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THE SCHOONER

The Official Newsletter of the Dalhousie Investment Society (DALIS)

Trade of the Month

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BComm'24

Position

On October 25th, 2022, Financials, Consumer, and Technology (FTC) placed a collar on Microsoft shares (MSFT) while the stock traded around the $250 level. This structure was covered by 1300 shares purchased on October 17th at an average cost of $232.90, with the collar being set up through the purchase and sale of 1300 November 18th options. We sold the $260 calls for a price of $5.95 and bought the $245 puts for $7.20 resulting in a net debit of $1.25 ($1,625.00 Total). The put options were sold on November 4th at a price of $29.50 while the calls expired worthless on November 18th. Thus, returning $28.25 per option or $36,725.00. This represents a return of 2260%.

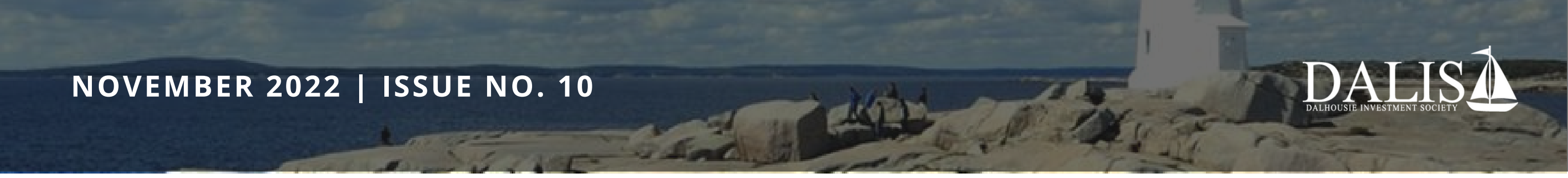
Rationale

Microsoft is the second largest technology company and the third largest company in the world with a market capitalization of over USD$1.8 trillion. The business generates over USD$198 billion in revenue sifting to roughly $73 billion in earnings ($9.28 per share). This stock was purchased in our portfolio as a value position. We believed that Microsoft was trading at a reasonable price and multiple when compared with historical levels, and so the business fit into our strategy assuming a longer time horizon.

Technology stocks have been darling investments over the past decade and even more so since the words "Covid-19" entered our lives. During the pandemic, people across the globe were forced to spend more time indoors, away from people, and so relied on technology for everything from work to school, to entertainment. The shift to working remotely forced companies to expand their software infrastructure and purchase the accompanying equipment necessary to facilitate increased demand. These new tech demands arose alongside a dramatic decrease in the cost of capital driven by the bank rate dropping to near zero at the same time as a large influx of currency entered the market through fiscal stimulus. The combination of increased demand and cheap money greatly benefited tech companies who expanded operations throughout the pandemic. Above all, these trends benefited the cloud storage business which is made evidently clear by the 94% growth Microsoft saw in its Azure service.

Since we already held a long position in Microsoft on the portfolio, we were able to use that position to cover our collar position – convenient. Moreover, since we had already experienced a seven percent gain, we entered the collar with a "max loss" over four percent. Given the current macroeconomic environment, our outlook on the share price of Microsoft was somewhat bearish in the short term, especially as the earnings date approached. We interpreted that the company would struggle with slowed growth across cloud, gaming, and software sales numbers as the world opened back up, a thesis informed by the Q3'22 shortfall in the other large tech names. We were concerned that the data would not meet that of the Wall Street analysts' expectations. And so, the collar position gave us the option of exiting the long position if numbers were surprisingly awful or at the very least, would give us the opportunity to lower our cost per share. Indeed, the released earnings numbers were as expected: below the analyst's estimates. As such, we decided to close the options position but maintain our long hold. Despite the difficulties Microsoft faces in the near term, both Microsoft and FCT remain confident in the business and still hold a positive outlook for the future given long macroeconomic trends. The Financials, Consumer, and Technology group were able to effectively reduce our Microsoft position's ACB from $232.90 to $204.65.

A Glimpse of What's Inside:



Wait, the Pandemic's Over?

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Dalhousie has resumed in-person learning, but if you walked into a classroom, you wouldn't think so. All semester I've been wondering, "Why is attendance so low?" Last week, there were 6 out of 52 students in my class. That is an attendance rate of eleven percent! I could see the disappointment on my professor's face when he asked me, "Where is everyone?" Before I could respond, he hit me with a follow-up question: "Are they all at home watching TV?"

I know for an absolute fact that my fellow classmates were not at home watching TV. I saw several of them in the library on my way to class.

So, if it's not that students have collectively and simultaneously stopped caring about physically attending class, what is it? I've discussed this with peers and professors, and today, I'm bringing you what I've found.

First, I need to make several acknowledgements:

1) My thoughts are observations, not facts.
2) Dalhousie University has hundreds of classes, I am a student in only six.
3) I've only experienced one year of university pre-pandemic.
4) I am in my fourth year, as are most of my peers .... we may all just have senioritis.

So, let's get into it. Why is class attendance so low?

