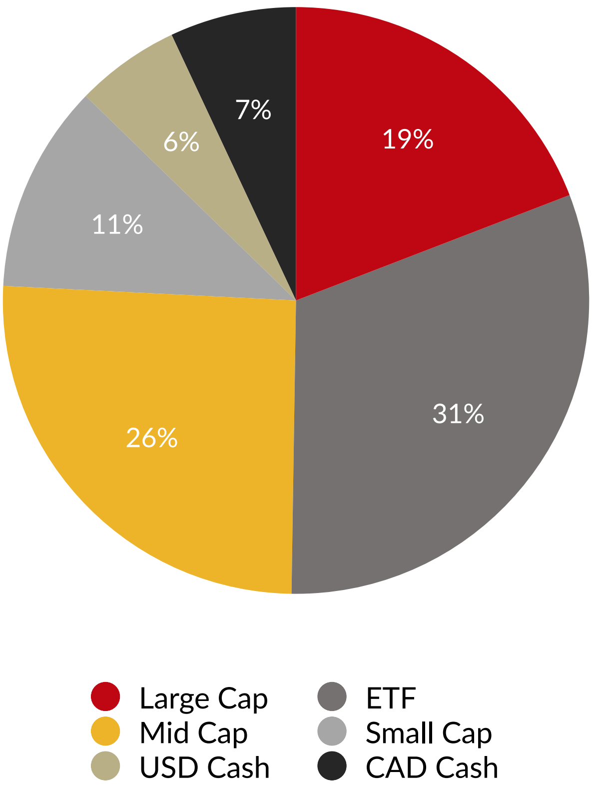
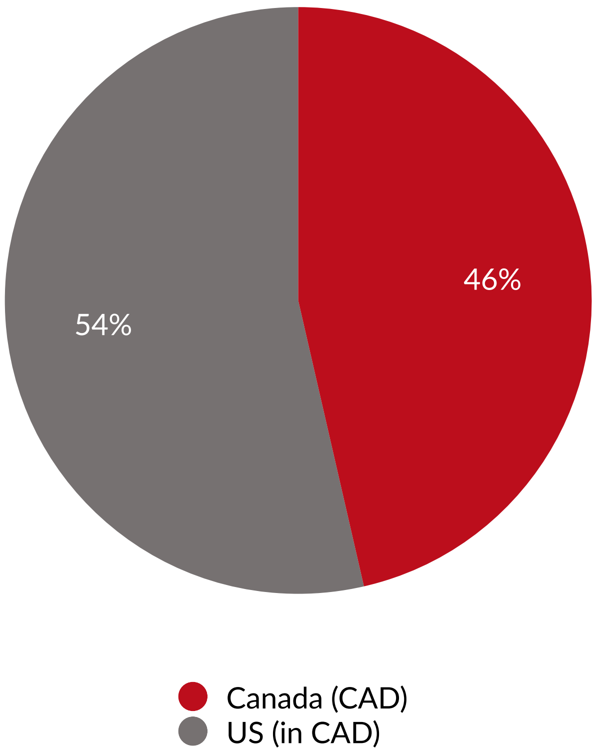


Figure 6: Fund Currency Allocation as of September 30, 2018



Selected Holdings

Emergent Biosolutions (Holdings Period Return: +39.01%)

We bought this specialty biopharmaceutical company in February 2018 on a view that the market was under-appreciating the company's promising new products, long-term government contracts, and growth in the European market. Our investment theses played out quite nicely and the stock reached and exceeded our initial price target. With the above points now already reflected in the stock price we decided to sell and take profits. The proceeds of the sale were invested in a Healthcare ETF while we wait for our Healthcare team to identify another undervalued name.

Estee Lauder (September Performance: +4.36%)

We purchased Estee Lauder in November 2017 on a view that he company was particularly well positioned to benefit from increasing global demand due its strong brand line and recent acquisitions. Indeed, Q4 2018 earnings beat expectations, with strong sales growth in Europe, Middle East & Africa (EMEA) and Asia-Pacific. The company reported sales of 3.3bn, a 14% increase vs. the prior-year period, representing a 1.6% upside surprise. Management has conservatively forecast that growth will slow to 5-6% next quarter due to changes in accounting standards, a strengthening dollar and tariff uncertainties. We feel management may be under-promising, and see continued upside potential for the stock. Analysts similarly expect a growth rate closer to 7%.

CAE (September Performance: +0.61%)

On September 26, 2018, the flight simulator company announced that CAE USA had been awarded a United States Air Force (USAF) contract to provide comprehensive C-130H aircrew training services. The eight-year contract, awarded as a three-month transition effective October 1, 2018 with a one-year base period and seven additional option periods, is valued at a total of more than US$200 million. The award of this new contract positions the company to be a leading provider of training systems and services for military aircrafts. Meanwhile, the CAE-Cebu Pacific joint venture, Philippine Academy for Aviation Training (PAAT), announced on September 25, 2018, the expansion of its training capacity with the acquisition of a new Airbus A320NEO full-flight simulator. The company is aiming to provide best-in-class training standards to pilots. The PAAT joint venture was initially established in 2012 in Clark, Philippines, offering Airbus A320 pilot training to Cebu Pacific Air and other operators in the region. Meanwhile, CAE announced last week it would expand its training capacity in Japan to maintain its business and network across the region. Overall, the above bodes well for the company's growth outlook and we maintain a positive outlook for the stock.

