GAVIN

GAVIN EQUITY POOL: TALE OF THE TAPE

Edition 2, Volume 1, March 2021

SHORT-TERM RESULTS	3-Month	1-Year
GAVIN EQUITIES	12.13%	46.74%
S&P/TSX COMPOSITE	8.05%	44.25%
BENCHMARK INDEX*	3.51%	40.11%

*50% SP/TSX Composite and 50% MSCI World Index (CAD)

While the calendar year turned over, market volatility from 2020 carried forward. Equity markets for the most part fought through the volatility with the S&P 500 returning 6.17% while the technology heavy NASDAQ 100 Index advanced just 1.76%. Commodities continued their torrid pace which began last October. The Dow Jones Industrial Index gained 8.29% and the commodity-heavy S&P/TSX Composite (Canadian equity index) climbed 8.06%.

With the recovery in full swing, equity markets continued to price in much easier year-over-year comparables on the economic front. Meanwhile, the pandemic winners seem to have been justly isolated by the market as they face more difficult comparisons. Technology names for example, benefitted from the "work from home" dynamic as a result of stay home orders. With vaccines being rolled out this is largely in the rear-view mirror and these companies now must show growth over those difficult comparisons. Technology companies are also often considered long duration assets, so increases in bond yields mean that valuations should moderate.

In our opinion, however, the technology weakness seemed misplaced given the reason interest rates were rising. Higher growth prospects should generally be a scenario that lifts all growth and cyclical assets, therefore the sell-off in technology names may be more of an opportunity. The news of a large technology-heavy fund liquidation at the end of March also suggested something else was pressuring technology names. The forced selling of an over-leveraged hedge fund, at the Prime Brokers discretion, caused a number of high-flying share prices to give back lofty year-to-date gains. Viacom for example had been up 164% but is now flat on the year. There are several questions as to why this occurred, the main one being "why a fund that was up so significantly was forced to liquidate", however we are simply reminded to stay focussed on our goals and the long-term prospects.

Commodities and commodity-linked companies have been generating outsized returns over the last few quarters. Lumber in particular continues to make new all-time highs as the influx of first-time homebuyers combined with lower mortgages rates has overwhelmed supply. Oil prices have risen nearly 50% since October and copper has gained nearly 32% during the same time period. Supply restrictions for various reasons have also supported commodity prices. Agriculture commodities, both grains and livestock, have also seen prices surge higher as Chinese demand increases. A third factor supporting commodities has been the declining US dollar.

The GAVIN Equity Pool returned 12.1% for the quarter and 46.7% for the last year, beating the benchmark over both timeframes. The top contributors for the first quarter included Designer Brand (+34.5%), Hingham Institution for Savings (+29.6%), and Canadian Natural Resources (+28.6%). The largest detractors to performance included Agnico Eagle, CargoJet and IAA Inc which declined 18.4%, 24.4% and 16.0%, respectively. During the quarter we exited our position in IAA Inc which had gained 60% since the spin-off as well as Polaris and Nutrien which gained 30.0% and 14.6% during the quarter. With the proceeds we firmed up a few positions while the lone addition to the portfolio during the quarter was Designer Brands Inc.

1Q 2021 Contributors

Designer Brands Inc. (+34.5%) – DBI is a "Big Box" branded shoe retailer that offers discount pricing through consolidated buying for its brick-and-mortar stores and online platform. The stores carry thousands of stock-keeping units (SKUs) of predominantly dress footwear. More recently, management has been adding an athletic selection which was previously a source of pain. DBI also carries discounted handbags and accessories. In our opinion, the company is underfollowed and misunderstood but has strong earnings power over the long-term. This is due to its pivot to athleisure as well as the acquisition of wholesale group Camuto. The wholesale acquisition should provide better pricing knowledge and transparency. Today the stock appears to be benefitting from the re-opening of the economy in the United States. With offices functioning and nightlife getting back to normal levels DBI should be a beneficiary after being severely impacted by the pandemic. In its most recent corporate quarterly earnings report, the company put up a -20% year-over-year comparable in core DSW sales. The important thing however is that the rate of change is getting better as the two previous quarters came in at -30% and -42%, respectively. The market also seemed to recognize the impressive margin improvement in a difficult environment. Gross margins improved 200 basis points while operational expenses decreased by nearly $80 million on an annualized basis. Some of this was due to store closures, headcount reductions, which will come back after re-opening but there should be some flow-through.