The Learner

Could it be that COVID-19 has changed the way we learn? For two years we had the ability to pause a lecture at any given time, as many times as we wanted. It makes sense if a lot of us are struggling to keep pace in a traditional, in-person lecture. However, I don't think that's the main factor at play. Instead, I believe that COVID-19 has changed the way we think we learn. We've been students since we were five years old. Two years of online learning only makes up a small fraction of our student lives and is certainly not enough time to completely re-wire our brains.

Instead, I think our perceived value of in-person learning has diminished.

For those who excelled during online school, this force is even stronger, serving as tangible evidence that we do not need to be in a physical classroom to succeed. But what defines success? Does a high grade always translate into a high level of understanding?

The Teacher

The most obvious explanation is that online resources have become too plentiful, thereby reducing the value of in-person learning. There are so many reasons why an online option may supersede an in-person lecture from a student's perspective. I've already mentioned one, which is that students have adjusted to their own pace of learning and feel overwhelmed in a traditional class setting.

Since I've attended school, there have always been online resources. Although there may not have been pre-recorded online lectures, there have always been online textbooks, and I can recall that most of my first-year professors (pre-pandemic) uploaded their lecture slides.

I think the more likely culprit is the fragmentation of grading schemes. What I mean by this is that instead of having the bulk of your grade determined by midterms and exams, it's split between many assignments, discussion posts, papers, quizzes, mid-terms, and exams. In an online learning environment, this was an effective strategy. Frequent deliverables kept students engaged, and the dispersion of grading gave students more chances to demonstrate their understanding, effectively reducing stress in very uncertain times.

That said, "the state of emergency" is over. We are back in-person, and we have a lot less time. For example, I am currently in six classes. I did the quick math, and my classes account for 16.2 hours from Monday – Friday. Assuming eight hours of sleep per night, classes account for over 20% of my time. This may not seem like a lot but with weekly deliverables - often multiple - in each of these classes, I am often forced to skip class. Not because I want to, but to get my work done.

The Administrator

I don't have access to the information needed to make accurate conclusions concerning administrators. That said, it's worthwhile to raise the following questions: "Has COVID-19 changed the way professors have been asked to teach?" And "Has Dalhousie encouraged the fragmentation of grading schemes, thereby unknowingly encouraging students to skip classes?"

Why Should You Care?

By now, I hope you understand why I've chosen to discuss this issue, but if not, I'll tell you why. As students, professors, and administrators, we are all investors in Dalhousie. It's our duty to question the value of our investment. With participation rates as low as 11%, we are all losing out.

However, I raise these issues with optimism. I do think we can increase our ROI.

What Can We Do?

This is a multifaceted issue and thus, it requires a multifaceted solution.

Students: Avoid using your laptops in class. The temptation of distraction is too high, especially when we struggle to keep pace and have online resources to fall back on. In order to get the most out of class, you need to be 100% present. I had a professor last semester who prohibited the use of technology, and it worked. Despite initial resistance, the consensus among students was that this enhanced their quality of learning, from both a tangible (grade) and intangible (takeaway) perspective.

Professors: Restructure your grading schemes to incentivize attendance. Three possible ways of doing so are by including participation marks, in class assignments/quizzes, and adding or assigning more weight to mid-terms and final exams.

Administrators: Recognize this issue, and please, provide us with a viable path forward.

Strengthening of the Mexican Peso

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This year, the Mexican Peso (MXN) has strengthened against the US Dollar (USD) while the majority of G10 and EM currencies have depreciated against the US Dollar. The Mexican Peso is currently trading at around 19.34 Pesos per Dollar, up from 21.37 Pesos per Dollar in March 2022. I have identified three main factors, along with many smaller factors contributing to the Peso's strength.

First, global oil prices rose as a result of Russia's invasion of Ukraine. This geopolitical event was an incredible opportunity for Latin American countries, including Mexico, whose oil markets are usually shadowed by larger producers. In the first eight months of 2022, Mexican crude oil export revenue increased by 42% YoY to US$ 22.3 billion. When OPEC+ set a limit of two million barrels per day (bpd), many global economies looked to Mexico (which was part of OPEC+ and thus had to adhere to the limit) and Brazil for crude oil to replenish their reserves. The Russia/Ukraine factor in conjunction with the OPEC+ limit aided Mexico greatly. To capitalize further on high energy prices, Mexico reversed its plan to phase out crude oil. Prior to the recent reversal, Mexico intended to become self-sufficient and halt crude oil exports, and refined oil imports from the United States.

Foreign Direct Investment in Mexico has increased by 29.5% from the previous year. For the first nine months of the current year, Mexico received an inflow of US$ 32.15 billion. Of the $32 billion 45.2% was new investments to establish Mexico as a global manufacturing hub. The United States was the largest foreign investor, followed by Canada, Spain, Argentina, and Japan. Foreign manufacturers are investing in Mexico because it is the closest, and largest trading partner to the world's largest economy, the U.S.. With FDI at an all-time high for Mexico in the last 20 years, that massive inflow of money contributed to the peso's strength.

The active central bank is another reason the Mexican peso is so strong. In anticipation and response to the Fed, the Banco de México (Banxico) aggressively raised interest rates. Banxico started to raise interest rates in June 2021 compared to the Fed, which started raising rates almost a year later in March 2022. The spread between the interest rates has been huge. Because of the conflict in other parts of the world, Mexican markets have proven to be stable for investment. Therefore, carry traders have a fantastic opportunity here. Traders borrow in low-yielding US Dollars, to invest in the higher-yielding peso, resulting in increased demand for the peso, which helped push it higher.

