

Dynamic LIVE Call Summary

Positioning for the Known Unknowns

August 12, 2021

This special conference call featured Vice President & Portfolio Manager Tom Dicker providing an update on the US equity market and real estate markets, highlighting the opportunities and challenges he sees going into the Fall.

We've seen a massive rebound in activity this year, and at the same time consumers appear to be in excellent financial shape. Do you think the US has reached peak growth for the economy earnings? And how will a moderation towards a more sustainable level look?

The question of peak growth comes up a fair bit. It's safe to say that for the consumer peak year over year growth was in the second quarter. For most companies that were in some way affected by the shutdown, businesses doing things in person, it's safe to say that the peak is now in the rear-view mirror. That's just because a lot of the world was fully shut down for the whole of Q2 of 2020, or in some parts of the US it was only part of the quarter.

Certainly, we've seen things like internet retailers have their peak growth as people go back to their more normal activities. They're doing more in-person things and less online shopping. They're just finding other things to do, and it makes sense. When you're locked down, there's only so much you can do from your house. Now that menu of options has opened up for a lot of people, and certainly ahead of the Delta variant percolating the fourth wave we're seeing in the US. Many heard a month or two ago that we're seeing even things like air travel really come back quite strongly. Our view is as things get back to normal you want to get some exposure to that consumer as their activities go back to normal. What do those things look like? You are getting some exposure to in-person shopping through TJX, as an example in the US funds.

In the real estate fund, maybe that's taking some exposure from grocery anchored retail to something like retail, as an example of a way that we've gotten a little bit of exposure to what will be higher utilizations of these services and activities into the back half of the year.

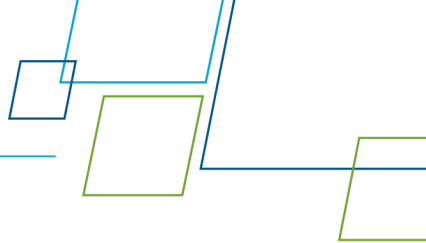
What are your thoughts on US equity valuations? Many have pointed them as at worrisome levels. What do you think?

Relative to bonds, equities still remain the only show in town. If you were to look at, as an example, the S&P 500 price earnings ratio, it's trading at about 22 times forward earnings. That's quite high and quite a bit higher than the historical long-run average. That's definitely true, but bond yields remain very low. There is limited ability for people to invest their money and earn a decent return in the bond market, especially with the specter of inflation. The equity market, and I would also say hard assets, are a place that people are getting pushed into with their money. That means things like real estate and infrastructure remain very, very well bid. Broader equity markets also remain very well bid here.

Inflation has been a very hot topic and it seems that everybody has an opinion on the extent to which it's going to be transitory. What are some of the messages you're hearing from management teams when you have your calls with them? How does that align with the Fed's message?

It's definitely THE topic right now. It doesn't matter whether or not it's an internal call with my own team or if we're talking to sell-side analysts, or even the companies. Inflation is the topic of the day and with good reason. There are lots of moving parts right now. The headline inflation prints we've seen have been very strong, even yesterday, which didn't really scare off the market very much. We saw over 5% annual inflation. That's certainly the highest I remember seeing it as a professional investor.

There are definitely a handful of areas where we see strong inflation that could continue into the future, beyond this 'lapping easy comps' period that we're in right now. The semiconductor shortage situation remains. The guidance that



we're getting from both the users and the makers of semiconductors is they think that this is going to take a year or two, at least, to resolve. Some folks think that it's peaking right now, and I hope that that's true, but shortages in the semiconductor area are likely to continue. Certainly, the carmakers are really feeling it. I heard from a friend of mine who works for Land Rover that basically they're just getting sent models without the features that they'd like to have. There's no backup camera because it requires too many semiconductors to get all of hardware working. They sell the model for effectively the same price. That just shows up in inflation. You're not getting the product, but you're effectively paying for it.

You're also seeing the price of shipping containers up three or four fold year over year, as a result of all the crazy disruption that we had. People are shopping more online and that created a huge demand for goods from China to come over to the US. That disrupted a bunch of the supply chain in other areas of the world. We saw things like there's all sorts of rice in Thailand they can't move off the port because they can't get a container, because that container's being used to move goods from China to the United States.

