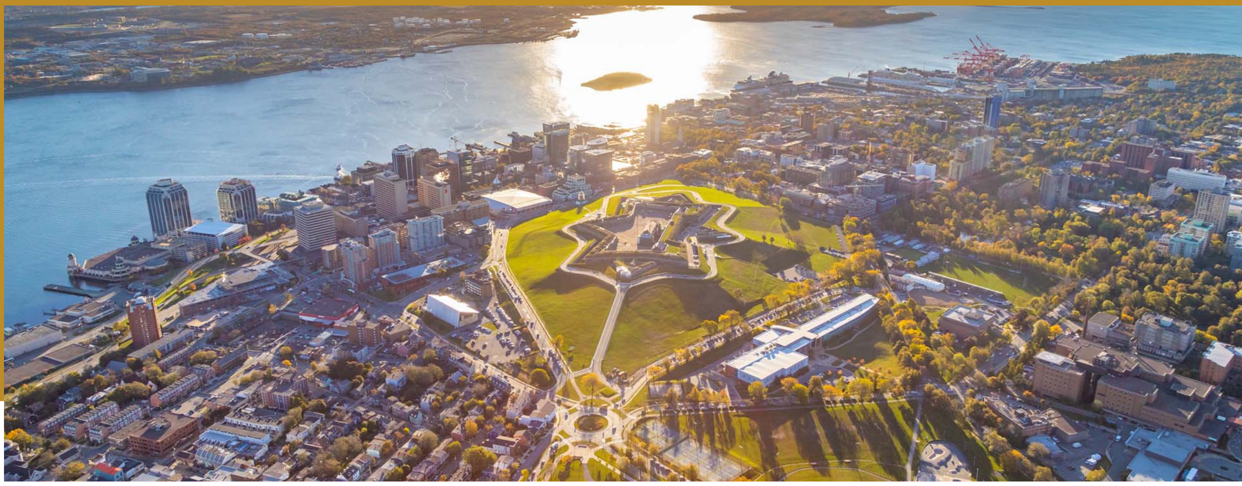
DALIS
DALHOUSIE INVESTMENT SOCIETY

February 2022 | ISSUE NO. 5

The Schooner



Trade of the Month

Position: Commodities currently holds 25 April futures contracts of lean hog valued at $106.075 per pound (LHJ2 CME). We initially purchased the 25 contracts at $95.70 per pound, reflecting an unrealized 10.8% return on investment.

Rationale: Inflationary concerns have veered commodity prices to multi-year highs, notably WTI and Brent both surpassing the $105 mark on March 1. Although our portfolio is well-positioned in energy, much of our focus in February was within livestock, specifically lean hog futures.

The cost of inflation is most felt in grocery stores as consumers have no other options. Similar to the inelastic burden of paying for gas, consumers have few alternatives of protein—considering pork is already one of the cheapest substitutes. The costs associated with farming, slaughtering, and transporting hogs has increased steadily with other livestock, primarily attributed to amendments made within the U.S. animal welfare act. The act mandates costly measures aimed toward increasing the well-being of swine. Some of the largest meat producers in the United States, including Tyson Foods, reprieve the mandate, reiterating that meat prices have already appreciated due to pre-existing supply chain issues, inflation, and should not further burden consumers.

Due to the organic increase of prices stemming from supply chain issues and systematic increase in price due to inflation, we equipped our portfolio with 25 generic April contracts at 40,000 pounds per contract and $95.70 per pound. Today, our position of 1,000,000 pounds is marked at $106.075 per pound— a ~11% return over the month. We remain bullish on lean hog futures as inflation continues to rise and as Russia, the world's fifth largest hog exporter, continues its invasion into Ukraine and sees its exports constrained.

