Canadian Equity

COMMENTARY Q3 2016

FRANK MERSCH | GERARD FERGUSON | RICK UMMAT

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MARKET OVERVIEW

Strong capital markets took most investors by surprise in the third quarter with both the U.S. markets (S&P 500 +3.85%) and Canadian (S&P/TSX +5.45%) powering higher. Given the events at the end of June (BREXIT), ongoing global macro risks, and the Fed beginning to signal higher rates, one would have expected a negative reaction with increasing volatility. In fact, the opposite has occurred as markets moved higher in relative uniformity while volatility probed new lows.

Although we expected capital markets to shake off the BREXIT vote, we were surprised how quickly investors put the expected impacts in the rear view mirror. The knee-jerk reaction of a plunge in the markets and an explosion in gold prices quickly reversed as markets turned their attention to future macro risks facing the economy and the Fed. With respect to this last point, the Fed once again deferred hiking rates in September, citing uncertainty with respect to global conditions; but it did indicate that conditions were improving which the markets took as an indicator that a December hike was most likely. Barring any global hiccups, we too anticipate an end-of-year move to hike rates, which —although indicative of strong underlying growth—is a departure from the stability we have experienced since the last hike in December 2015 (which was also expected, though it nonetheless caused a significant sell-off in markets).

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FUND MANAGERS:
FRANK MERSCH, GERARD FERGUSON & RICK UMMAT

Against the macro-economic backdrop described above, we were pleased with the very strong move in the Tactical Equity Class (+10.1%) continuing on the strength exhibited in Q2.

From a company-specific perspective, we would like to highlight two holdings:

Brookfield Business Partners (BBU.un) – A new name, BBU.un was added to the Fund over the past quarter and immediately had an impact. The company (founded by parent Brookfield in 2016 and spun out in June of this year) is the entity the conglomerate will use to own, operate and invest globally *outside* of their core focus of real estate, infrastructure and renewable energy. Crosslisted on the TSX and the NYSE, the company consists of a basket of mature cash-flow businesses with additional upside potential via special situations. Essentially, the company is a well-financed vehicle that will be used to invest in private equity strategies that can have a meaningful impact, with a target of 15-20% annualized returns. Although the vehicle is new, the positions are long established and the opportunities and management team are deep. In addition, their relationship with the parent (Brookfield Asset

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As at September 30, 2016[1]

YEAR-TO-DATE	ONE YEAR	THREE YEAR	FIVE YEAR	SINCE INCEPTION
16.5%	17.7%	8.2%	6.5%	6.4%

Management) will allow them access to situations and finances that typical venture capital teams cannot leverage. We look forward to commenting on their progress in commentaries to come.

Kinaxis Inc. (KXS) – First purchased for the Fund in Q2/2015, Kinaxis is once again a material contributor to Fund performance this past quarter. As a refresher, KXS is a provider of supply chain management and analytical applications for a wide array of customers. Specifically, KXS is a cloud based SaaS vendor that makes both short- and long-term supply and demand balancing decisions, enterprise-wide. In the following points, we explain why KXS remains a high conviction idea:

- Customer Testimonials – What better way to prove the effectiveness of KXS' technology than hearing it straight from customers:
  - Schneider Electronic - $200mm in inventory savings
  - First Solar - $100mm in inventory savings
  - Fortune 500 Co. - 35% improvement in inventory turns
  - Merck - "We realized we weren't going to be able to sustain our corporate performance without a platform like Kinaxis, because the supply chain is growing more and more complex."
  - Although some companies do not believe the solution can do what they say it can do, they are convincing skeptics. For example, Ford initially found the technology sounded *'fantastico'* and remained a skeptic... but they are now a customer.
  - The rollout with Procter and Gamble is getting more material by the day and the relationship with P&G is key as it will open more doors in the massive consumer packaged space.
- Valuation – Kinaxis is by no means 'cheap' (7.8x 2017e EV/Sales), which continues to be the only pushback on the stock. But in terms of tech stocks, expensive names supported by growth and industry-leading solutions tend to be the best bets. We acknowledge when compared to its high-growth U.S. peers, KXS looks fully-valued. However, in terms of growth we estimate KXS only has ~5% market share as the company has been expanding its recurring revenue base by ~30% over the past five years. So we think there is a clear runway for KXS to not only grow into its current valuation but also to surpass it materially. That said, we are aware of industry risk, as seen in February this year when the pullback in SaaS names took KXS down ~30% with it but has since rallied 100% since that low.
- Competition – In terms of competitors there are a few out there but most notable is SAP. From speaking to industry experts we are aware SAP is trying to become more prominent in the supply chain management space but the obstacle remains speed. Feedback from users is what KXS can do in one minute is what SAP can do in three hours. Simply, we believe SAP is light years behind KXS' game-changing disruptive technology and will have to invest materially to improve its overall product offering.

After a shaky start to 2016, capital markets, as well as the fund, have had a strong move off the January lows. Although we remain positive, based on the fundamentals of continued low rates, slow but steady economic growth and an improving global picture, we would expect market growth in the fourth quarter to be much more measured. Uncertainty regarding the US election is first up to create volatility. Expectations are that a Democrat win (Clinton) will result in a status quo with respect to markets, Fed activity and global relations. However a Republican victory (Trump) is expected to result in global uncertainty, a rally in safety assets (Gold) and a market correction. For the most part we agree with these short term reactions, and given we expect the status quo (Democrat) to prevail we have not positioned the Fund defensively, yet. We are however cognizant of the unexpected results of recent elections (BREXIT, the Federal Liberals and the NDP victory in Alberta) and will take precautions as the election nears. Once the election is behind us, the December hike will be up next on the radar screens of investors creating further uncertainty and opportunity. We continue to monitor these uncertainties and will move quickly to rebalance if we witness any significant changes.

Please note: Co-managers Gerard Ferguson and Rick Ummat are expected to leave Front Street Capital and join J2 Capital Management Inc. in mid-November (see press release on our website at frontstreetcapital.com), and Greg Taylor will join Frank Mersch in co-managing the fund. Frank has been a senior portfolio to the Tactical Equity Class since its inception.

FRONT STREET CAPITAL

33 Yonge Street, Suite 600
Toronto ON M5E 1G4

TORONTO 416.364.1990
TOLL FREE 800.513.2832

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[1]The indicated rates of return are the historical annual compounded total returns including changes in share value and reinvestment of all dividends and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Comparisons to indices and other benchmarks are inherently unreliable indicators of future performance. “NOT THE INDEX” is a registered trademark of Front Street Capital 2004.