Oil prices, FDI, an active central bank, remittances from outside Mexico, and proactive trade relations with the US have all aided Mexico in increasing demand for the peso, causing the price to rise.

Exports, remittances, and FDIs are the major contributors to the large inflow of money and reserves into Mexico, which has helped to strengthen the peso this year, while other currencies have depreciated against the US dollar. It will be interesting to see if the trend of an outperforming Peso continues in next year.

The 'R-Word'

If Only There Was A Crystal Ball

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No... I am not here to talk yet again about recession - not that 'r-word'. But rather, risk, the probability and magnitude of an event that can alter the expected outcome of decisions, particularly investment decisions. Risk is often thought of in negative connotations when in reality, there can also be good risks. As such, it should more appropriately be thought of as the possibility of good or bad things happening. This 'R-word' is one that engulfs the finance world and is baked into every trade, stock position, news article, and most other aspects of business or investing. Sometimes, we all wish we had some sort of crystal ball... but can we come close?

Risk Identification

It is not an exaggeration to say that simply acknowledging and identifying risk is ninety percent of the risk management field. Uncertainty is by far the biggest enemy of any investor; I mean, when was the last time you loved having absolutely no clue 'what comes next?' When approaching any investment, even most day-to-day decisions for that matter, it is crucial to identify the catalysts that can force a deviation from the expected outcome. Remember: risk identification is not limited to the analysis of downside-risks, but also the upside-risks too. By knowing what may push you positively from expectations, you gain the advantage of being able to influence desired outcomes indirectly.

Classification

Risk can take many forms and arise from most any parts of a business. Nearly all events can classify under one of the following types of risk: hazard, financial, operational, strategic, and ESG. Hazard risk is the threat to life, health, property, or environment. Operational risk is the possibility of failed processes, people, and systems that effect the flow of business. Strategic risk refers to internal and external events that affect objectives of an organization and can often be tied closely with financial risks as it could encompass mergers and acquisitions, market/industry, and macroeconomic changes.

As we are Dalhousie's Investment Society, I will center around financial risk, which is the focal point when investing in the markets.

Measuring and Analyzing Risk

Every activity, every decision, every investment: all encompass some sort of risk. Not every event has the same level of effect, probability of occurrence, or allowance of mitigation. Risk analysis is incredibly hard and requires a combination of art and science through both quantitative and qualitative approaches. By conducting such assessment, you can have a better idea of the possible events, their significance, and how much you should be paid to take on that risk. It is important to understand the various ways you might be able to deal with the identified risk, especially in regard to how it aligns with the values and objectives of the organization. From there, you can decide whether you eliminate, avoid, ignore, accept (for a price), or mitigate.

Financial Risk Management

Throughout the financial world, there can be endless variables to which an investor can be exposed. The magnitude can span from anywhere between global and individual security. The types of risk an investor can expect to encounter include but are <u>never</u> limited to:

- Currency Risk
- Credit or Default Risk
- Market Risk
- Interest Rate Risk
- Commodity Risk
- Sovereign Risk
- Inflation Risk
- Political Risk

Now you see this list and probably think, "Now why in the heck would I want my money exposed to these things?" While that is a valid question, a better question to ask would be, "How much should I be compensated for taking that risk?" The return in which an investor receives on their money is combination of the time value of money (risk-free rate) and the risk premium. There is a theoretical positive linear correlation between risk and return meaning an investor should accept a higher return for an increased likelihood of an outcome that different from what is expected. An investor can gauge how much they will receive in premium by deducting the rate at which government debt is trading at for a similar time period. Government debt is as close to a 'risk-free' investment as you can get, additional returns are generally a measure of the markets' perceived risk.

Dealing with Financial Risk

Now onto my favourite part of the risk management processes: mitigation. Risk is incredibly difficult to avoid, near impossible to eliminate, brave to accept, and beyond foolish to ignore. Most often, if it is possible, reasonable, and aligns with objectives, it is wise to make an effort to hedge against such events. This again is a delicate balance of art and science as excessive efforts to combat negative risk can end up increasing the likelihood or provoking the event to happen. This self-fulfilled prophecy (if you believe in that sort of thing) is called risk homeostasis.

Special instruments have been created to allow an investor to diminish financial risk. I am thrilled to finally introduce derivatives, which are securities whose value derives from that of an underlying asset. For those who do not know me, I love derivatives, and will struggle to wrap up this article before boring you with my overexcitement.

These instruments, although traded like an average security, are arguably more of a tool than an investment vehicle. Options contracts are derivatives that give the right, but not the obligation to buy (Call option) or sell (Put option) a specific asset at an agreed price on or before an expiry date. They allow for increased participation in the upside and protection from the downside risks of underlying assets such as equities. You can think of a call option as a rain check, where you can purchase a good at a specific price (hopefully for less than retail price) by a specific day; all for a premium. Conversely, you can think of a put option as an insurance plan that allows you to sell an asset at a specified price if something were to happen, again for a premium. These premiums (risk premiums) are considered the cost of the risk that the investor on the other side of the contract is willing to take on. Options allow for an investor to hedge against the risk of price movement. The applications of options are incredibly fascinating as they can be configured in many ways depending on the investors outlook on the market or underlying asset. See what I mean, now I'm worked up over derivatives and trying to finish an article whilst vibrating with excitement – yikes!