Josh Franchuk, Commodities PM
BComm'22

A GLIMPSE OF WHAT'S INSIDE:

The World's Most Controversial Resource

Hedging Against Stagflation

Bond Market Messages (For Equity Investors)

The Growing Importance of ESG Investing

Book Review: Superforecasting

Rick's Rant: The Knowledge Commodity

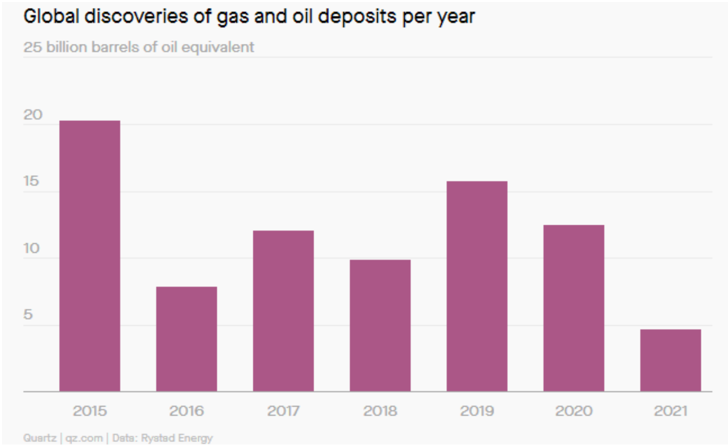
The World's Most Controversial Resource

Carter Cranmer-Smith

I walked through the quad on Dalhousie's campus earlier this month and was met by students calling for the divestment of fossil fuels from the university's endowment fund. They shouted as I passed that continued investment in Canada's top energy companies was destroying people's lives. This dangerous rhetoric of divestment from fossil fuels has unfortunately reached and influenced those who hold positions of power in both the public and private realms. The demonization of the oil and gas industry has resulted in a lack of investment to fund the exploration and production of the world's most important and controversial resource. Without oil, there would be no cars on the road or planes in the sky. Universities would be empty, and hospitals would close their doors. Practically every single aspect of the modern economy is reliant on oil. Unfortunately for Mr. Trudeau and Ms. Thunberg, oil is still the most important source of energy in the world. Although the age of oil will end eventually, the end is not as near as many think. Whether we like it or not we have become "Hydrocarbon Man".

Jeff Currie, Head of Commodities Research at Goldman Sachs proclaimed that "this is a molecule crisis. We're out of everything, I don't care if it's oil, gas, coal, copper, aluminum, you name it we're out of it." If you follow commodities, you'll have noticed that many futures curves are trading in super-backwardation. This structure indicates that traders are paying large premiums for immediate supply. When there is a downward sloping shape in prices it generally means that these commodities are severely undersupplied.

In 2021, oil and gas companies had their worst year for new fossil fuel discoveries since 1946. The proven reserves to production ratio is also at its lowest level since 2011. Without additional investment into existing fields, global oil production declines by roughly 7% per annum. While some of the investment has been shifted to renewable energy production, a large amount of capital has simply been deployed into entirely different sectors. How much is this investment shortfall exactly? JP Morgan's head of oil and gas research Christian Malek has identified a $600B shortfall of upstream investment that is needed over the next decade. This underinvestment is going to come back and bite the global economy before it is ready to transition to renewable fuels.



Yes, the transition to renewable energy is something that has to happen and will happen. However, it's not going to happen in the next decade or even by 2050. We simply do not have adequate replacement capacity nor the ability to store electrical energy at the metropolitan scale for long periods between generation and use. By bowing to renewable energy lobbyists and climate alarmists, investors and companies have created a unique environment in which the fundamentals have been completely ignored. It is not a matter of if but when we will see triple-digit oil prices. As such, DALIS is extremely bullish on the energy sector and thanks to the misinformation that convinced many that the end of oil is near, valuations have collapsed. Energy stocks are severely mispriced, and investors can get the free cash flow from barrels of oil to be produced in the future for virtually nothing. We recommend specifically looking at Canadian E&P companies. I'll admit that there is some element of political risk discount as our federal government is not the sector's biggest supporter, but at least we haven't been sanctioned by virtually every developed country in the world.