Hingham Institution for Savings (+29.6%) – After outperforming peers through 2020, we were happy to see HIFS continue to deliver alpha in the first quarter. HIFS is a commercial and residential real estate lender operating primarily in eastern Massachusetts. Deposits are sourced within a small proximity including Boston, South Shore, and the island of Nantucket with a focus on high-net-worth individuals. Managements stringent focus on risk management through covenant and loan reserves drew us to the group. The pandemic gave us the opportunity to add the holding and we have been quickly rewarded as shares have climbed nearly 90%. More recently the share advance has been fueled by a steepening yield curve as traditional banks increase profitability with a widening between short-term and long-term rates. Our team has had numerous calls with HIFS's management and each time we come away with new information pertaining to the space. Fundamentally the company is currently firing on all cylinders as 2020 resulted in 30.4% growth in earnings despite the pandemic. Net loans grew 12% versus 2019 while the credit quality remained strong. Furthermore, the return on equity exited 2020 at 23.8% compared to 18.6% a year earlier.

Canadian Natural Resources (+28.6%) – Oil prices have recovered to pre-pandemic levels as supply restrictions as well as the re-opening have provided support to crude. Shale producers in the United States, which had become the swing producers, are also showing signs of structural issues as financing availability appears to have slowed. A Biden administration, which ran on being hard on fracking, should be bullish for oil prices. In Canada, the cancellation of the Keystone pipeline was viewed as a negative however the proposed Energy East pipeline could more than make-up for this. Canadian Natural is a diversified oil and gas company with upstream and midstream capabilities. What it lacks in downstream operations versus its closest peer, it makes up for in management's ability to allocate capital. The team has continued to deploy capital during periods of stress, acquiring Devon Energy's heavy oil assets in 2019 and more recently adding to its natural gas portfolio with the Painted Pony addition. Guidance has been established to grow oil production by 5% year-over-year. At current prices this should provide a large lift to free cash flow despite the uptick in capital spending. Free cash flow is expected to yield around $2.3 billion, which equates to a 6.3% yield and a 69% payout ratio on the dividend.

1Q 2021 Detractors

Agnico Eagle Mines (-18.4%) – AEM found its way to the bottom of the performance list for the second straight quarter. With hindsight, we should have been more aggressive in trimming our position. Our mistake was giving too much credence to the egregious spending that is taking place at the government level and lack of any monetary discipline. While we still lean to the fact that all the spending will come home to roost through inflation, and that debt levels will not allow for material growth, we should have recognized the crowded positioning taking place in gold. We can take comfort in the fact that Agnico is firing on all cylinders and remains one of the premier gold producers. The company also operates in mining jurisdictions that are business friendly. Production guidance for 2021 is in line with the company's three-year plan that was laid out February 2020, with a 2.2% increase on the Q4/20 exit rate. The Odyssey Project was also updated with mine life production a little higher than expected which helped to offset rising costs. The IRR on the project is projected at 17.5% assuming $1,550/oz gold price. Rising costs appear to be hitting the mining industry as 2021 cash costs increased slightly for existing projects.

CargoJet Inc. (-24.4%) – CargoJet is Canada's leading provider of time sensitive domestic network air cargo services, representing over 90% of domestic overnight air cargo available in Canada. As customers pre-purchase a guaranteed amount of space and weight within the network the majority (75%) of revenues are fixed. The contract includes variable surcharges for uncontrollable cost changes including CPI adjustments, annual price increases, and fuel and regulatory coverage, but they will rise and fall with overall level of customer volume expressed in pounds. Growth for the company has been fueled by the emergence of Amazon which also owns 15% of CJT shares and recently expanded their capacity within the fleet. As a result, share price movements are correlated. Meanwhile, the company's highest input cost is related to the price of oil, so it was of little surprise to see the shares trade lower despite a solid quarterly earnings report. The growth plans, laid out previously, were on full display in the report as revenues jumped 34% year-over-year and EBITDA margins improved 1,000 basis points. The company had previously outlined its fleet growth plans including the addition of five more 767 freighters to support the expected network volume growth. The equity financing during the quarter, a prudent move by management in our opinion, will be used to fund the purchases as well as two larger and longer-range Boeing 777 freighters. We used the weakness over the quarter to increase our position and lower our cost basis.