Wrapping It All Up

I will refrain from going too far and try to summarize the concept I am attempting to get across. Risk is a biproduct of virtually everything that you do, or in our case, invest in. Without risk in the financial markets, you have little to no chance of making additional returns or 'alpha'. Acknowledge the risk and respect it; do not avoid or ignore.

Seek to understand, minimize, combat, and monitor. We do not get the luxury of a crystal ball, and if for some reason you do, please send it my way.

Nova Scotia's Ongoing Venture

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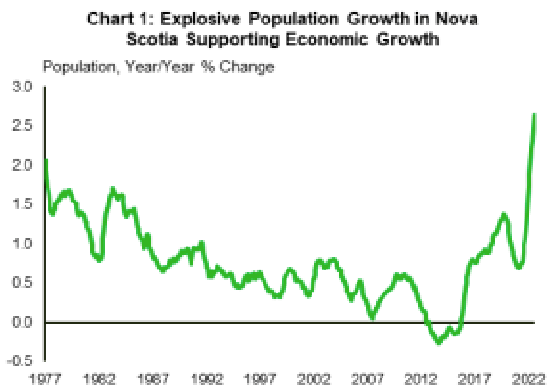
Since the peak months of the Covid-19 pandemic, Canadians began to realize what Maritimers have known for decades; that Nova Scotia may be Canada's gem hidden in plain sight. With the pandemic continuing to get further in the rear-view mirror, we see more people taking advantage of the opportunity to relocate from traditional big cities to smaller, rural areas. The gradual realization that hour-long commutes home after work, which should take 15 minutes, are in the past, here with the relaxing, laid-back lifestyle that Nova Scotia offers. But this isn't just the opinion of some Dalhousie student who like living within walking distance from the ocean. Believe it or not, for the first time since the 1940s, Nova Scotia grew faster than the prairie provinces. Nova Scotia's finance and treasury board stated, "Nova Scotia's revenues are projected to grow at a compound annual average rate of 2.6% per year while expenditures increase by 1.6% per year." With the ongoing population growth and increasing economy, they are bound to continue developing quickly, as shown below.



Source: Statistics Canada, TD Economics.

In Nova Scotia's past, there has been limited access for local companies to acquire venture capital. Until 2013, there was little funding available for early-stage companies, provided by Innovacorp, but its pool of acquired funds could only support so much. After seeing Nova Scotia's growth, especially in Halifax, one of Canada's fastest-growing metropolitan regions, with a population growth rate higher than that of Toronto, Montreal, or Vancouver, it was apparent that it was time for a change.

Former premier of Nova Scotia, Darrell Dexter stated, "The opportunities were segmented and relatively small. There was no pool that was particularly focused on Atlantic Canada," In response to that, three maritime provinces created a 32.5-million-dollar regional venture capital fund in 2013, Build Ventures, formerly known as Atlantic Canada Regional Venture Fund. This project aimed to fund companies that were in their infancy, with investments ranging between $1 million and $5 million on each venture. This project has been privately managed by Rob Barbera and Patrick Keefe and has thrived ever since.

In 2016 the government of Canada decided to hop on the bandwagon and partner up with the Atlantic provincial governments to continue Atlantic Canada's growth by creating The Atlantic Growth Strategy (AGS). Their goal for this project was to accelerate the growth of Atlantic Canada's economy. Their strategy has created well-paying middle-class jobs, strengthened local communities and grown innovative companies in the region. The AGS Leadership Committee met for the first-time post-pandemic in July 2022.

Their projected economy over the coming years, its venture funds, and the Atlantic Growth Strategy are in place for the right reason. Nova Scotia's ongoing venture to grow its population and economy will be inevitable. I may have come to Halifax for the ocean, but I can't wait to be a part of this province's prosperous future.

Time for the Little Guys?

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As 2022 boils to an end, many macroeconomic topics continue to haunt the already trepidatious psyches of investors. From inflation and the FED's tangled policy response towards combating it; lingering supply chain issues; recession talks; the energy crisis in Europe; the situation in Ukraine; and a sluggish Chinese economy, certainty and confidence are depleting. However, let me present an adage that offers some direction in this chaotic landscape: *time in the market, not timing the market, is what builds wealth.*

With that prelude behind us, let me introduce an investment strategy that appears increasingly desirable, both in terms of risk and return diagnostics.

Given the current investment environment, the question of where to allocate capital is a tricky one.

Investors are not only facing an excess of macro headwinds but also a historically unprecedented elevation of asset prices that transcends one single asset class (housing, bonds, stocks, etc.). However, despite this trend, small-caps have become notably cheap this year.

For the majority of the previous decade, small-cap stocks have been more expensive relative to both their own history and their typical multiples against large-cap and mid-cap stocks. Yet, in more recent years, a substantial lowering of small-cap valuations has occurred, with the asset class falling roughly 39% from their post-Global Financial Crisis peak versus the broader market. Within the US today, small-caps trade at a 21% discount versus their typical relative multiple against the total market.