Selected Holdings

Zions Bancorporation (September Performance: -5.97%)

On September 30, 2018, Zions Bancorporation NA successfully merged with its holding company, Zions Bancorporation. As a result, S&P raised its rating on Zions Bancorporation's senior unsecured debt from "BBB" to "BBB+". S&P also raised the rating on the subordinated debt from "BBB-" to "BBB" and the rating on preferred stock from "BB" to "BB+". The upgrades are a result of those issuances no longer being associated with an entity viewed as structurally subordinated. S&P holds a stable outlook on Zions, believing the company will continue to remain strong based on capital ratios and asset quality. The company's stock price had been depressed by uncertainty around the merger approval and uncertainty on whether the merger would result in the corporation being considered a Systemically Important Financial Institution (SIFI). On September 12, regulators confirmed the new corporation would not be considered a SIFI, and thus not subject to the associated increased scrutiny from the Federal Reserve. With this major hurdle now out of the way, we believe attention will return to the company's ability to operate more efficiently and grow its loan book. We retain a positive outlook on both these points.

Dollarama (September Performance -18.18%)

Following the release of their latest earnings report, Dollarama's share price abruptly tanked. Although earnings were in line with expectations, revenue missed, and more importantly management revised growth guidance for same-store sales from 4%-5% to 2.5%-3.5%. The slowdown is explained by a decision of minimizing price hikes on products in order to remain competitive in their market even if the recent minimum wage increases have an impact on their bottom line. However, CEO Neil Rossy mentioned that as usual, Dollarama would react quickly to any move from the competition and stands ready to hike prices with cost inflation if others do. The stock price reaction to the earnings announcement appeared overly dramatic to us based on our revised valuation model. From a fundamentals standpoint the stock looks attractive to us at this price. Nevertheless, the recent decline triggered an exit signal from our momentum quant signal and we exited the position on Oct 9 at a price of $39.41.

SRI Fund Update

We launched the Desautels SRI Fund last month and as of the end of September were invested entirely in 4,250 shares of an S&P 500 Ex Fossil Fuels ETF (NYSE: SPYX). The ETF is used as a placeholder, and we expect to transition out of the ETF and into individual names as we identify undervalued companies that also meet our ESG criteria. Recently, SRI analysts pitched Polaris Infrastructure Inc. (TSX:PIF) and Lowe's (NYSE:LOW). Following our internal due diligence process, we decided to allocate about 3% and 5% weight to the positions, respectively.

Polaris Infrastructure Inc. (**TSX:PIF**) is a Toronto-based company that operates, acquires and develops renewable energy projects in Latin America with a market cap of close to $200M. Polaris Energy Nicaragua S.A (PENSA) is a subsidiary of PIF and owns and operates a geothermal power plant in San Jacinto. Geothermal energy is a low cost but highly environmentally friendly method of creating power by extracting energy from the earth's heat and converting it into electricity through steam turbines. We believe PIF is an attractive buy for two reasons: i) the market is overestimating the country risk for PIF's Nicaraguan operations, and ii) Polaris is well positioned to benefit from acquisitions in the future.

Due to Polaris' significant operations in Nicaragua, their stock took a significant hit during the country's recent political crisis. While the unrest is certainly a negative and poses real threats, a thorough analysis of the risk factors suggests that the 50% stock price drop was an overreaction, possibly due to fears of a Venezuela-like escalation, something we view as unlikely. Risk of expropriation should be low, civil unrest in the nation's capital should not affect the national power grid, and we don't believe the company's assets will be a target of attack. The company is locked into a contract with an energy purchaser for 11 more years and given that the contract is denominated in USD exposure to local currency depreciation is minimal. Even if the energy purchaser were to default, something we view as unlikely, the demand for the company's very cost effective power supply should allow it to find a market.

Given Polaris' Board of Directors' experience in energy developments and financing, coupled with a Nicaraguan energy market comprised of 83% independent private power producers, the company stands to generate significant value through acquisitions. Based on our SRI Utilities team valuation analysis, including conservative risk estimates, we see upside potential of up to 100% in a bull case scenario. We are currently looking to the next earnings call at the end of October as a catalyst for stock price appreciation.

SRI Fund Update

Lowe's (**NYSE:LOW**), the US-based home improvement retailer, was recently pitched by the SRI Consumer discretionary team. The company has a market capitalization of US$88B and commands approximately 30% of the market share of the home improvement market, second only to Home Depot. Lowe's is committed to sustainability and social responsibility, they strive to reduce resources used, while at the same time using environmentally friendly products. Furthermore, Lowe's has a history of providing support to communities in need and recently committed $2M for hurricane Florence disaster relief. Our purchase of Lowe's is based on two investment theses: i) new management's ability to increase margins, and ii) underappreciated growth in the remodelling sector.

Lowe's recently overhauled its management team and brought in veterans from across the retail sector. Marvin Ellison, former CEO of JC Penney, was appointed CEO in July 2018. He had spearheaded the massive turnaround strategy at Home Depot in 2009 after the subprime crisis, making that retailer into the giant it is today. We believe Ellison's expertise combined with the new executive management's experience in areas of inventory rationalization, supply chain strategy and omni-channel initiatives will significantly boost Lowe's bottom line and improve margins, which have trailed Home Depot since 2010. The market appears to be underestimating the potential of these initiatives given the cautiously positive tone in research reports.

While there are concerns of a potential slowdown in new housing starts, we opine that the market is not fully factoring in the growth potential in remodelling activities across the US housing market. LIRA, a leading indicator of remodelling activities, forecasts a 7% growth in remodelling through 2019 and we believe the company is well-suited to benefit from this trend, which should help boost Lowe's top line.

Incorporating all the above points into our valuation model we get a target price of US$152, an increase of about 35% from current price. A key upcoming catalyst will be the analyst conference in December, where Lowe's new management team will reveal their strategy blueprint.

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