marnoa
PRIVATE WEALTH

July 18, 2023

Mid-Year Update

I would like to announce our new team member and welcome Paul Thomas to Marnoa Private Wealth. Paul is an industry veteran and joins us as a Financial Planner. I also welcome his clients and look forward to meeting everyone in the near future.

Time flies when you're having fun. With half the year behind us, we are well into summer and the beginning of a new earnings season.

On a year-to-date basis (as of June 30), all of our mandates generated positive returns. For the first six months of the year ending June 30, 2023, our results are as follows:

Marnoa **Growth** mandate being the closest to all equity generated returns of +9.76% year-to-date compared to +5.7% for the S&P/TSX.

Marnoa **Moderate** mandate, which targets a 60% equity, 30% income/cash and 10% alternative, generated +5.26%.

Marnoa **Conservative** mandate with a target allocation of 40% equity, 50% income/cash and 10% alternatives generated +3.68%.

Marnoa **Strategic Allocation**, which follows a typical 60/40 model but uses only ETFs and the occasional mutual fund, was up +5.7%.

Monthly Activity

Marnoa Growth:
Buys – Constellation Software
Sells – None

We purchased Constellation Software in the Marnoa Growth mandate. We discuss Constellation Software in our "Company Highlight" section.

Marnoa Moderate:
Buys – None
Sells – None

Marnoa Conservative:
Buys – Hamilton Utilities Yield Maximizer
Sells – Emera

We exited Emera in the Marnoa Conservative mandate and replaced it with the recently launched Hamilton Utilities Yield Maximizer ETF. This product invests in Canadian utilities, rail, pipelines and telecoms. It utilizes a covered call strategy on 50% of the holdings, which in combination with the dividends from the underlying securities is generating a yield of approximately 13% annualized. The rationale to exit Emera was that it represents 7% of the ETF. By holding the ETF, we maintain exposure to Emera and increase income to client portfolios.

Marnoa Strategic Allocation:
Buys – None
Sells – None

Company Highlight

Founded in 1995, Constellation Software is a Toronto-based conglomerate that owns and acquires vertical market software (VMS) businesses. These are businesses that provide mission-critical software solutions in niche markets such as education, travel, automotive, hospitality, mining, healthcare, payments, among many others. Constellation is a well-diversified global company, with six operating groups (Volaris, Harris, Jonas, Vela, Perseus, and Topicus) in more than 140 vertical markets.

Over the years, Constellation has created significant value through the scalability of its decentralized M&A business model. The decentralized model allows investment decisions to be made by one of the six operating groups and further down to the underlying business units within the operating group. This model of decentralized capital allocation allows the business unit(s) to operate with agility and make small investments in VMS businesses using a disciplined

framework to capital deployment (>20% hurdle rates and returns on capital). Constellation has a long track record of executing this M&A playbook over two decades.

VMS businesses are great businesses. In general, they have high recurring revenues (over 70%), high margins, and highly predictable cash flows. Because they're mission-critical, switching costs are high, making customers unlikely to switch to a competing product or service. Moreover, VMS businesses have low capital intensity, which allows for excess cash flows to be used for acquiring other software businesses. According to RBC, the acquisition targets in Constellation's database total 40,000 VMS businesses, implying a large $200 billion addressable market and opportunity.

Constellation Software is a wide-moat business with a long runway for growth. The recent moves to spin-out sub-operating groups (i.e., Topicus and Lumine) have helped unlock value inherent in the business model. We believe Constellation will continue to execute its M&A strategy and compound capital at high rates over the long term.

General Recap

As we've written in previous letters, the strong performance in the NASDAQ and S&P 500, which are market cap weighted indexes, can be directly attributed to a handful of technology companies. But when the hood is lifted, the story is significantly different. The Dow Jones 30 and S&P TSX Composite, which have less exposure to technology, are great examples. These widely followed indexes significantly underperformed tech-heavy indexes in the first six months of the year, generating returns of +3.8% and +5.7%, respectively.

Adding to the challenging environment has been the rise of bond yields, which in turn generate negative returns for bonds (inverse relationship). To offset some interest rate risk and take advantage of decent yields, we have been buying short-term investment grade bonds at a discount and intend on holding them to maturity. It's important to note, as interest rates rise, these bonds may fluctuate in value—even dropping in some cases. But as they near maturity, the value of the bond moves closer to par and erases the loss. During the holding period, investors collect interest payments, and at maturity, they are repaid at full value. The bonds we've added are yielding over 5% per annum and in some cases 6%.

