QWEST_ALPHADELTA CANADIAN FOCUSED FUND

Quarterly Investment Review

Q1 2018

Investing as it should be.

“A thousand miles and poles apart
Where worlds collide and days are dark...”
- from Skyfall by Adele

Commentary

This month China’s space agency informed the world that the defunct Chinese space station, Tiangong, would fall to earth. The problem is, we just don't know where. This event is what economists would euphemistically call an "externality". Cynics might claim this as proof of Chinese intellectual property theft, given the space junk was built on the same plans as the U.S. Skylab. The ill-fated American station haphazardly fell to earth in 1979, landing in the Indian Ocean, just missing Australia.

News today seems primarily designed for entertainment and sensationalism rather than thoughtful analysis. In the financial columns, there is no shortage of daily controversies that are purported to move the markets.

Over the past few weeks attention has focused on the burgeoning trade war between the United States and China. Headlines on tariff barriers have caused stock market volatility as investors handicap risks to businesses.

The past few decades have been notable for increasing globalization and dramatic growth of world trade. This has allowed emerging markets in general and China in particular to experience incredible economic growth. In the multilateral trade agreements underpinning the wave of globalization, the United States has consistently been the primary giver and other nations have been takers, none more so than China. The growing trade imbalance has been underwritten by fiscal imbalance, primarily Chinese ownership of what has become over three trillion dollars of short term U.S. treasury notes.

These imbalances, however, are becoming increasingly unsustainable. The Trump administration has floated a program designed to cut the the US’s $375 billion trade deficit with China, or $275 billion by China’s calculation. The $100 billion difference between them is made up of goods sent through Hong Kong destined for the U.S. and counted as Hong Kong exports by China. About a third of these are products such as cellphones, computers, etc. that are assembled from parts made elsewhere.

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But China is increasingly making these components domestically as the relevant knowledge base is transferred from foreign direct investment firms to local enterprises.

An example of China's aggressive trade behaviour can be seen in steel. US Steel alleges that the Chinese People's Liberation Army hacked into U.S. Steel, stole the proprietary formula for one of the company's highest value-added grades of steel and helped Chinese competitors make similar products.

Studies show that trade with the U.S. generates for China a current account surplus equal to 2% of U.S. gross domestic product every year. This amounts to a massive transfer of wealth and huge losses of manufacturing employment for the U.S. Manufacturing jobs are especially important since they tend to support a number of service jobs.

No matter how it is counted and by whatever means it is generated, the global trade situation with China looks increasingly unsustainable. The fix cannot come from U.S. tariffs or from China behaving better as a trading partner. Solutions are elusive and the political ramifications are unpredictable.

Inevitable trade balance adjustments will ultimately lead to fiscal adjustments and both make for heightened uncertainty. We are seeing the initial stages of what is likely to be a long-playing readjustment process.

A subtle but potentially more dangerous factor causing market uneasiness is the change taking place in the credit markets. One of the most challenging times for equity investment is during periods of contracting credit. Credit conditions are not tight at this moment: certainly not in Europe; nor in Japan; and not yet in North America. But there are worrying signs of change in U.S. Federal Reserve policy. Although it is opaque and difficult to judge, China could be said to be enacting credit-tightening policies as the central bank has clamped down on shadow banking and is attempting to stop the longstanding proliferation of debt.

Tight credit conditions are most definitively signalled by an inverted yield curve. This is an abnormal condition where short term interest rates are higher than long term interest rates, contrary to the time value of money. It reveals a desperate need for cash as over-extended borrowers seek to survive. We are not there yet but the differential between short and long rates in North America has shrunk to the lowest levels of the past decade. As the Federal Reserve finally embarks upon a program of policy rate increases with the only question being how fast and how long, credit conditions are going to bear careful watching.

CANADIAN FOCUSED PORTFOLIO

Canada has always been viewed internationally as a ‘hewer of wood and a drawer of water’ as basic commodities such as oil, gas, copper, lumber and uranium have been the most important drivers of growth while we have depended on trade for most finished goods.

While the energy sector may look undervalued in the short-term as stock valuations are depressed and oil prices stays firm around US$60-$65 per barrel, it’s a lot harder to make a good long-term argument in favour of the Canadian oil market and investment therein. According to the IEA, while the average price of West Texas Intermediate (“WTI”) is up an average of 18.8% over the past year, Western Canada Select (“WCS”) has risen only 5%, with the increasing spread between them causing capital investment to slow down. So Canadian producers are still only recovering their costs, despite the well-known rise in WTI. Further, though demand will no doubt increase short term, political will and the WCS spread will limit any foreseeable profitability growth – which makes oil investment impractical.

The movement in commodity prices (oil in particular) has always been closely correlated with moves in the Canadian dollar. But, in reality, financial capital is the most liquid and transferable asset. As US bond yields continuing to rise (though nominally), Canadian yields remain well behind our neighbour to the south as expected lower economic growth from worries about NAFTA have kept interest rates in check. The Canadian/US dollar spread widening accordingly as capital is drawn toward the higher yields.