Hedging Against Stagflation

Spencer Osborne

Inflation has been relentless, and unfortunately for consumers it seems like this month will be no different. With traders pricing in a potential 10% inflation for February and end of year up to 5% (compared to the 3.3% consensus). combine this with the interesting recovery (or lack thereof in some cases) from the pandemic, stagflation is on the minds of many economists and traders ; mix this with the insanity that has been rising gas prices, it may be too little too late to get a grasp on inflation in the short term. Somewhat fortunately however, it appears that the Fed may be looking to target the inflation, taking a more hawkish stance many officials are now considering a 50-basis hike. This means however that equities will suffer, although not in the short term with these hikes priced in, but to reign in inflation the Fed won't stop at this one hike. As returns begin to come back in the area of fixed income, money will flow from equities to bonds again, causing downward pressure in the markets. With the markets already in a steep correction, this could create some significant volatility, causing some to speculate on a potential bear market heading our way.

It's important to remember the other aspects of the economy that these rate hikes will change, and how it affects the everyday consumer. These rates directly correlate to your loan and mortgage rates, something that in a world of high inflation (and potential stagflation) can cause significant issues for the Canadian economy. The average Canadian has a debt-to-income ratio of 1.73, or in other words for every dollar they make they have $1.73 in debt. This is a number that's sustainable precisely due to our low interest rate environment that allows there to be little interest gained on these debts. However, in a world of quick and consistent rate hikes this won't be the case for long. As these debts begin to have larger payments and more interest gained, this could quickly become detrimental to the economy as these debts become unpayable. This is often considered to be a large reason the BOC has been hesitant to take a hawkish approach. The current world of high inflation and geopolitics however will likely force the hand of the Fed and BOC.

Usually this can be mitigated by raising wages, if the debt payments raise but income raises to match it everything will equal out. However, this is the fear of stagflation, where the income levels don't rise to meet the raising costs of goods, services, and debts. So, what are we to do in the scenario of potential stagflation? Well, as usual we can try and derive some wisdom from history. The '70s had a period of harsh stagflation, beginning in 72 and stretching all the way into the 80s. One of the main aspects of protecting (and making) wealth in a period of stagflation is finding foreign assets, especially bonds, that are stronger than your own economy or even swapping out your currency for a stronger one. However, one of the most useful forms of hedging against this is to let your own money ride the inflation. What do I mean by this? Well, simply invest in the commodities that are inflating. In this way, you can ensure that your money, basically by definition, keeps up with the inflation. Common commodity hedges are gold and oil, but there are many other commodities that have had quite the run these past couple years, including but not limited to, coffee, corn, wheat, and lumber. You can easily see the thinking process here, as an average consumer you may notice the price increases when filling up at the pump, when buying a cup of coffee, when getting ingredients for a meal. The easiest way to ensure that your money can keep up with these raising prices is to invest directly into the prices that are rising. Another way to look to invest is in pure value, yes, it's not as sexy as growth stocks but there are many value picks that we've talked about in previous editions of the Schooner that can benefit from rising rates that often come with high inflation.

A more aggressive attempt to hedge against stagflation can be done with derivatives, in a similar concept of currency pairs or foreign bonds mentioned above. The idea here is that you can take out puts (or sell calls, depending your strategy) on the weaker economy and buy calls (or similarly sell puts) on the stronger economy. A similar strategy of course would be to take a look into bull call spreads or bear put spreads, however these can be a bit risky when talking about long-term macro changes thanks to theta burn. To save us all the headache, I'll spare you the discussion on the actual derivatives and leave the research to those interested.

So, let's take a brief attempt to actual grapple the important question here: what's the likelihood we even see stagflation? Well, in Canada GDP per capita peaked back in 2013, taking a steep dive in 2015 and 2020. Although it's projected to increase significantly through 2021 and 2022, this is in an environment of incredibly high inflation. So the short answer is, that while still unlikely for us to see significant or long term stagnation as we begin to leave the pandemic behind us and (hopefully) begin a strong global recovery, it isn't the worst idea to take some time to consider a hedge, especially in such an uncertain environment.

Bond Market Messages (For Equity Investors)

Jack Durno

There is an interesting relationship between stocks and bonds that often gets overlooked. It is useful for equity investors to analyze the bond market for potential messages about the health of the economy and equity market conditions.