Making individual bonds even more attractive at this time is the potential to generate capital gains for non-registered accounts. Bonds are issued at $100 par. The coupon is the interest rate paid until maturity, and bonds mature at par ($100). Due to rising rates, older bonds are trading below par or at a discount. While the coupon does not change, the difference between purchase price and par is classified as a capital gain. So the annualized yield is actually a combination of interest income and capital gain. From a tax perspective, bonds purchased at a discount can be much more attractive than GICs or other fixed income products generating 100% interest income. Not to mention, bonds can be sold at any time, whereas GICs are typically locked until the maturity date.

To further reduce volatility and risk, we have taken advantage of rising rates from the Bank of Canada and hold high interest savings accounts with a guaranteed rate of over 5% and daily liquidity. As the overnight rate increases, so does the rate received on these types of products. On July 12, the Bank of Canada again raised rates by another 0.25%, and this increase will be reflected in this type of product.

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From a valuation perspective, parts of the market look expensive. In particular mega-cap technology companies. Some valuations are higher today than pre-pandemic levels. Yet interest rates have gone from nearly zero to 5% or higher. These valuations leave many scratching their heads, wondering what is driving prices.

Analysts use what is called a risk-free rate to determine the value of a company. In brief, the lower the risk-free rate, the more valuable a company should be as investors are willing to take on risk to generate a return. But the higher the risk-free rate, the lower the value of equities should be as investors are no longer willing to take on as much risk investing in equities when returns can be obtained risk free elsewhere.

The other head scratcher is the resilience of the consumer. A typical 5-year closed mortgage rate is around 7%. Two years ago, it was just under 2%. Variable rates were about the same, and today, they have tripled in some cases.

Yet, consumers seem to be hanging in. While cracks are starting to show, they do not seem to be enough for central banks to cut rates. In my view, we may experience higher for longer. Not increasing for longer, but higher for longer.

For the Bank of Canada to cut rates, we first need to hit the 2% inflation target. Then the central bank needs to believe the economy is entering or has entered a recession. While inflation is clearly weakening, the consumer and the economy (for the most part) continue to move along.

This earnings season may shed some light as companies report and guide forward, but for now, we remain cautious and very selective of the investments we hold or add to portfolios.

From a valuation perspective, I do see opportunities emerging in the small to mid-cap segment.

As I said in my previous letter, I say again in this one: A quality business, in our opinion, has a strong balance sheet to help it weather turbulent economic times. This type of business enjoys growing sales, high margins and pricing power and is a leader in its industries. The companies we hold are, in our opinion, quality businesses.
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As we look under the hood and identify businesses that have sold off significantly last year and continued to do so this year, our optimism as investors is growing. We are approaching a time when we will be adding to our "collection of great businesses".

"A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices."

Warren Buffett

Our 3rd Annual Investment Symposium

We welcome everyone to join us at our 3rd annual Investment Symposium. We will send out the invitation in a separate email this week, including the details on how to RSVP.

As always, please do not hesitate to reach out, should you have any questions or wish to discuss any matter in further detail.

Yours truly,

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OUR TEAM

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Performance as of June 30, 2023

Gross performance results as of June 30, 2023, for our discretionary model portfolios are as follows:

	Performance Summary (%) as of June 30, 2023							
Portfolio Mandate	3 months	6 months	9 months	Year-to-date	2022	2021	2020	2019
Marnoa Strategic Allocation	2.86	5.70	7.54	5.70	-12.70	12.38	18.01	15.78
Marnoa Conservative	0.92	3.68	5.54	3.68	-12.05	10.86	9.90	19.86
Marnoa Moderate	1.08	5.26	7.18	5.26	-13.55	12.92	20.79	25.52
Marnoa Growth	3.49	9.76	10.94	9.76	-17.26	15.00	29.74	28.70

The returns above are gross of fees. Individual performance may vary based on cash flows and fees. Performance figures for periods greater than 1-year are annualized. The performance data quoted represents past performance. Past performance is no guarantee of future results.

Disclaimer

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The returns presented are gross of fees. Individual performance may vary based on cash flows and fees. Performance figures for periods greater than 1-year are annualized. The performance data quoted represents past performance. Past performance is no guarantee of future results. The above performance data is current as of June 30, 2023.

Inception date is January 1, 2019 for Marnoa Strategic Allocation, Marnoa Conservative, Marnoa Moderate, and Marnoa Growth.

Generally, mandates with higher returns entail higher levels of risk. Investors should consult with their advisor prior to making an investment decision to help ensure their investments are suitable for their particular situation.

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