The third quarter of 2022 proved extremely turbulent for small-caps. From the beginning of July through the mid-August high, the Russell 2000 Index gained more than 18%. However, this rally proved to be short-lived, reverting 17.5% from the mid-August high through the end of September. Sudden and seismic price movements over the short-term point to one narrative: investor psychology (in this case over macro factors) is the driver of asset returns, not fundamentals.

The Russell 2000 Value Index lost more than the Russell 2000 Growth Index in this year's third quarter, down 4.6% relative to a gain of 0.2%. Small-cap value lagging reversed the prior pattern—prior to third quarter 2022, the Russell 2000 Value had outperformed the Russell 2000 Growth for seven consecutive quarters. Additionally, both the brief rally and the quarter as a whole were dominated by lower-quality small-caps: companies with negative EBIT outpaced those with earnings. Considering this deviation from the historical trend -- which can be the closest thing investors have to a crystal ball -- small-cap value is poised to recapture its long-term historical advantage over its growth counterpart. For reference, as of the end of last year, the five-year annualised average annual return for the Russell 2000 Value was 9.1% relative to a gain of 14.5% for the Russell 2000 Growth. With growth's noteworthy underperformance so far this year, the spread has tightened substantially for the five-year period ended 9/30/22 when the Russell 2000 Value was up 2.9% relative to 3.6% for the Russell 2000 Growth. Further evidence of value overperformance relative to growth is the fact that over all five-year monthly rolling average periods since their inception (12/31/78), the advantage was firmly in value's favour: 11.9% versus 8.9%, respectively.

Another bullish indicator for the asset class as a whole is this irregular state of long-term small-cap performance at the end of September. For the periods ended 9/30/22, the three- and five-year annualised returns for the Russell 2000 were 4.3% and 3.6%, respectively. These respective long-term returns were well below their three- and five-year monthly rolling averages since the inception of the Russell 2000, which were 10.8% and 10.5%, respectively. Trailing three- and five-year periods have not had returns at or lower than these levels since March 2020 and June 2009.

So why is this pertinent? Well, small-cap's historical return dynamic shows that lacklustre return periods have been followed by above-average return periods, with a much lower-than-average frequency of negative return periods. Specifically, subsequent annualised three-year returns for small-cap from comparable trailing low-return entry points have been positive 97% of the time—that is, in 30 out of 31 three-year annualised periods—since the Russell 2000's inception, averaging 11.9%.

In conclusion, as the cheap capital and irrational exuberance that have been artificially propping up markets begin to fade, speculation will once again be replaced by fundamentals in terms of what drives investment returns. Small-cap value will be eager to outperform.

I think a necessary caveat to what I have highlighted is the importance of rigorous investment analysis and a fundamental approach to valuing the stock of these small-cap companies. Historically, high-quality small-cap companies have produced more substantial returns than the small-cap asset class in its entirety, all with lower volatility. Since 1976, small-cap quality has outperformed the small-cap asset class in the U.S. by 1.8% annualised and has also outperformed the all-cap U.S. market by 2.8% annualised. These more predictable, long-term winners are very often undervalued by the market, stifled by the buzz of stocks long on narrative and conviction but short on fundamental soundness.

America's Attention Problem

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On the morning of October 12, 2022, Adderall, the leading drug prescribed to treat ADHD was confirmed to be in short supply by the United States Food and Drug Administration ("FDA").

Almost immediately after the news broke, many were quick to jokingly draw a comparison between the shortage of the drug and the turmoil of many major names in the cryptocurrency space. Those who took part include none other than Elon Musk, who re-Tweeted and responded to a Tweet stating that, "Week two of global Adderall shortage and the entire crypto currency market has exploded." (@SCHIZO_FREQ, Twitter). Although the joking comparisons are comical, the shortage itself is anything but funny.

From a broad perspective, the shortage of the drug in the United States is as simple as supply not being able to keep up with demand. In 2021, there was an increase in Adderall prescriptions in the U.S. in-line with the decade-long trend which shows rising demand for the drug. However, the increase of 41.1 million prescriptions was 10% over the increase from the previous year, and represented a jump that manufacturers and the FDA were not prepared for. In hindsight, it actually comes as a bit of a surprise that neither the manufacturers nor the FDA anticipated the increased demand for Adderall. Given that millions of Americans were forced to work remotely throughout the pandemic, it was straightforward to assume that focusing for 8-hours a day from the confines of one's home might have dampened attentiveness and subsequently productivity. Beyond consistently growing demand, diagnoses for ADHD (the main disorder Adderall is used to treat) have become much easier to receive and much more prevalent over the past 10 years. This is made clear by the fact that during the pandemic - and continuing in its wake - there was a boom in startup pharmaceutical firms who diagnose patients for ADHD, with many of these diagnoses following one-time, 30-minute video appointments that are conducted entirely remotely. This new method of diagnosis spawned out of the social-distancing requirements of the pandemic environment. However, the efficiency of being able to see many more patients in a day has prolonged this method of psychiatric diagnosis which is outpacing the longer step-by-step process typical of the pre-pandemic, in-person world.