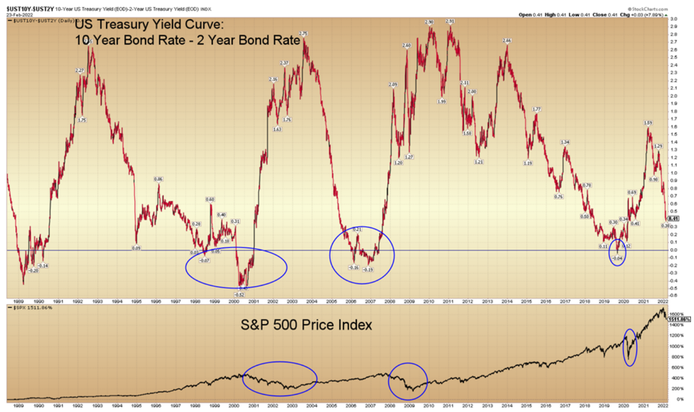
The central banks in Canada and the US have been open about their intention to increase interest rates, most likely starting in March 2022. Using market data, we can predict how many interest rate increases the market is pricing in for the remainder of 2022.

According to US Fed Fund Futures contracts trading on the Chicago Mercantile Exchange, the market (as of 23/02/22) is currently pricing in a 95% chance of 4 interest rate increases of +0.25% each and an 80% chance of 5 increases by December of 2022. In Canada, using similar data from the Montreal Exchange, the market is anticipating at least 5 rate increases of +0.25% each by December of 2022. The market is clearly expecting a steady path of interest rate increases during 2022 in Canada and the US.

We can see the impact of these expected interest rate increases reflected in the 2 year US treasury bond rate. Last year at this time, the interest rate on a 2 year US Treasury bond was about 0.15%. A year later, the 2 year bond currently sits at approximately 1.5%. This increase of +135 basis points is consistent with the expected central bank's interest rate hikes. However, the 10 year bond rate has only increased about 70 basis points in the same time period, half of what the 2 year yield has done. As a result, the difference between the 10 year bond rate and 2 year bond rate is now only about 0.4%. In other words, an investor only earns an extra 0.4% on their money when lending it out to the US government for 10 years compared to 2 years. That is a full 8 extra years of 'risk', which the investor is willing to sacrifice for only an additional +0.4% in interest. Is there a message from the bond market to equity investors in this very narrow 'spread' between the 10 year and 2 year bond rate?

One way to interpret this flattening yield curve is that the investors in the 10 year part of the market must not be as concerned about runaway inflation and continuing strong rates of economic growth. In previous historical periods, when the 10 year bond rate falls below the rate of the 2 year bond (an inverted yield curve), the economy has experienced an economic slowdown or recession in future periods (see Graph 1). In this graph, the black and red line is the spread between the 10 year bond and the 2 year bond (there is a line drawn at 0 so you can see periods of inversion). Notice the future S&P 500 equity market returns after the yield curve has inverted (blue circles). When the yield curve inverts, equity investors may want to take note of this due to its prior success at predicting recessions and difficult market conditions. We will point out that the yield curve is not inverted now; however, it is flattening very quickly.

As equity investors, we will remain focused on the messages the bond market tells us, especially as central banks start increasing rates. This 'game of chicken' between the long end and short end of the US treasury yield curve is an important one to watch during 2022. While equity investors are hoping for a soft landing of the economy - a successful series of interest rate increases without causing recession - there is a risk that central banks tighten too much and could weaken the economy more than expected. This is particularly true today as the economy is more sensitive to higher rates than ever before because of the larger than normal debt levels at both governments and households.



The Growing Importance of ESG Investing

Kyle Grabke

What is ESG Investing?

An investing strategy initially born in the 1960s has recently re-familiarized itself with investors following the COVID-19 pandemic. ESG investing is a strategy that focuses on the non-financial elements that investors use to evaluate a company's sustainability. The model highlights and scores a company's environmental, social and governance impacts. From a more general standpoint, ESG investing is based on the idea that good corporate behavior improves business results.

Where is the Value?