IAA Inc. (-16.0%) – We have held IAA since its spinoff from KAR Auction Services in June of 2019. IAA was started 35 years ago and through 175 sites across US and Canada as well as 13 in the UK, is a leading provider of salvage auction services for total loss, damaged and low-value vehicles. IAA operates in an oligopoly where along with its competitor, Copart, they dominate 80% of the market. Suppliers of product to IAA include insurance companies primarily, who will determine whether the auction value of a vehicle is greater or less than the cost to repair. Insurance total loss vehicles make up 80% of volumes that pass through their marketplace, with dealers, vehicle leasing and rental car companies, and the general public making up the remaining supply. Also, dealerships, rental car companies, fleet lease companies and charitable organizations take part. Despite a global pandemic, shares of IAA advanced over 48% in less than 2-years as the stability of the salvage market as well as the pivot to online auctions have helped keep the topline intact. The transformation to digital auctions in 2020 helped improve margins significantly which has been one of the biggest surprises in terms of execution speed. With shares performing and margins closing the gap with their faster growing, lower-leveraged peer we took the opportunity to liquidate our position.

1Q 2021 Additions / Subtractions

Designer Brands Inc. (DBI-NYSE) – DBI is a retailer of branded footwear and accessories for women, men and kids. Disappointing retail sales leading to loss of market share, a failure to capture a meaningful position in the Athleisure segment and impacts from COVID-19 shutdowns have resulted in DBI stock dropping 72% from its peak in November 2013. With very low leverage (mostly leases), a management team shake up and the ability to integrate the wholesale business, patient investors could be rewarded as the proven management team rights the ship to improving same-store-sales. The first major catalyst is the re-opening of the economy. The headwinds of COVID will transition to a re-opening tailwind as in-person meetings take place and life outside home resumes. The Athleisure segment, which caused the company to lag peers in 2016/17, has risen to nearly 27% of revenues from just 6% in 2016. The company's acquisition of Camuto provides a significant boost to visibility on wholesale pricing from third party suppliers. This will improve gross margins going froward. Camuto also adds capacity for DBI to expand its private label brand which will likely lead to yet another leg up in margins. The latter should be the largest margin lift.

Cargojet (CJT-TSX) – Cargojet's position was increased after adding it to the portfolio in November. As mentioned last quarter, the company owns a monopoly in domestic overnight air cargo in Canada. With e-commerce growth accelerating following the pandemic, we did not feel comfortable buying a large position in CJT as shares had for the most priced in a lot of the positive news. This was evident with the shares selling off on the back of a solid quarterly earnings report which saw the company meet a lot of their growth and margin projections. We took the opportunity to add to our position given the secular growth trend.

Polaris Inc. (PII-NYSE) – As our exposure to discretionary spending has grown over the last few months, we reduced our position to this factor by selling Polaris. PII is a high quality but highly cyclical company that has recently benefitted from the COVID-19 pandemic. As travel became restricted, discretionary spending was re-routed to activities at home, in particular outdoor endeavors which allowed for socializing. Shares now reflect this fact and are trading north of our $105 intrinsic value. We exited the position at $125. Our average cross base across the portfolio was closer to $80. While the momentum in fundamentals and the share price is strong, we believe there are better risk/reward opportunities out there.

Nutrien Ltd. (NTR-TSX) – Fertilizer giant Nutrien was sold during the quarter as well as our commodity exposure was getting extended, and the US dollar may have found some support. Corn, which the fertilizer stocks track closely, also has one of the largest net long positions by speculators in recent history. We sold the position only 3.0% off its closing all-time.