You also have this cash-flush US consumer, who is doing lots of online shopping and buying things for their backyards and not spending money in restaurants. They have a lot of disposable income. Again, like we were talking about earlier, less of a menu of options where they could spend that money. That really created a big disruption. Now, we think that is going to abate. Those inflationary factors are likely to get better, but they're going to persist for a little while. Certainly, some of the raw material price increases, whether its lumber or copper, remain volatile but they're off the peak and we would expect that to likely be the case that we don't see continued higher highs in these prices, as the supply side of the economy gets back to normal.

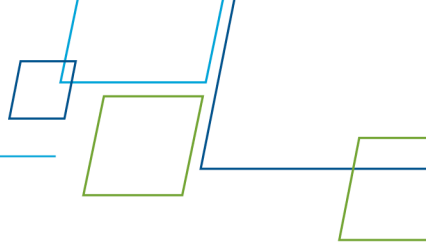
Another two other things I haven't talked about yet, which are very real for people, are the cost of food and the cost of housing. The housing shortage issue in North America, that is going to persist. We're not going to see a turnaround in the price of housing, especially in the US. In Canada, maybe things soften up a little bit. If we don't get immigration coming back, there'll be a fair bit of some new supply in areas like apartments and condos. Maybe not a lot of new single family. That housing shortage and the price of housing, that is definitely going to persist. That's one area that people definitely see, and then there's food.

Food inflation has been very strong. We own the largest cold storage company in the world. They're saying food inventories will not get back to "normal", or 2019 type of levels, until at least the middle of 2022. I think that that has an asterisk right now, as to whether or not they can do it, because of labor shortages. They just can't get the labor in some of these lower paying food processing type of jobs, where both the risk of COVID is relatively high, and the pay has historically been fairly low.

Those areas of food and housing, I think we're going to continue to see a fair bit of inflation, and that introduces the mother of all inflation sources, which is labour costs. Do we get higher labour costs and expectations remain for 3% to 4% plus wage inflation, even into next year? That is much higher than we saw from most of the last cycle. Definitely there are some signs that we're going to see a bit more inflation than we have historically. Now, do I think it's going to look like what we have right now next year? Probably not. I think it's going to taper down and be less than what we're seeing currently, but still remain a little bit higher and fairly robust until that supply side normalizes and we really see housing move back into balance, the food situation moves back in balance and semiconductors move back in balance, which could take another year or two.

The question I'm going to ask you is around the stickiness of the current price levels. Obviously, prices have gone up, or they've been pushed up. Companies won't want to give that away, because it has an impact on their earnings. How do you see this playing out, especially if you think inflation is transitory? What's going to happen with these current higher prices?

I think for most things that we buy that don't normally fluctuate, think about the food on the menu in a restaurant which everyone who's been to a restaurant since they've reopened has noted how much food prices are up, I think you're going to see those almost universally remain high. I don't think you'll see price cuts in those.



The price of gasoline may not be sticky. I suspect it will be a bit stickier than we would all like, but I suspect that it could definitely go up and down. I would say by and large, whether it's the price of labour, the price of finished goods, the price of services, I would expect those to stay pretty high. Maybe the conclusion there would be the rate of change will decrease, but the price, the absolute levels will probably remain fairly high.

One thing we've seen in the past is how quickly the markets reacted as soon as there was a hint of tapering language from the Fed. Given the current economic improvements, the inflation environment that we've talked about, when do you think the first move is going to happen, and what kind of impacts do you think it's going to have on the market?

It's something we spend a lot of time thinking about. Certainly, when I was, early on, managing a fund in my first four or five years here, we had the big taper tantrum in 2013 when the Fed started to taper following the financial crisis. As a manager for a real estate fund, and I run a real estate and infrastructure fund, we certainly had a tough year there.

It would be very easy to say, okay, well, the Fed's likely to start tapering and our expectation would be in early 2022 so maybe they start talking about it over the next couple of months or even as early as the next Fed meeting. I think if you grab your playbook from 2013 and say, "Aha, it's easy then", I think that that would be a little bit naive right now because at that time, areas like REITs, utilities, and other kind of predictable higher-yielding areas, those were really expensive relative to the rest of the market. Remember that the rest of the market in 2013 was trading at 15 to 16 times forward earnings, and as I was talking about just now, it's trading at over 22 times earnings. Quite a different picture now versus then in terms of overall market price-to-earnings ratio.