Often for manufacturing companies, increases in demand are not usually recipes for disaster unless they are matched with almost equal supply shortages. The biggest manufacturer of the drug, Teva Pharmaceuticals, has been in the spotlight facing supply issues since 2019 when they began experiencing labor shortages from the pandemic. These labour shortages are still affecting Teva. However, the company alone is not entirely at fault for the lack of Adderall supply to the U.S. drug suppliers. For obvious reasons, the import and export of drugs are heavily regulated and the FDA has restrictions and protocols that have to be executed before drugs can come into the country.

These regulations have pressured an already injured supply chain for Adderall, making suppliers and manufacturers even slower. This has led some health professionals to suggest that without improvement, the U.S. could be on the brink of another opioid-style crisis, as folks resort to illicit amphetamines in an attempt to facilitate the benefits they derive from Adderall.

Adderall is not a drug that can be easily replaced with other substitutes, and when those in need cannot get their fix, there is a potential for users to turn to other stimulates which could move millions to the illicit drug scene. Teva Pharmaceuticals has publicly stated that they expect the shortage to last until at least March 2023. This is coming from a company who has struggled to supply users since before the biggest increase in demand in over a decade, so we should take it with a grain of salt. Nevertheless, it is positive news that they have provided a timeline of when Americans may see the shortage soften. On top of that, the FDA announced that they expect the shortage of supply to Adderall in the U.S. could be over as soon as January 2023. Once Adderall manufacturers can fulfil demand at a better rate than they are now, millions of Americans will begin to receive their new prescriptions for their needed medication. So, what can we expect looking at the pharmaceutical manufacturing sector? For starters, many of these large Adderall manufacturing companies have yet to experience the benefits that often come from a massive demand increase for a product they supply. This is because they have yet to actually supply Adderall. As a result, there is potential in the sector for companies to increase revenues and therefore potential for investors to benefit from manufacturers whose stocks remain undervalued relative to these future sales revenues. Moreover, large manufacturers such as Teva are poised to capture even larger amounts of the market share for ADHD medications in an environment with millions of new consumers.

Entering the new year, Adderall supply is something to keep an eye on in the U.S., with consensus finding drug demand may continue to increase as diagnoses remain much easier to get than in the past. Hopefully, we can rely on the FDA and manufacturers to work hand-in-hand so they are better prepared for the continued increase in demand. For now, the fight against America's attention problem is far from over.

A Theoretical Overview of the Strengthening U.S. Dollar

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The US dollar has continued its bull run heading into Q4 2022, leading the way against many other currencies including the British pound (GBP), Japanese Yen (JPY), and the Euro (EUR). The strength of the US Dollar has lifted the currency to a 20-year high, while the Pound sits at its lowest point since 1985, and the Yen is down to 1998 levels. The Euro is no different, having dropped lower than the US Dollar for the first time since 2002. The thought of a stronger US Dollar sounds good, the same way steroids jacked up Ronnie Coleman to eight-peat Mr. Olympia; but currencies are not bodybuilders, and, in the end, everything has its consequences. Love you, Ronnie.

What Causes Currencies to Fluctuate?

Before discussing the negative impacts of a strong currency, lets discuss what causes a currency to move. It is a basic macroeconomic principle that the amount of currency circulating in any given economy that can be exchanged for another currency, and that this amount is constantly changing. The changing value of a given currency reflects how much governments, companies, banks, and individual traders who participate in these markets are willing to pay. In their most basic forms, supply and demand are what ultimately move currency markets. When the world needs more US Dollars, the value of USD will increase. It follows that when the value gets too high, demand will settle and drop back down towards equilibrium. Breaking the question down further there are more particular key influences that will shift exchange rates.

Interest Rates and Inflation:

Interest rates and inflation are connected to one another, and both influence exchange rates.

Inflation, the rising prices of good and services, can be healthy for an economy, showing increasing demand. On the flipside, too much inflation can quickly turn bad insofar as goods and services become unaffordable. In the case of runaway inflation, the central banks will introduce higher interest rates, increasing the cost of borrowing, subsequently cooling off rising prices. Put simply, when inflation goes up, interest rates rise and vice versa. On another note, higher interest rates can increase the value of a currency by attracting foreign direct investment which increases the demand for foreign currencies. (A more thorough breakdown of these dynamics is fleshed out in Arsh Merchant's contribution on the Mexican Peso.)

International Trade:

How a country trades with the rest of the world will impact the value of its currency. A country whose exports exceed their imports -- a trade surplus -- will tend to have a stronger currency
compared to countries with a trade deficit. In terms of the US, businesses outside of the US are purchasing American goods. To complete these transactions, foreign entities need to purchase USD which ultimately drives up demand for the US Dollar.

Indeed, many more considerations factor into the movement of a country's currency, but generally when a country shows strong economic growth and low debt, in other words economic stability, its currency will be in greater demand. On the flip side, countries with weak growth and higher debt levels will see weaker demand followed by a lagging price in their currency. This is not to say that growth alone will result in a strong currency. Emerging economies such as Brazil and India have strong economic growth forecasts, however, their currencies do not display the same strength as USD. This is because the growth in emerging economies tends to be explained by the performance of a few industries – generally in manufacturing – and often specialize in the export of specific commodities – unique to their geography. Fundamentally, this places emerging nations in unstable boom and bust situations, compared to more diversified economies such as US or Japan which tend to more stable.

