Issue 30

PALOS
INVESTMENT FUNDS

July 27, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

The REIT

Whether interest rates move higher or lower, this REIT will continue to do well. InterRent REIT (TSX: IIP-U) is the best positioned REIT in Canada to fence off any potential rate increases. The reason for its advantageous positioning is that it's not a traditional REIT where assets are purchased and a minimal amount of maintenance capex is spent. IIP-U is growth-oriented, with the vision of increasing value through acquisition, development, and the refurbishing of legacy assets. This activity allows IIP-U to grow like no other residential REIT in Canada. For example, IIP-U reported a 6.9% growth in net operating income for its second quarter. Its most recent growth project, LIV (www.livottawa.com) is quickly approaching full occupancy. As of the end of its second quarter, IIP-U achieved an occupancy rate of 88%. We are expecting LIV to be fully occupied by the end of the summer, which will have a positive impact on AFFO. What excites us even more is its potential project pipeline. In the next few months, IIP-U will be analyzing all its existing properties to determine if they have excess land. IIP-U believes that some of that land could be used for future development. We are expecting one to two new projects to be announced by year-end.

Here a few highlights on IIP-U:

- Delivers on NOI growth;
- NOI margins at 64%;
- Portfolio occupancy rate at 95.7%;
- Focus on growth and distribution;
- Conservative AFFO payout ratio of 67%;
- Trades at 10% discount to estimated NAV.

In conclusion, Palos prefers to invest in REITS that have interesting growth prospects and that are not only focused on income; especially in an unstable interest rate environment. We see IIP-U as a compelling investment with a healthy yield of 3.1%.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.51	1.58%
Palos Equity Income Fund - RRSP	PAL 101	$6.29	1.70%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos IOU High Yield Fund (May 31, 2017)	PAL 701	US $7.00	-3.83%
Palos WP Growth Fund - RRSP	PAL200	$9.92	-0.82%
S&P TSX Composite			0.95%
S&P 500			11.82%
S&P TSX Venture			51.25%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			4.35%

Chart 2: Market Data*

	Value
US Government 10-Year	2.31%
Canadian Government 10-Year	2.00%
Crude Oil Spot	US $49.15
Gold Spot	US $1,258.70
US Gov't10-Year/Moody BAA Corp. Spread	207 bps
USD/CAD Exchange Rate Spot	US $0.7966

* Period ending Jul 27, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

On Artificial Intelligence-Productivity

It's easy to see what is going on in the technology sector of the stock market but it's not so easy to understand what is going on in the technology sector of the economy. In the past ten days, I have read two books, ten working papers, and three research reports as well as a variety of articles found in the Economist, WSJ, NYT and FT on Artificial Intelligence. Below is a precis on what I read. I hope and trust that it may provide a good idea of what is happening in the world of technology.

Small but perceptible productivity gains are starting to show up; and there is evidence that productivity is about to fizzle. Up until now, the digital revolution had a much greater effect on reducing inflation than increasing productivity. The disruption effect on inflation has been felt in the retail industry, in the creative sector and the "gig" economy. The issue is that the preferences of end buyers have not changed. Jonathan Taplin of the WSJ got it right when he wrote a few weeks ago that "people are not reading less news, listening to less music, reading less books, watching fewer movies." They are simply paying less for what they want. We are getting the same amount goods and services at a much lower cost. In other words, they are making online purchases at a lesser price. One day very soon, the same digital disruption will wreak havoc on the physical part of the economy.

We are about to witness a surge in the use of information technology in many physical industries. Its lack of usage in the physical part of the economy explains the "productivity paradox". The physical industry, which is comprised of health care, transportation, education, manufacturing and retail, has not enough technology to increase efficiency. It makes up 75% of private-sector employment but only 30% of all IT investments. Accordingly, productivity in this sector only grew 0.5% in the past 15 years. On the other hand, the productivity of the digital industry, which includes technology, media, finance, professional services and software, grew 2.8% for the same period under review. The reason for this enormous "productivity gap" is based on the fact that the physical industry did not deploy enough information technology to make a big productivity difference. While we recognize that the physical industry had many hindrances like regulation, lack of knowledge and inexperience, preference for the status quo is the real reason. Research in this field shows that incumbents often believe that they are so proficient and knowledgeable of their industry that they fail to see what is going on and what is coming. They are caught up in the status quo and unable to see the unrealized potential. This "curse of the unknown" and the "status quo bias" and its negative effect on productivity is about to change. A new mind-set is brewing for the new executives are figuring out how to apply information technology to existing processes, customers, suppliers, business models, products, platforms and marketing. The long historical drag on productivity will soon end for more of the economy will embrace the digital revolution and leverage artificial intelligence (AI) encouraging new and better ways to achieve tasks.

Today, AI is a hot topic in boardrooms, governments and media. What is remarkable is that AI is starting to work not only as an embedded tool but as a machine that understands, anticipates and performs. We are on the cusp of a completely new computing paradigm. After many years of false starts and hopes, AI is rapidly gaining significant traction in the marketplace. The confluence of increased computer power and the vast amount of unstructured data is creating an ideal situation for the development of AI companies and services. AI is moving beyond hype into widespread development. AI is the second round of the digital revolution and it will bring about a productivity boost that will more than compensate for the slowing and aging demographics. Few will mind for the individual and social benefits will be too great to overlook. According to Tractica, AI revenue is expected to grow by leaps and bounds over the coming years. Revenue from the AI industry was hardly $1.0 billion in 2016. The same revenue is expected to surpass $35.0 billion in 2025. The forecast may appear optimistic, but the conditions that should enable an acceleration of AI are present. Firstly, sensors are being put in just about everything, like cars, mobile devices, buildings, trucks, machinery, homes, clothes, and all connected through the cloud. Secondly, chips are so inexpensive that, eventually, there will be a processor in everything and computing capacity will be available everywhere. Thirdly, the amount of data that is digitally available has proliferated as everything has moved online. Fourthly, algorithms and mathematical models can discover complex patterns, even in data that is unrefined, to predict future outcomes.