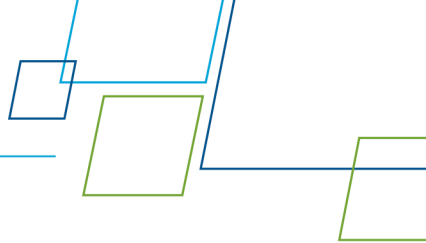
The other thing is REITs and utilities were the only expensive things then. Now, I would say they're still relatively cheap compared to some other areas of the market. Certainly, if you compare the market value of REITs to the private market value of REITs, they would have been trading at a premium in 2013. I think, broadly, we're seeing discounts to what the true net asset values are. This week we saw WPT Industrial, which is a Canadian-listed REIT but all their assets are in US industrial logistics properties, taken out at a 17% premium after already going up a fair bit this year. Those are the things to give us a lot of confidence that the real estate space isn't super expensive.

I think if we're thinking about a taper, it depends on how much they taper and how quickly they do it. I think last time we saw that they didn't taper as much as investors thought and it didn't turn into rate hikes as quickly as you expected. There are lots of caveats, whether it's the Delta variant or the level of the S&P 500. I think if the S&P 500 goes from 4,400 to 3,400, the Fed will not taper, but if they get the green light from the market and the market's willing to digest a little bit of tapering, then we could see a bit of balance sheet tapering.

As we move towards the fall, the wild card seems to be the spread of the Delta variant. How do you see this impacting the progress of all the reopening of the economies that we've seen? What areas of the market do you think are most at risk?

It's something that I wish we didn't have to think about because I think we're all pretty tired of this whole COVID thing. It's not lost on me, that we've been two or three months away from COVID ending for 16 months now, and I think people are tired. But we do need to acknowledge the risks that we have a new threat out there. I think so far markets have been fairly placid and have for the most part ignored the threat. We had a little bit of a sell-off in early July, but it hasn't created too much volatility so far.

The thing that I'm most worried about would be if we saw a really widespread China shut down. We're starting to see some signs that they're making some attempts at shutting things down. That one's hard to price, but we know that they can really shut things down when they want to. It really affects the whole supply chain. It's the world's second largest economy. We really need to be aware of that now. As a playbook, do you pull up the same one that would have been helpful on March 1st, 2020? Probably not, because we know that it's going to be temporary. We know the financial institutions are well-supported by monetary policy. The necessity for credit markets to panic is probably not there.



It could mean that for a number of companies in a number of areas, the earnings are at risk. There are a few areas you really have to worry about, like things that are related to mobility. For North American office real estate, that could really be the nail in the coffin. If we had another six months or a year where no one goes to the office, again, as a result of the Delta variant, that's a non-zero probability right now. We have to think about that as something that maybe is already in the process of happening and that return to the office we were hoping for in the Fall maybe just doesn't come.

Travel would clearly be an area where we would just avoid altogether and continue to avoid that altogether. Other things like gyms, we used to own Planet Fitness in Dynamic Small Business Fund, we're not exposed there. I think that probably remains of a risky area post-COVID. Any restaurant that really relies heavily on in-person dining, if you have some balanced ability to either deliver or do drive-through, in the case of McDonald's, as an example, we'd be much more open to owning it because in fact, we've seen these companies be anti-fragile. They've been able to steal market share whenever there's a shutdown, because other restaurants can't survive.

Now, our base case is that it's not as big of a shutdown nor as long of a shutdown, because we have, especially in Canada, a very high vaccination rate. In the US, you're starting to see vaccination rates tick back up again. I think that governments and the private sector, and what I would call broadly vaccinated society, is going to start to impose their will on the unvaccinated by either removing their privileges or requiring them to do a whole lot of testing in order to behave like vaccinated people. You'll see more vaccinations and that'll be helpful. The other thing that will help will be if the mRNA vaccines are approved for use in children under 12, that will bring us a whole lot further towards herd immunity as well.

When you look at dividend-paying stocks, how do you think they're going to perform relative to the broad market as we enter the final stretch of 2021?