What Caused the Strength of the Dollar?

The US Dollar can serve as a haven when markets turn volatile which we have seen so far throughout 2022. The US Dollar is unique in that it serves as the worlds "reserve currency". This means that central banks and financial institutions around the world hold large amounts of US Dollars to use facilitate international transactions. Using a single currency across the globe advances international investing and lending by eliminating the need to contently convert currencies.

Moreover, the strong economic growth of the US has been an adding factor to the currency's strength. The US economy is well on its way to recovering from the pandemic, and therefore, is much healthier compared to the still depressed economies of other countries. For instance, countries in Europe have been struggling immensely with high inflation and slowing growth driven by energy supply disruptions among other factors. This has moved money out of the Euro into USD.

The strong US Dollar is also represented in the broader views towards central bank policy. The US Federal Reserve is focused on slowing inflation and is adjusting interest rates more aggressively and methodically than many other central banks. Higher interest rates offer greater yielding bonds and other interest rate related products, attracting more foreign investment. Meanwhile in the UK, the Bank of England is struggling with high inflation and weak growth which culminated in the Pound falling to a decade low when a failed tax cut regime forced the Conservative leader out of office.

Why is a Strong Dollar Potentially Bad?

One of the apparent risks of a strong US Dollar is a threat to investors portfolios. US companies within the S&P 500 make up nearly half (44.4%) of overseas sales. As such, when it comes time for these companies to exchange their cash back into USD, they will get less money for their foreign currency. Therefore, a strong US Dollar will influence a company's revenues, earnings, and evidently their stock prices.

The rising US Dollar will also make it harder for non-US investors who are trying to purchase American stocks and bonds. As a result of the higher prices relative to their home currency, foreign institutional investors might decide against investing in American markets and choose to allocate their money elsewhere. If the Dollar gets too expensive, capital reallocation outside of the Dollar can drag-down demand for US securities.

Can a Strong Dollar be Good?

A strong US Dollar will make buying international stocks cheaper for US investors, which can benefit those trying to diversify their portfolio. International stocks have in the past outperformed US stocks and are not necessarily correlated one-to-one with US markets. Therefore, allocating a percentage of one's portfolio to international stocks during times of an inflated US Dollar provides a bargain opportunity and can distribute portfolio risk.

Another benefit of a strong US Dollar is that imports become cheaper as the value of one US Dollar increases. It is straightforward that each Dollar can buy more in other countries than it could previously. Although this will not make too much of an impact, it may help to soften the blow of the high domestic inflation in the US.

Can the US Dollar Keep its Strength?

It is expected that the US Dollar will continue its strength as the US economy continues to outperform other economies. While the Fed remains hawkish, meaning raising rates to aggressively fight inflation, their priority remains fighting inflation, even if this means interest rates will move up higher. As interest rates continue to rise, the value of the US Dollar will keep pushing upwards.

So, all in all, to any US travellers, pack your bags and hit the road! Whether it's to row a gondola in Venice, or a getaway to Margarita Island, your US Dollar will stretch further abroad and is better spent elsewhere.

Understanding the Long/Short Equity Strategy

Chris Lauer, Portfolio Manager; FCT

Generally, the long/short equity strategy is described as a long equity position (buying a single stock or basket of stocks) combined with short sales of stocks, indices, or derivatives related to equities.

In other words, the strategy aims to minimize market risk of the long position while profiting from its gains and (but not always), profiting from the short position.

The short exposure tends to have at least one of the following three purposes:

1. It can represent a bet that an overvalued stock will decrease in value in the near term;
2. It can be a hedge against the market risk of the long position;
3. It can collect interest (e.g., derivative premiums or interest rebates on short sell).

This strategy is popular among Hedge Funds, which tend to have a 'net long' bias, meaning they have more long exposure than short exposure. In bear markets, managers may reduce their long exposure and increase their short exposure. While not as common, some managers may even choose to be 'net short.'

Managers tend to take valuation approaches for their long positions. They may take the form of value/growth-oriented bottom-up approaches, fundamental (e.g., DCF model), or quantitative (e.g., Orthogonal Regression), among others.

By way of illustration, consider the following variations of a short position:

1. Long a basket of undervalued stocks and short a basket of overvalued stocks

   Take Waratah's Alternative ESG fund as an example. In 2022 they've averaged a 105/70 structure ('net long bias'). To clarify the implications of this structure, consider the following; they have $100 cash, buy $100 of equities, short sell $70 of equities, then use the short proceeds to buy $5 more of equities.

   The fund is highly diversified across sectors. As of October, tickers CNQ and CVE (energy sector) were their top weighted long holdings at 6.8%. For their short position, tickers XIU (9 sectors) and ZEB (financial sector) are their top holdings at -6.5%.