With the economic peak behind us, our expectations of the Canadian stock market in general for the balance of 2018 is muted. Canadian yields remain well behind our neighbour to the south as expected lower economic growth from worries about NAFTA have kept interest rates in check. The Canadian/US dollar spread widening accordingly as capital is drawn toward the higher yields. We will continue to take advantage of the nascent volatility to more prudently trim or add to our positions when given the opportunity.

Performance

	Three Months	One Year	Two Years	Three Years	Since Inception
ALPHADELTA CDN FOCUS	**0.55%**	**13.05%**	**17.22%**	**7.84%**	**7.84%**
S&P/TSX Composite	-4.52%	1.71%	9.84%	4.07%	4.07%

With the S&P/TSX Composite Index down -4.5% in the quarter, there were few bright spots. Energy stocks were down -9.5%, with precious metals down -28% and steel stocks off -21%. Only two index sectors had positive gains – Technology was up 10% and Real Estate eeked out a small 0.5% gain.

Against this backdrop, our portfolio rose 0.55% net of all fund expenses in the quarter largely due to our US holdings – however, before fund expenses, our return was 2.11%. Over the past twelve months we have outperformed the index by 11.3% net of Prosperity fund expenses.

TOP CONTRIBUTORS (%)		TOP DETRACTORS (%)	
National Instruments Corporation	1.25	Gildan Activewear Inc.	-0.36
Align Technology Inc.	0.81	Altus Group Limited	-0.50
IPG Photonics Corporation	0.75	PrairieSky Royalty Ltd Common	-0.52
Intuit Inc.	0.66	DIRTT Environmental Solutions Ltd.	-0.76
S&P Global Inc.	0.66	Element Fleet Management Corporation	-1.11
	4.12		-3.24

Our top contributors were led by US holdings, specifically **National Instruments** and **Align Technologies**, as strong quarterly earnings report's incented investors.

Our detractors were led by **Element Fleet**, one of the worlds largest fleet management companies, and **Dirtt Environmental,** a designer and manufacturer of custom prefabricated interiors. Further comments on these holdings follow.

Portfolio Activity

	Current Quarter ($)
Market Value December 31, 2017	2,491,289.24
Interest Received	151.32
Dividends Received	5,951.28
Deposits	421,373.73
Withdrawals	-138,216.16
Portfolio Fees	-2,732.10
Change in Market Value	5,419.89
Market Value March 31, 2018	2,783,237.20

During the quarter we sold **DIRTT Environmental (DRTT**) from the portfolio. Further to our client note on the first business day of the quarter, we decided to exit our investment in the DRTT following a surprising announcement of a series of changes to its management team and Board of Directors. As noted previously, the top two executives were removed from their roles and external replacements were given interim titles. Our assessment of the changes was extremely negative. While we continue to believe there is value in their proprietary ICE technology and prefabrication manufacturing capabilities but it will be difficult for the company to thrive without proper leadership.

We also sold **Element Fleet Management Corporation (EFN-T)**. This was a rather small investment which did not work out well. The original thesis keyed to the potential of telematics did not change but as we got to know the company better we became uncomfortable with management.

We replaced these two positions with two new investments in Hexcel Corporation (HXL-N) and Brookfield Asset Management (BAM.A – T).

Hexcel Corporation has been in business since the end of World War II and focused throughout that time on innovative plastic composite materials with aerospace as a primary customer. Their products have excelled in light weight and durability which are increasingly prized as fuel efficiency and long service life grow more and more important. Hexcel operates 23 manufacturing sites around the globe and employs over 6000 people to generate approximately $2 billion of revenue. Hexcel has a long history of innovation and a deep well of intellectual property. Combining this with the increasing focus on light-weighting and durability along with novel material handling skills provides a very promising future for this company.

Commercial aerospace (72% of revenue) is the largest user of Hexcel's advanced carbon fibre composites. Since the introduction of novel production techniques in the 1970's, composites have grown to account for over 50% of the airframe in the latest Boeing and Airbus models. The benefits of composite materials are manifold but primarily relate to reduced weight along with greater toughness and durability than any alternatives. Recent advances in 3D printing and additive manufacturing are enhancing the applications and opportunities for composites even further.

The specifications for materials and components for commercial aircraft and for military and space programs are more rigorous than any other applications. The fact that Hexcel has the greatest number of aerospace qualified products of any composite materials manufacturer worldwide is testimony to the company's dominance of the premium grades segment of their line of business.

Hexcel is a leader in the Space and Defense market (17% of revenue). They are qualified on more than one hundred helicopter, military aircraft and space programs in North America and in Europe.

