Perspective

Daniel L. Bain
Chief Investment Officer and CEO

Novel Coronavirus Pandemic Plunge Navigated with a Tactical Response to Reduce Risk

WE'LL BEAT COVID-19 TOGETHER

During this unprecedented and challenging time, I'd first like to thank all the frontline workers. Medical, emergency services, military, grocery, public transit, legislators, and the army of volunteers all deserve our appreciation. We would be nowhere without them all!

The pandemic is difficult for everyone; however, we will get past this challenge. We will emerge stronger and, despite adjustments, life as we know it will continue. We can't avoid the realities of this pandemic. Indeed, life is about facing and overcoming challenges.

Along the way, there have been and will be many hurdles. The most basic is keeping each other safe, including things like social distancing, getting tested (when available), and staying physically and mentally healthy. Critically, we must help each other, especially the most vulnerable. As we deal with various personal consequences, people need to buy groceries, pay rent and mortgages, and function financially. For many people and businesses, cash flow will be a severe dilemma. Fortunately, Canada has numerous government relief programs to assist, but it won't be easy.

During this pandemic, many things are out of our control. However, there is also much within our control, like how we protect our physical and emotional health. We can also control our investment decisions, where discipline is necessary. At Thornmark, tactical investing is designed to adapt quickly to changing economic and market conditions. Just like during the Tech Wreck in 2000 and the Credit Crisis in 2008, we quickly moved to protect portfolios as the threat of the novel Coronavirus increased. Likewise, as healthcare stability emerges, and opportunities to resume "normal" life commence, we need to be prepared for the economic reality and investment recovery. Below I explain how Thornmark's tactical investing adjusts risk to a rapidly changing investment environment.

CORONAVIRUS INSURANCE

To protect investments, we undertook a series of measures. First, in early February, we started implementing tactical "insurance" strategies designed to immunize portfolios from the novel Coronavirus uncertainty. We added hedge strategies to reduce, but not eliminate, portfolio risk. We used put options to protect the riskier portions of portfolios. Index put options, for example, are designed to rise in value when the stock market falls. The strategy was implemented to offset some of the losses resulting from a potential stock market drop, as turned out to be the case in February and March. While the short-term stock market outlook was uncertain, insurance helped to safeguard wealth without eliminating the opportunity for growth. While we continue to optimize strategies, option protection remains in place.

While technical details of our put option insurance strategies are beyond the scope of this Perspective, for those interested, we would be pleased to discuss this with you further.

THE VALUE OF INSURANCE

People generally have various types of insurance – healthcare, auto, home, life. However, for the most part, we don't buy insurance because we want to use it. Instead, insurance is designed to mitigate financial losses from medical expenses, car accidents, loss of income, etc. So how did Thornmark's tactical protection work out? Put options on indices, and some core investments, provided significant wealth protection. During the worst of the first quarter bear market, North American equity markets were down more than 30%, bottoming on March 23rd.[1] During the same time, the Thornmark Investment Funds Consolidated Performance[2] was down less than half the stock market decline. A significant portion of the outperformance of the Thornmark Funds is attributable to the put option protection, which provided roughly eight percentage points of protection. Looking at is another way, the tactical put protection reduced Thornmark portfolio loss by 35%. Although we would have preferred not to need protection, it was the right thing to do.

PROTECTION REMAINS OPTIMIZED

Since the March lows, stock markets have surged higher, up more than 15% by March 31st. While we expect the stock market recovery to continue, the healthcare and economic uncertainty mean it's prudent to maintain protection. However, protection can work both ways. As stock markets plummeted to cycle lows, we also had our eyes on what might come next, including upside opportunities. However, to keep risk relatively low, we added "halleluiah" protection. If widespread and accurate COVID-19 testing, treatment, and/or a vaccine were to become available, the stock market should rally as investors sigh a collective halleluiah. While uncertainty remains, rather than commit a lot of capital to a fast recovery, we are again using "insurance" to reduce the risk of participating in the stock market recovery. We supplement stock-picking with long-dated call options to participate in the relief rally in the event of a positive pandemic or other developments. Using this strategy means we forego some market upside, but it also means we have less money at risk, another way of protecting wealth during uncertain times.