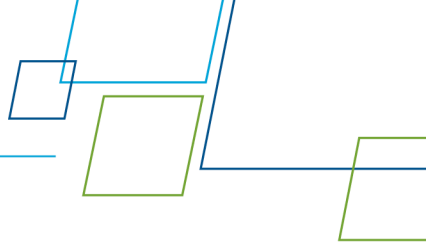
It's pretty hard to peg such a short timeframe. I do think dividend stocks, as the world lurches its way back to normality, are probably going to shine. We had a period where growth was extremely scarce and then we had a period where growth, at which we're going through right now, is very abundant, because you're seeing things reopen and the economy get back to normal. As we are lapping the period where growth is very abundant and where the economy looks a bit more normal, which hopefully it will 12 months from now and that would be my base case, in that scenario I think high-quality companies do really well. The companies that can earn a decent return on their invested capital, the companies that were able to survive COVID and maybe even steal some share; I think that they'll perform, very well.

I think areas which had been largely ignored, like health care, are starting to really come back into favor because people are looking out a couple of years and they have great secular trends. The valuations are undemanding, especially relative to the rest of the market. The competitive advantages that they had pre-COVID remain intact, so that their growth is not relying on a big reopening of the economy to show really strong growth. Typically, in a low-yield environment, dividends look very attractive. I would expect that we'll be in a relatively low yield environment. Maybe not quite as low as last cycle, but it's certainly possible.

Dividend stocks tend to do very well in those environments. I'm very comfortable investing in dividend-paying companies right now. I think they're not as cheap as they were the day before the Pfizer vaccine was announced, but they remain fairly cheap and relative to lots of areas of the market. As always, we think we've got a great high-quality portfolio that's well-positioned to be durable, whether the economy is really good or not that good.

Inflation is also a very relevant topic for your real estate funds. So far this year, real estate has performed very well amidst all the reopenings. How do you see the current trend in inflation impacting rates?

We spend a lot of time thinking about inflation in real estate, because typically a lot of people think that the quick sequence of events is we're getting a bit of inflation, so rates are going to go higher and real estate stocks are going to go lower. A lot of investors think that it's that simple. I really don't think that's true. If real estate and dividend-paying stocks are the only things that are expensive, as I was saying earlier, then relatively in a higher rate environment, that would be negative. But over time what we've seen is that a good economy is really good for real estate. What drives demand for real estate? Typically employment, employment growth and the supply-demand situation matters way more than interest rates in any one given year.



We're certainly seeing a big inflation in house prices that's translated into strong demand for apartments. As the price of raw materials and labor has gone up, that has increased the replacement costs for real estate. That's typically moved up the prices for existing assets, and then we're still in a pretty low rate environment. Despite higher inflation, the headline rates and borrowing remain really, really cheap.

I want to be nuanced about this because not everything is doing really well, but broadly there are lots of really strong areas to invest in within real estate. Whether it's property types like self-storage, single family rentals, cell phone towers, data centers and industrial real estate, they have performed well. When you think about what industrial real estate is, it's land with a bunch of steel and cement on top of it that's being leased to a tenant to move goods around. Land is more scarce, good land is even more important. Steel is more expensive. Cement concrete is more expensive, the labor to build it is more expensive. The rents that you can get when you lease it out are even higher. Broadly, we see an inflationary environment as being good for real estate. If it's in the context of a good economy and a good job market.

One of the areas that's seen the longest running impact is offices. Could you share with us your current base case for the return to the office?

That's the moving target. You and I worked for a big employer, and we know that we haven't been given guidance yet on when we're going to return to the office, other than that they'll be cautious and they'll be flexible, but that we should expect to come back. I think that's been the message so far for most employees of most big companies. In the US, you're seeing a different approach. Some of that has been unwound already. We saw last week Amazon, Wells Fargo and Apple delayed their return to office. That's meaningful and it's as a result of the Delta variant picking up. In Ontario, for the folks listening, and if you're listening to the replay it's Thursday at 2:30 in the afternoon, we saw in Ontario 500 cases today. That's the most since June, so we're clearly getting into it here as well. I don't think that any company who's seen their employees and their company function in a work from home environment feels the need to rush it today in the face of tripling off the bottom just a few weeks ago of COVID cases.