The value in ESG investing is derived from the prospect of long-term growth created from reduced risk. The COVID-19 pandemic highlighted this perfectly for investors. When the World Health Organization first declared COVID-19 a pandemic, the S&P Global Market Intelligence analyzed 26

ESG based funds from March 5, 2020, to March 5, 2021. In this year-long period, 19 of the 26 funds outperformed the S&P 500. These funds surged from 27.3% to 55%, whereas the S&P 500 rose by 27.1% in the same period. Furthermore, in 2021 alone, an estimated $120 billion was dumped into the global sustainable investment market. This more than doubles the annual record of net new money allocated in ESG investing that was set last year.

The reduced risk and promotion of long-term growth are generated by investing in companies that account for ESG risks in their operations. To begin with, although there are numerous ecological risks in this day and age, there are two primary environmentally-related threats that firms must address.

On one hand, consumer preferences will continue to shift towards more environmentally friendly products as the concern of climate change becomes an increasing issue in today's world. Companies that fail to produce products in a green way will experience increasing backlash from the market and likely a drop in sales and revenue.

On the other hand, this increasing interest in protecting the environment means less environmentally friendly companies will be predisposed to higher costs. This could pertain to higher taxes and fees imposed on emissions, lawsuits and fines resulting from environmental damage, higher borrowing costs, and even simply the cost of a damaged brand image.

Similar to the increased pressure towards preserving the economy, the social risks that firms now face have become more prominent in the twenty-first century. Workplace safety, data security, diversity and proper employee compensation are just a few of the numerous elements companies must now allocate more time and money. When these social elements are not addressed appropriately, businesses will struggle to get the best productivity out of their workers and attract and maintain employee talent.

The third aspect of ESG investing is related to governance implications. Governance risks are generally related to how the company is run. In most cases, when a firm fails to prioritize the shareholders, it will often pay the price. For instance, in 2016, Wells Fargo was involved in a scandal when the company created millions of fraudulent accounts without consent from their clients. Due to top-down pressure placed on bank employees to meet aggressive sales quotas, these fraudulent accounts were created. When the scandal first came to light, Wells Fargo faced an estimated $2.7 billion worth of criminal suits. As a result, investors experienced a 10% drop and a two-and-a-half-year low in the company share price.

What does the future hold?

ESG investing has been growing at a record pace for the past six consecutive years. Recently, COVID-19 reignited investors' fire and importance in utilizing the ESG model in their portfolios. As previously mentioned, numerous companies and funds with concrete ESG track records demonstrated lower volatility and risk than their non-ESG counterparts. As markets are now responding to the Ukraine-Russia affairs, and we are still experiencing the effects of the pandemic, having an ESG based portfolio will continue to be beneficial for the short term.

On the flip side, looking 5, 10, 15 years down the line, ESG investing and practices will continue to grow. The ongoing development in technology and data collection will improve investors' ability to obtain up-to-date analysis on the ESG rating of a portfolio, fund or firm. Moreover, one poll performed by Domini Impact Investments exhibited that among millennials, nearly eight of every ten investors say they are interested in adding an ESG investment to their portfolio within the next two years. As a result of this increasing development and drive towards ESG investing, firms that are not currently implementing ESG practices into their business operations will soon be forced to shift towards more sustainable practices.

Book Review: Superforecasting

Quinton Luck

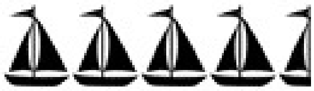
Superforecasting: The Art and Science of Prediction by Philip Tetlock and Dan Gardner is by far one of the best books I have read in the past year, albeit with a bit of fat that could have been trimmed along the way. As described in the book, we interact with, and rely on forecasts much more than we may think. We all know that opening the weather app in the morning to see if it will, in fact, storm on Friday again is a form of utilizing forecasting. In addition to that, technically speaking, you forecast your dinner when you decide to cook stir fry for the fifth day in a row (I'm not judging, I say it because I do the same). As DALIS members, we forecast when we pitch that a specific stock is going to hit X price by a certain date. A large portion of this book, however, refers to forecasting as a prediction surrounding the occurrence, or not, of specific global events. Think: Will Vladimir Putin cease to be the president of the Russian Federation before 1, January 2023? (this question is currently live on the Good Judgement Project website, and 235 forecasters have predicted the current likelihood of this happening to be 20%). The thing is, some people are incredibly effective at forecasting, and Tetlock and Gardner sought to find out why.

