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# Palos Weekly Commentary

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# Palos Funds

*By Charles Marleau, CIM*
*& Joany Pagé, CFA*

## The Good and the Bad of 2018

I won't lie, this has been a very frustrating year for the funds. In many cases, stock prices have not followed fundamentals or the macro theme. With that said, I'm confident that our portfolio companies will create shareholder value in the coming months and years.

The Palos Income Fund LP is down 10.41% compared to the TSX down 3.93% on a year to date basis. Most of the negative alpha occurred in the month of October and November which is somewhat unusual. This drastic change can be explained by the tariff fears, NAFTA, Interest rate, and oil price.

Our real estate, health care, utilities, and consumer staples performed the best in 2018. Here are a few of our big winners Interrent Real Estate (TSX:IIP-U), Hexo Corp (TSX:HEXO), Northland Power(TSX:NPI), and Loblaw (TSX:L). This is of no surprise, as volatility rises, defensive sectors tend to outperform. Unfortunately, the positive price action from the defensive sectors was not enough to offset the more cyclical sectors.

Our energy and material exposure were the largest negative contributors to our performance. As you can imagine, energy contributed negatively to the fund, but not as much as you would think. Our energy exposure had a negative contribution of 3% to the overall portfolio. If we compare our energy performance to the index, we significantly outperformed iShares S&P/TSX Capped Energy Index. The energy component of the funds is down approximately 15% compared to the index down 23.6%. in hindsight, the funds' energy exposure outperformed the energy index by 8%. The outperformance came from LNG services companies, infrastructure, and E&P's that are less or not exposed or benefit from the oil differential. We continue to see significant opportunity as the market is not differentiating among companies and selling everything in sight.

The main underperformance really came from our materials exposure. In the materials sector, you have many segments including base metals, precious metals, packaging, and specialty chemicals. Our underperformance in the sector can mostly be attributed to our exposure to battery materials. Base materials and specialty chemicals also did poorly. The fund was exposed to battery metals like copper, cobalt, and rare earth during the year. This theme has not played out the way we

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anticipated. Even with all the positive news from Volkswagen, Tesla, BMW, Nissan, and KIA on electric vehicles, the battery metals have been slow to react to the higher demand in the many years to come. You would think that sentiment would be positive, but it has not been the case. If the EV revolution is taking place and I'm of the opinion that it is, then we are only at the beginning of something big. There, is no question that we will need more lithium, cobalt, nickel, graphite, and rare earth. Meanwhile, no one cares and companies like Lundin Mining (TSX:LUN), Neo Performance Material (TSX:NEO), and cobalt27 (TSX:KBLT) are all trading near their year lows. It is also important to mention that the materials space has been severely impacted by the China US trade war, tariffs and fears of contagion in emerging markets.

Additionally, our 5% gold equity exposure did not act in the way we anticipated, even if the companies we own, like Agnico Eagle Mines Ltd (TSX: AEM), Franco Nevada (TSX:FNV), and B2Gold Corp (TSX:BTO) beat estimates and guidance every quarter this year. On a year to date basis, our gold portfolio is down 15.8%. It did however outperform the S&P TSX Gold index which is down 16.7% this year. The USD's stubborn appreciation throughout the year definitely worked against gold names. We continue to view the USD as being overbought especially as the probability of rate increases in 2019 decreases.

The last segment of materials is packaging. Yes, packaging is part of materials. The fund has exposure to two packaging companies, CCL industries (TSX:CCL/B), and IPL Plastics (TSX:IPLP), and they both sold off aggressively because of polypropylene prices. In the third quarter, prices spiked and the companies were unable to pass through the price increases, which led to margin pressure. Since Q3, the price of polypropylene has moved down from its high. This should translate to a better Q4 as margins get back to normal. We see the price action on the packaging companies as being overdone. Nonetheless it had a negative impact on performance.

The last reason for the underperformance came from being underweight Canadian National Railway (TSX:CNR) and Canadian Pacific Railway ltd (TSX:CP). The rails make up 5.82% of the TSX index and they significantly outperformed the market in 2018. The funds were underweight the rails during the year as I feared NAFTA may have a negative impact on transportation. I was obviously wrong as volumes continued to rise and the heavy oil opportunity was larger and longer than I anticipated. We have been increasing our exposure but only on significant weakness as I don't see any short-term fix to the heavy oil differential.

In conclusion, it has been a difficult year for the funds, however, we continue to believe in the quality of our investments and that they, along with our themes, will excel, but it may take some time before the market recognizes the value in the Canadian market. I continue to believe that we are in a slowdown not a recession and that we just need to get back to an economic equilibrium. Please remember that 95% of my investments are invested in the funds. My money is always beside yours.