READY FOR RECOVERY

With tactical downside and upside protection in place, portfolios are well-positioned for our base case investment outlook - COVID-19 will be sufficiently and sporadically contained. While there will likely be further outbreaks and spread, and economic reopening will be slow, curve flattening should prevent a healthcare catastrophe. However, there is a wide range of outcomes, including everything from social isolation failure to fast development of treatment and a vaccine. Therefore, amongst other things, tactical strategies remain focused on reducing risk using options to both protect wealth and participate in the upside.

COMPANY COMMENTARY

Two particularly exciting investments during COVID-19 are Cargojet and Amazon.

Since 2002, Cargojet (CJT) has operated a fleet of 24 cargo aircraft, transporting parcels and freight. It dominates Canadian airfreight with a 95% market share. The company is well-positioned to benefit from increased home delivery demand during mandated national isolation. CJT has long-term contracts ranging from three to seven years with Canada Post, Amazon, and UPS, including take-or-pay volume guarantees. Therefore, all-time high home package delivery demand is a significant financial benefit to Cargojet. The company also benefits from travel restrictions that effectively grounded global civilian aviation. It is not economical to operate empty passenger aircraft for cargo-only flights so, CJT is servicing additional flights to Asia and Europe. That is a big opportunity for CJT's on-demand business, which generates significantly higher margins as the company increases fleet utilization. Going forward, as the pandemic restrictions ease, changes in personal purchasing habits and financially distressed retail closures mean e-commerce should remain at elevated levels. High operating rates, sustainable new business, and lower fuel cost mean CJT's operating margins should materially exceed consensus expectations, boosting the stock price to our $150 price target. Therefore, Cargojet should provide more than 50% total return over the year ahead, with upside if e-commerce demand continues to accelerate.

Amazon (AMZN), one of the world's largest companies, is a global e-commerce and cloud computing behemoth. With a 39% share of US online retail sales through its vast assortment of products, low prices, customer service and fast delivery, Amazon is the leading e-commerce brand. Its Prime Membership fees subsidize shipping costs, and dense delivery routes are an enduring cost advantage. The company recently increased its workforce by 20% to handle the surge in new business, which will increase profitability. Many existing and new customers are using AMZN's premium Prime Membership service and trial grocery delivery in some regions. Like the 2009 Credit Crisis surge in e-commerce, we expect a high proportion of the new customers to be retained as people modify purchasing habits to take advantage of shop-from-home and delivery convenience.

Meanwhile, Amazon Web Services (AWS), its cloud computing segment with a 32% market share, will benefit from the shift to telecommuting and work-from-home. Telecommuting is becoming a more critical and sustainable business continuity strategy that AWS helps to facilitate. Consumers will stream more videos and games, also benefitting AWS. We expect consolidated sales accelerated from pre-pandemic 17-20% growth to 20-24%. At the same time, estimates suggest the S&P 500 revenues dropped 8%. While valuation is in line with its peers, Amazon's growth rate is 40% higher. The peer group traders at 19 x's 2021 EV/EBITDA. Amazon should trade at a significant premium to befit its dominant growth business model. Therefore, our target price of $2,900 is a four-point valuation premium of 23x 2021 EV/EBITDA, offering a total return of 50%.

David Barr

1. Local currency, S&P/TSX and S&P 500 indicies.
2. Thornmark provides the consolidated returns of the Investment Funds ("Consolidated Performance") to demonstrate the aggregated returns generated by the Investments Funds, or their predecessors, between 05/01/93 and the present. Please see full disclaimer for more details. O-class units, in Canadian dollars, with distributions reinvested and net of operating expenses and management fees.

This is not an offer to buy or sell any securities. The information contained herein has been obtained from sources believed to be reliable. Thornmark Asset Management Inc. and/or its employees and/or the Thornmark Investment Funds may at any time have an interest in any securities discussed herein. Important information about the Thornmark Investment Funds is contained in the Offering Memorandum, which is available upon request, and should be read before investing. Past performance may not be repeated, is not indicative of future returns, and does not guarantee future results. Unit values and investment returns will fluctuate. There are no assurances that the full amount of your investment in the fund will be returned to you.

THORNMARK ASSET MANAGEMENT INC.

Office: 416.204.6200
Toll-Free: 877.204.6200
Email: info@thornmark.com
Website: www.thornmark.com