To do this, the authors created a tournament of forecasting and put it under the banner The Good Judgement Project. By performing some investigative analysis on the top performers of this tournament, Tetlock and Gardner were able to decipher a few key traits of a good forecaster (a Superforecaster, if you will), and the results of their analysis are then shared in this book.

I found the way the information is presented to the reader to be easily digestible, primarily due to the anecdotal stories. Through the use of these stories, we as the reader see how people like Doug, a retiree, is better at forecasting than not only his tournament competitors, but professionals who have more resources, information, and time than him. Pertaining to DALIS, the lessons spoken of in this book are easily transferrable when looking at something like the purchase or sale of a position for the Maritime fund. Things like being able to admit your errors and change course, gathering evidence from multiple sources, or in specific cases disassociating personal feelings from your decisions, can all be extremely beneficial traits to have when making decisions in the market.

Overall, I thoroughly enjoyed this book. The gamification of forecasting that occurs as a result of the Good Judgement Product tournament has me interested in potentially trying to make some forecasts of my own, all in an attempt to pit myself against the elusive group of Superforecasters. I also think the lessons spoken of in this book are highly applicable to day-to-day life as, after all, we are all forecasters whether we know it or not. The only gripe I have is that some information was repeated a bit too much, to the point that I think around 50-60 pages could have been trimmed off the book and the same message could have gotten across.

The pros of the book highly outweigh the cons, and for that reason **I am giving Superforecasting: The Art and Science of Prediction 4.5/5 DALIS Boats**



Rick's Rant
Rick Nason, PhD, CFA

I have been led to believe that this issue of the Schooner has a bunch of great articles dealing with commodities. Given that, I have a rant about commodities – namely the commodity of knowledge!

In a world in which the answer to any question that has a definitive answer is simply a “Hey Alexa”, or a Google search away, knowledge is a commodity. Furthermore, knowledge is a commodity that has little to no value.

That is something that we as educators, and you as students, and you as alumni often seem to forget – or perhaps never understood in the first place.

Knowledge itself is not worth much. It is what you do with that knowledge that has value.It is what you create with that knowledge that has value. It is how you reconnect disparate bits of knowledge to create disruptions or paradigm shifts that has value. It is how you use your existing knowledge to create new knowledge that has value.

To turn knowledge into something of value, you need to do something with it. You need to think. You need to dream. You need to ask better questions. Answers (see knowledge) are cheap. Questions – now there is something of value. With the right questions, it is trivial to acquire the knowledge. However, a person who never creates good (and novel) questions is akin to the person who does not read; they are no better off than the person who cannot read (as someone much smarter than me once said, but I am lazy and Carter is screaming for this article and it is last minute and I need to submit these typos and all with no time left to look up quote attributions …)

The knowledge worker is a myth based on the confusion between having knowledge and acting on knowledge. The knowledge worker is a myth that the educational community has exploited to great effect. No longer does a grade 9 education suffice to work as a mechanic on a manufacturing line. Now you need at least a full undergraduate as well as perhaps a graduate degree to do work that your uneducated grandfather did with likely much higher efficiency.(My own grandfather had a very limited education, and knew nothing about the theories of causation or effectuation but somehow, he was able to be a very successful serial entrepreneur. Amazing that he did that without a single BComm or MBA class!)

The reality is that the knowledge worker is being replaced by the knowledge bot. If you do not understand and appreciate the significance of the Turing Test, then there is a very high probability that you will be a victim of it.(Go ahead and Google "Turing Test" – I'll wait.)

In a VUCA world (again – look it up, or scream "Hey Alexa!" – there must be one within listening distance), knowledge is a commodity. In fact, and quite ironically there might be significant value in being humble about knowledge. Knowledge humility might be a scarce commodity that is increasing exponentially in value. Think about it.

Contact Information

Carter Cranmer-Smith, President
carter@dal.ca

Alex Saratsiotis, Vice-President
alex.saratsiotis@dal.ca

Quinton Luck, Executive
quinton.luck@dal.ca

Spencer Osborne, Executive
s.osborne@dal.ca