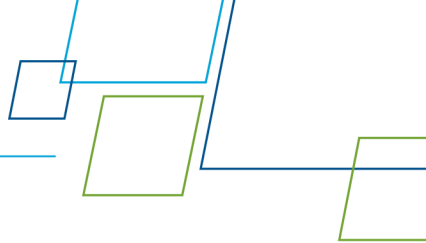
I've been hearing companies completely giving back their space. Not companies the size of a big bank, but I have heard of say, the branch office of a US company in a medium sized Canadian city saying, "We'll just give it back. Everyone's just going to work from home." There aren't many, but these are new developments from the last few months. That's really interesting. Clearly that has broader implications. Does that turn what's been 17 months of de-urbanization into a trend that has longer term legs? Because that does have huge implications for the value of real estate. For example, the value of something that's close to public transit.

Could you discuss the trends that you're seeing in terms of occupancy, cap rate, cash flows and things of the like. Do you still see the potential for the sectors outperform?

When we're looking at areas that have had reopening benefit, or could have had but maybe haven't, we would point to things like retail, even multi-families apartments, hotels, seniors housing. For some of them we're not really seeing much of a benefit yet. Areas that have been strong and stayed strong would be areas like single family residential, self-storage, cell towers and industrial. We've improvement in multifamily in the US.

We're starting to see some improvement - but it's early- in Canada in the multifamily sector. While they held in very strong and rent collection remained high in Canadian multifamily, we did lose a bit of occupancy, and the companies did need to give away some free rent in order to maintain occupancy. Now we're starting to see the free rent period go away and if the university's open that will get better.

Areas like retail real estate in the US are very strong. They've been reopened for a few months in the US and they're leasing to restaurant companies and any of those strong remaining retailers are starting to potentially look at taking up more space. They have a good pipeline but you're definitely seeing restaurants come back and open new concepts and things like that. In Canada, there are signs of bottoming in retail but we're not really seeing the strength so far of the US. The Canadian listed real estate companies have hung in there quite well. Their collections remained very high thanks to government support and thanks in no small part to their big exposure to grocery stores that have remained really strong. We just haven't seen leasing really accelerate and it makes sense. We've only been open in Ontario for a month and a bit in any reasonable way.



The area that remains weakening would be office, where we're seeing lower occupancy still, lower rents still, and we think that will translate to lower property valuations, and maybe tighter credit there. We think the office sector will continue to be quite weak as far as the reopening side.

Cap rates have been very, very strong in the areas that were strong. Whether it's single-family, residential, multifamily storage, towers, industrial, those areas cap rates remain very low, i.e. prices remain very high. We haven't seen a whole lot of transactions in the office space to point to and say cap rates are really moving up, especially for the sorts of things that are owned in the Canadian market. We don't really have a lot of data there, my expectation would be the cap rates will grind higher in office (ie prices will go lower), because credit is going to become a bit tighter and occupancies are lower. I just don't see leasing picking up in the way that it was in 2019, and there's a lot of new supply in Canada that's coming on.

There are a lot of known unknowns as we head into the Fall. Could you give us a quick summary of where you think the market is under, and also overestimating, some of the trends we currently see and any big surprises in the horizon?

I think the big surprise would certainly be if we saw a really big shutdown in China that really affected the supply chains in North America. Again, because that was quite disruptive the last time around. I don't think it's being priced in how disruptive that would be. That'd be the thing I'm most worried about today. That could change, and you're always going to have something at the top of your biggest risk list. I think that the market is not overpricing or underpricing, their risk. There's a really wide range of outcomes right now.

There were lots of individual companies where markets were overpricing or underpricing risk. I certainly would have looked at an area like pharmaceuticals earlier in the year, where markets were really, really focused on drug price reform, and we just thought it wasn't that big of a deal. It certainly would have some effect on the companies, but they were getting traded like revenues were going to go down 20% or 30% and that just was never going to be the case. Broadly, the markets come around on that, and for the most part and we've seen stocks like Pfizer, which has been a long-term holding of ours, finally catch on to the fact that they have this great vaccine. People were really under appreciating how many vaccines they were going to sell over the next 10 years. We've always thought it was way higher than the market was appreciating, and the market is finally coming around to that.

For us, mostly we're doing these from a bottom-up basis. We don't really do a whole lot of theme investing. The market probably got too excited about renewable energy earlier in the year then got too pessimistic on it by the middle of this year.

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