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Investors should not avoid the sector for it is just too promising. On the contrary, professional investors cannot afford not to be part of this arrow. In our judgement, it is not a question of who is winning the digital race for the number of possibilities of how it can be used is enormous. AI is rapidly becoming ubiquitous in everyday life and it is turning into a very useful tool for decision making in the corporate world. A recent study by Gartner projects that by the end of the decade, the average person will have more conversations with a virtual assistant or chatbot than with immediate family members. Given this potential momentum, we thought it would be a good idea to explain what AI, ML and DL is.

What Is Artificial Intelligence(AI) ?

Deloitte says that "AI is machine intelligence that can empower organizations to use automation and robotic capabilities, to enhance computers' inferences and prediction, to continually monitor operations, to fix looming problems and supplement human activities in the workplace--often resulting in cost savings, increased efficiency and smoother operations". Stanford University says that "AI is the science and engineering of making intelligent machines, especially intelligent computer programs. It is related to the similar task of using computers to understand human intelligence that are biologically observable".
Global X says that "AI is the concept of machines accomplishing tasks which have historically required human intelligence.

What Is Machine Learning (ML)?

Deloitte says that "ML---algorithms that can automate increasingly complex workloads and cognitive agents capable of mimicking human thinking and engagement---can enhance employee performance and unlock opportunities for organizations ready to rethink how work gets done".
Global X says that "ML is the process of building machines which can access data, apply algorithms to this data, and then train themselves to deduce valuable insights based on these underlying datasets". ML is used to recognize faces, voice commands and objects as well as translate languages. Think of chatbots, Siri, Cortana and Alexa.

What Is the Basic Difference Between AI and ML?

Unlike AI, ML does not rely solely on the code of its creator. However, ML starts off like AI with a computer code. But as it gathers data and information, the input is then studied. It has a close relationship with big data that makes ML and the "Internet of Things" closely intertwined. According to Kevin Ashton, a British technology pioneer who created the standardized system for Radio Frequency Identification (RFID), the Internet of Things means "sensors connected to the internet and behaving in an Internet-like way by making open, ad hoc connections, sharing data freely, and allowing unexpected applications, so computers can understand the world around them and become humanity's nervous system."

What Is Deep Learning (DL)?

DL is the cutting edge of AI applications. This is the new technology that is being developed now. It's a refinement of ML that goes a step further. DL mimics how the human brain works through the use of artificial neural networks. It puts a biological spin on AI. DL is based on a Neural Network architecture. Using the human brain as a guide, problems are broken down into simple processing units and built up hierarchically in layers and each layer passes its output to a higher level until a final answer is outputted. Globex explains it well. "In an artificial neural network, each neuron is charged with a binary (YES/NO) response to basic questions about a piece of data. By layering millions of these artificial neural networks, a DL machine is able to generate reliable outputs without changing the underlying code. Let's look at an example that turns what seems to be very complicated into something very easy. Consider a network with three neurons responsible to answer the three following questions to determine if a photo contains a banana or apple.

- Is the object round?
- Is the object yellow?
- Does the object have a stem?

The network would respond with no, yes, no for the banana and yes, no yes for the apple. In binary terms, the network would learn that a banana is 010 and an apple is 101. If one was to extrapolate the idea across millions of yes/no questions one would end up with exponential complexity and have the bases of artificial neural networks and, in turn, DL.

In conclusion, the space is moving fast and a lot of wealth is shifting over to the technology sectors from other areas. What is remarkable is that tech companies have come to dominate the world

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economy. One only has to look at the largest companies measured by market capitalization like Apple, Microsoft, Google, Facebook and Netflix. A handful of companies are not only the best performing stocks but, also account for a serious portion of the aggregate value of the S&P 500. As a whole, the tech stocks have finally passed their 17-year-old bubble and rallied at the incredible speed of 25% so far this year causing regrets and concerns. In our judgement, the gains are more like catch-up than bubble. They do not look frothy to us for they are producing sustainable growth at both the sale and profit levels. Since the low point of 2009, tech stocks are up 400% about the same as beaten down financials. As a matter of fact, real estate, consumer discretionary and dividend stocks have done better. Only because tech stocks are attaining new highs, it does not mean that they are in bubble territory. On the contrary, we believe that the tech sector has room to run. Adjusted for inflation, it still has a long way to go, perhaps as much as 40%.

In a primer that Goldman Sachs produced on June 14, 2017, they showed how they look at AI-based companies. Put simply, they are looking for answers to the following questions in order to make them investable.

- Do they have the expertise in-house?
- Do their solutions solve a real-world problem and present a meaningful ROI for potential users?
- Do they address a large market or are they a niche player? Niche is not good.
- Do they create a sustainable competitive advantage?
- Do they have access to a large, proprietary database of information to conduct training?
- How difficult is it to implement their solution? Will it require significant changes to workflow or employment for end users?
- Are they well-funded?

On A New Book: Machine Platform Crowd by Andrew McAfee and Erik Brynjolfsson

I will have a complete review of the book next week. It's an exploration of three big themes that the digital revolution has brought us. It shows why business must learn how to reorganize their business by using machine learning, platforms and the crowd (customers). The goal of the book is to help companies adapt themselves to the world being created by the new machines, platforms and crowds. Companies unwilling to adapt to the new reality will meet the same fate as the companies who failed to adjust in the past.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palos.ca