   Keep in mind - the long and the short could very well be in the same sector. Consider this illustration: you're long Ford, you're short GM. Both Ford and GM are American car manufacturers (highly correlated); therefore, given our buy and sell positions, the pair will have a negative correlation (enhanced diversification). However, be mindful that shorting a stock implies leverage is embedded in the position, meaning it is highly volatile, and selecting the wrong short position could dramatically impact return. That said, it is common to see portfolios of 100+ positions with concentration limits.

2. Long a stock and hedged downside risk with derivatives

Consider this Vertical Put Spread strategy: You buy 100 shares of Google for $100 each. You buy a put option (protective put) with a strike price of $98. This costs you $5 in premiums, but it gives you the right to sell your shares for $98. Thus, protecting your long position between $98 and $0. Rather than buying, you proceed by writing/ selling another put option with a strike price of $85 and you collect $4 in premiums from selling this. The result of buying a put option at a higher strike price and then selling another at a lower strike price is that now your long position is protected between $98 and $85 but offers no protection below that.

Do consider the expiry of the put options above. Managers usually have a pre-determined position time horizon along with an entry and exit strategy. There are many ways to hedge a long position with derivatives, and some other examples are index put options or even forward contracts.

Rick's Rant: Bay Street vs Las Vegas Boulevard

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During Reading Week, I took the opportunity to visit Vegas. It was my first time in Vegas, (except for a plane transfer or two), and admittedly Vegas was never on my list of places to visit. I was there with my wife for bit of a birthday party, to attend a convention and to meet up with some friends from our days living in Chicago.Yes, we stayed at one of the hotels on the strip – albeit a brand new hotel/resort – and yes, it had the mandatory casino, shopping mall, convention centre and big name (and massively overpriced) restaurants. In other words, it was stereotypical Vegas.

If you believe that Hollywood productions are real, then you will believe in Vegas. I have never been a fan of science fiction, and I guess that is why Vegas was never on my radar as an attractive place to visit.Everything is so over the top that it becomes a caricature of itself. Water fountain shows are cool, but in my opinion, they will not replace visiting the geysers in Iceland. A fire show, with an admittedly impressive sound system, is not the same as seeing a live volcano (score another one for Iceland). Don't even get me started on replica Eiffel Towers!

And then we come to the gambling. I have only ever visited a casino resort once before in my life. That was very early in my career when I was a representative for a pharmaceutical company, and we had a company offsite in Puerto Rico. I used my complimentary casino chips to play 5 hands of blackjack – the only gambling game I knew – at a table next to Don King and his army of bodyguards. For those who think my "beat-ups" in Advanced Corporate Finance are intimidating, try playing blackjack with Don King and crew!Note: if you are under the age of 50, then you may need to Google Don King.

Gambling in Vegas is front and centre. You simply cannot avoid it. At most tourist traps, everything goes through the gift shop; in Vegas, everything goes through the casinos. As you might infer from the previous paragraph, I am not a gambler. I have never understood the principle of joy behind playing a game in which you rationally know you will lose in the long run.Yes, I realize there are professional gamblers who lead glamourous lifestyles, but even a blind squirrel finds a nut now and then. Sitting in the casino while enjoying a fine Dominican product, I marvelled at the people frantically pushing buttons on the casino games. One older couple I watched were frantically pushing buttons at adjoining machines at such a furious pace that I was sure they were getting cramped hands. But to each their own.

I got to thinking that many people approach investing just like they approach gambling.Indeed, Wall Street is often compared to Vegas, and the Hollywood image of Wall Street types is not all that different from the Hollywood image of gamblers. It started me thinking of what exactly the differences between gambling and investing are. (If you are interested in going down this rabbit hole, I suggest you start with Aaron Brown's excellent book, "The Poker Face of Wall Street.")

To start, I am highly convinced that many investors are actually gambling. Looking at some of the "hot" social media sites for investment "advice", they are much more like horse racing tip sheets than anything they tell you about in the Chartered Financial Analyst program. "Meme stocks" are nothing more than Kramer overhearing about a hot "mudder whose mother was a mudder" racing tip on the NY subway.(Shout out to Seinfeld aficionados!)Many popular investing platforms (looking straight at you, Robinhood) take their design cues directly from the casinos.Many people get addicted to following their stock picks, just as avidly as those at the roulette table following the circling ball.

So, what exactly are the differences between gambling and investing? While watching the "action" in Vegas, I came up with several. Thus, the plan was to write the column on answering this question, but I realize I am running out of space, and Nick and Noah are brutal editors (that last bit is a lie, but it sounded good). So instead of my telling you my answers, I truly believe it is important that you come up with your own explanations for how and why your investing activities differ from gambling. Some things you really do need to think through on your own – and this is one of them.

So, to conclude, I will answer the question on everyone's mind; did I gamble? The answer is yes.

While waiting for our friends to join us for dinner (remember, all things Vegas go through the casino), my wife and I sat down and placed a dollar (a whole American dollar) into a blackjack machine. After five minutes of trying to figure out how to get the machine to work (people next to us just assumed we still had fresh bruises from falling off of the turnip truck), my wife and I managed to win five dollars. Both of us were kind of sheepish about this, so the next day at check-out, instead of cashing in our winnings, we simply gave the chit to the next people in line who were checking in. Their smiles and their laughs made it a good investment.

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