I'm available for a meeting or a call upon request. Please contact Caroline (cvadboncoeur@palos.ca) at client relations to request a meeting.

| Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1] | FundServ | NAVPS | YTD Returns |
|---|---|---|---|
| Palos Income Fund L.P. | PAL100 | $8.53 | -10.41% |
| Palos Equity Income Fund - RRSP | PAL101 | $5.70 | -10.60% |
| Palos Merchant Fund L.P. (Mar 31, 2018) [2] | PAL500 | $1.83 | 7.25% |
| Palos WP Growth Fund - RRSP | PAL210 | $7.55 | -30.08% |
| S&P TSX Composite (Total Return with dividends reinvested) | | | -3.93% |
| S&P 500 (Total Return with dividends reinvested) | | | 4.44% |
| S&P TSX Venture (Total Return with dividends reinvested) | | | -30.30% |
| **Chart 2: Market Data [1]** | | | **Value** |
| US Government 10-Year | | | 3.06% |
| Canadian Government 10-Year | | | 2.33% |
| Crude Oil Spot | | | US $50.29 |
| Gold Spot | | | US $1,223.80 |
| US Gov't10-Year/Moody BAA Corp. Spread | | | 220 bps |
| USD/CAD Exchange Rate Spot | | | US $0.7533 |

[1] *Period ending Nov 28, 2018. Data extracted from Bloomberg*

[2] *Fund is priced annually*

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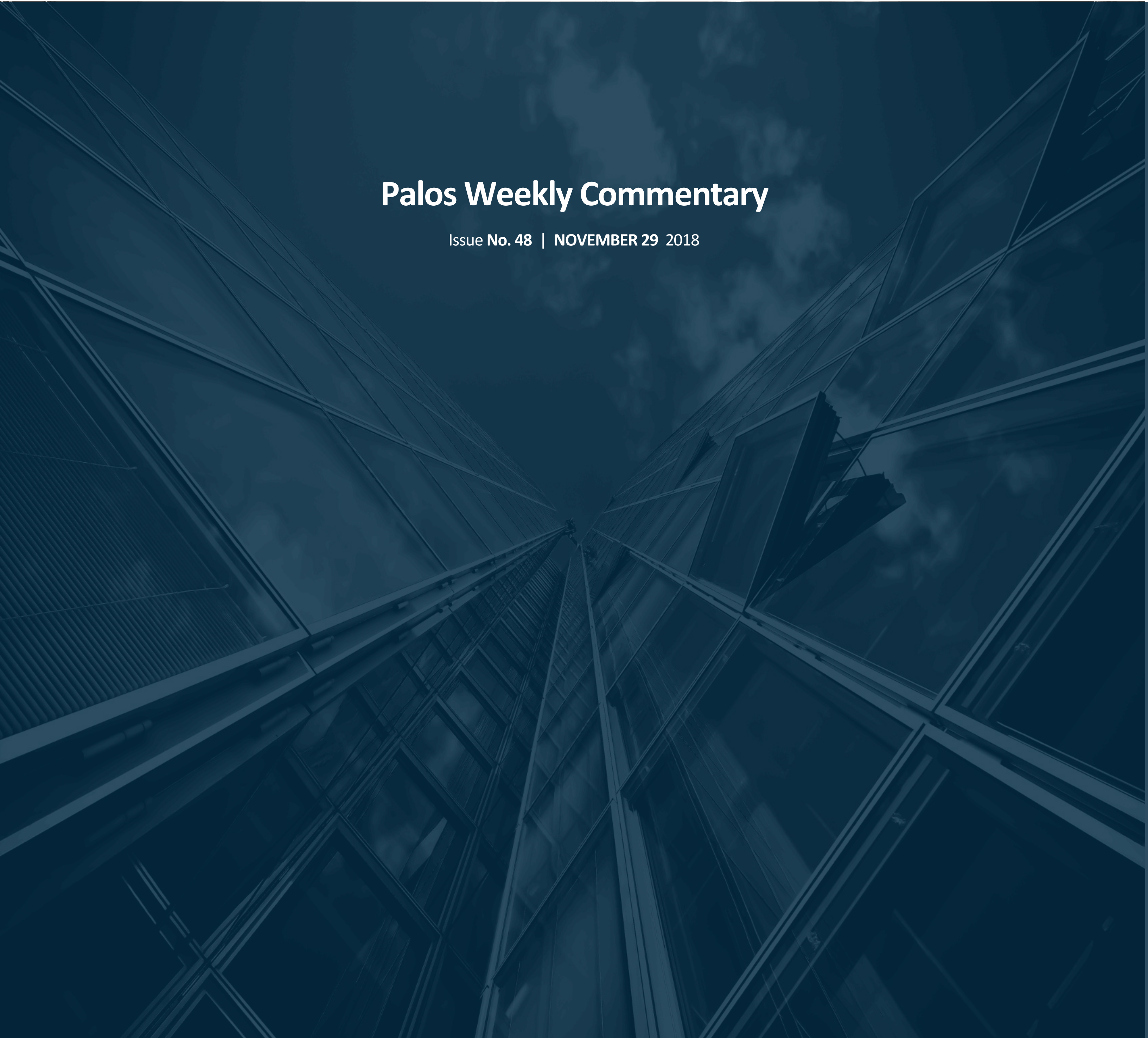
# Disclaimer:



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