Industrial business (11% of revenue) takes advantage of Hexcel's broad spectrum as the most completely integrated composite solutions provider. Their range of capabilities cover all stages in the composite chain: materials (carbon fibre and fabrics); resin formulation (thermo setting prepregs', laminates and pultruded elements); honeycomb structures; molding materials and composite tooling; and adhesives.

The performance driven market segments of Hexcel's industrial business are Automotive, Wind Energy, and other specialty areas with a focus on Sports & Leisure and Marine. Reaching these diverse market segments is supplemented by Hexcel Official Distributors covering various geographical regions.

In all of their sectors of industrial activity, Hexcel enables products that meet the most demanding requirements and are known for their cutting-edge performance and durability. Additive manufacturing using rapid advancements in 3D printing technology and materials dovetails nicely with Hexcel's skills in composites.

Companies with high barriers to competitive entry tend to provide excellent investment returns over time. Much of Hexcel's revenue is sole-sourced and is well entrenched. The design of aircraft and wind turbines require regulatory sign-off and design inputs do not change over the many years of a production cycle. Vertical integration of Hexcel manufacturing processes which incorporate unique and proprietary elements is a further barrier to competitive activity.

All of these characteristics enable Hexcel to maintain a return on invested capital (ROIC) in the top quartile among peers. The company also enjoys exceptional operating cash generation, a key metric in our

valuation process. For both operating and financial reasons, we see Hexcel as an excellent candidate for long term investment.

Brookfield Asset Management is a unique Canadian entity. They manage real assets in real estate, infrastructure (transportation, water, communication, etc), renewable power, and private equity. The objective is to earn attractive risk adjusted returns over the long term for the benefit of both clients and shareholders. Interests are aligned with clients as Brookfield invests alongside them. Benefits are received both from fees managing assets under their control and from participation in the enhancement of asset value over time.

Brookfield manages an array of public and private assets and services for institutional and retail investors. Activities are carried out primarily through four publicly listed partnerships: (i) Brookfield Property Partners, (ii) Brookfield Infrastructure Partners, (iii) Brookfield Renewable Partners, and (iv) Brookfield Business Partners. This unique structure provides access to significant amounts of capital. There are almost 500 co-investors in their 250 billion of total assets under management. Brookfield employs 700 managers to look after these investments.

A strong capital position and broad operating skills enable Brookfield to pursue the role of a leading global alternative asset investor. This places them among the world's largest owner/managers of real assets with 70,000 people employed in 30 countries. The scale and structure of the business facilitates investment in sizeable, premier assets across geographies and asset classes that only a few global players are able to match. Brookfield is quite unique among Canadian based companies.

A couple of important features make Brookfield appealing to us. Firstly, alternative asset management has during the past several years become a mainstream activity for large pools of capital. This has been driven by the growing scale of investment assets and the lack of alternatives in the traditional fixed income market. Prolonged low long-term interest rates have driven pension funds, sovereign wealth funds, private equity pools, family offices, etc. to seek new ways to earn historic levels of dependable long term returns on capital. Real assets can provide this and Brookfield provides the vehicles by which financial entities can participate......for a fee. Estimates suggest alternative assets have moved up from 5% in 2000 to about 25% of eligible total assets today. This portion is likely to move up closer to half over the next several years as the scale of these assets continues to increase so Brookfield is a key participant in a growing investment asset class.

Another feature we find attractive is the entrepreneurial culture of Brookfield Asset Management and its partner enterprises. Putting their own capital on the line and owning meaningful 26% to 28% participation interests along with client investors means Brookfield thinks and acts as an owner rather than as a third-party manager with only stewardship of assets. Brookfield more closely resembles historical investment banking partnerships that have mostly been superseded by publicly listed entities focused on short term returns rather than long term client interests. We admire Brookfield's ownership culture and long-term focus.

For all these reasons we are optimistic about long term steady and attractive results from our ownership of Brookfield Asset Management.

Summary

After a year of slow but steady improvement throughout 2017 with lower than normal volatility, the inevitable has begun to happen. Market gyrations have spiked upward with dramatic gains and losses happening day to day and week to week.

The indecision manifested by this investor behaviour reflects at least in part the tug of war between corporate performance and investors notion of appropriate valuation. On the one hand, corporate earnings are at the best level ever. The expectation for S&P 500 earnings for 2018 (a composite of all 500 companies in this index) is around $150, a 20% year over year gain from 2017. On the other hand, as credit conditions tighten (a condition we describe in the preceding commentary) the valuation of these earnings will be compressed. Tighter credit leads to higher interest rates and higher discount factors appropriate to value a long-term stream of corporate earnings. This change of assumption leads to compressed present value in cash flow discount models.

We do not pretend to be able to predict the machinations by which this process may play out. All we can do is exercise caution (as we always do) and put our faith in the strong business models of our corporate investments. Whatever may transpire in the near term, these businesses have demonstrated the ability to take advantages of opportunities offered by adversity and emerge stronger over the medium and long term.