TALL OAK
CAPITAL ADVISORS

Quarterly Report

2023

Q1

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In the first quarter of 2023, we bore witness to an almost inverse performance from that of the preceding year. Despite the challenging headwinds of a hawkish Federal Reserve (Fed), a downturn in global industrial production, a banking crisis, and volatile interest rates, the broad indices managed to end the first quarter on a positive note. However, markets were marred by high volatility and poor breadth as returns were heavily concentrated in a handful of sectors.

US

Despite the volatility caused by a regional banking crisis, the S&P 500 Index rose by 7.0% (USD terms), marking its second consecutive quarterly gain. The tech-heavy NASDAQ Composite Index performed even better, rising by 16.8% (USD terms) bouncing back after a 33.3% loss in 2022. Large-cap technology stocks made some of the strongest gains, rebounding significantly since the end of 2022. In fact, over 70% of the markets gains were attributed to the Technology sector, with Apple and Microsoft being the largest contributors to returns. Without Technology's significant gain during the quarter, the S&P 500 would have only been up 2.7%. Technology, Commercial Services, and Consumer Discretionary emerged as the clear winners in the first quarter, all posting double-digit returns. Banking issues dragged Financials down, while Energy fell, following a remarkable 59% return in 2022. Healthcare and Utilities, known for their defensive qualities, also underperformed.

Looking at commodities, most categories saw a decline in the quarter, with the exception of gold, copper, and other precious metals.

Quarterly Returns

Index or Proxy	%
EQUITIES	
S&P 500	7.0
Dow Jones Industrials Average	0.4
NASDAQ Composite Index	16.8
S&P/TSX Composite Index	3.7
iShares MSCI ACWI ETF	7.4
iShares MSCI EAFE ETF	9.0
BONDS	
iShares 20+ Year Treasury Bond ETF	7.4
iShares Core Canadian Universe Bond Index ETF	3.1
US SECTORS	
Consumer Discretionary Select Sector SPDR Fund	16.1
Consumer Staples Select Sector SPDR Fund	0.7
Energy Select Sector SPDR Fund	-4.3
Financial Select Sector SPDR Fund	-5.5
Health Care Select Sector SPDR Fund	-4.3
Industrial Select Sector SPDR Fund	3.4
Materials Select Sector SPDR Fund	4.3
Technology Select Sector SPDR Fund	21.6
Communication Services Select Sector SPDR Fund	21.1
Utilities Select Sector SPDR Fund	-3.3

Source: FACTSET, local currency terms unless otherwise stated

Canada

In Canada, inflation eased, prompting the Bank of Canada to pause its interest rate hikes and give time for the effects of previous tightening measures to permeate through the economy. Canadian stocks rose 3.7%, a solid return despite weakness in energy and bank stocks.

Europe

Eurozone stocks rose by 10% (USD terms) in the first quarter. European banks performed exceptionally well after years of underperformance. The unexpected improvement in weather conditions played a significant role in reducing fuel costs for many households and businesses, particularly in the UK. Nonetheless, concerns over inflation and the ongoing effects of the European Central Bank's interest rate hikes have exerted pressure on certain sectors of the economy.

Asia

In Asia, Chinese shares achieved robust gains, with the CSI 300 Index up by 4.6% [local currency terms]. This was due in part to loosened Covid-19 restrictions and better corporate relations with the government. In Japan, the Nikkei 225 also rose.

Fixed Income

Bonds were extremely volatile in Q1. Early in the quarter, both short- and long-term rates on US government bonds dropped as market uncertainty about economic prospects and inflation set in. However, this trend reversed in the middle of the quarter when Fed Chairman Jerome Powell delivered a highly hawkish statement, causing the rates of the 2-year Treasury note to soar to their highest level since 2006. This hawkish stance was short-lived, as a banking crisis hit the US on March 8th, triggering a highly volatile environment and causing rates to plummet dramatically.

A significant development in Q1 was the change in the 2-year to 10-year spread, which is an historical predictor of past recessions and closely watched indicator for potential future ones. It was highly inverted in early March and then became much less inverted. This shift suggested a potential pause from the Federal Reserve on further interest rate increases.

TALL OAK CAPITAL APPRECTION POOL

Q1 2023

Investment Objective

To achieve long-term capital appreciation with a focus on diversification and downside protection by investing across asset classes in Canadian and Global companies with market cap exceeding $500 million.

Investment Philosophy

The team employs a disciplined approach by combining a systematic and fundamental selection process that favours quality companies with growing earnings.

When building a balanced portfolio, the Fund will invest in a mix of fixed income securities and equities across a diverse range of regions and sectors.

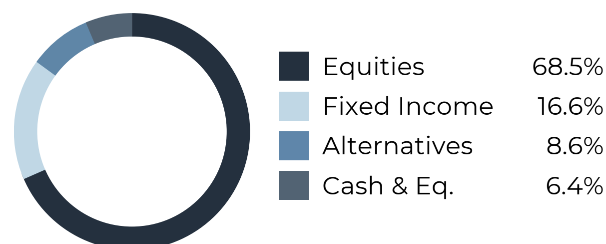
The team has flexibility with the asset mix, strategically taking advantage of market opportunities.

Current Positioning

Current Asset allocation is well below our long-term target of 75% for Equities and near the average equity exposure in 2022. Our decision to maintain our low equity exposure in Q1 is due to the changing economic environment and expected volatility.

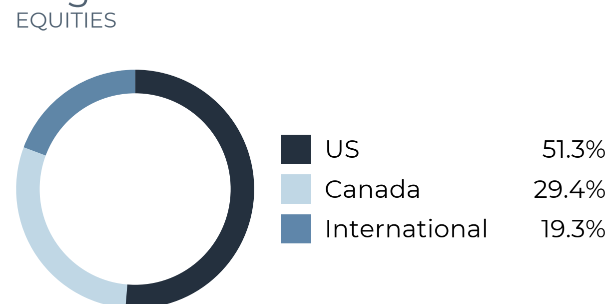
Equities and Alternatives are lower, while Cash is higher. Fixed Income has increased as short-duration, high-quality Investment Grade corporate issues are much more appealing, offering attractive yields. International equity exposure is also higher given their attractive valuations.

Asset Allocation



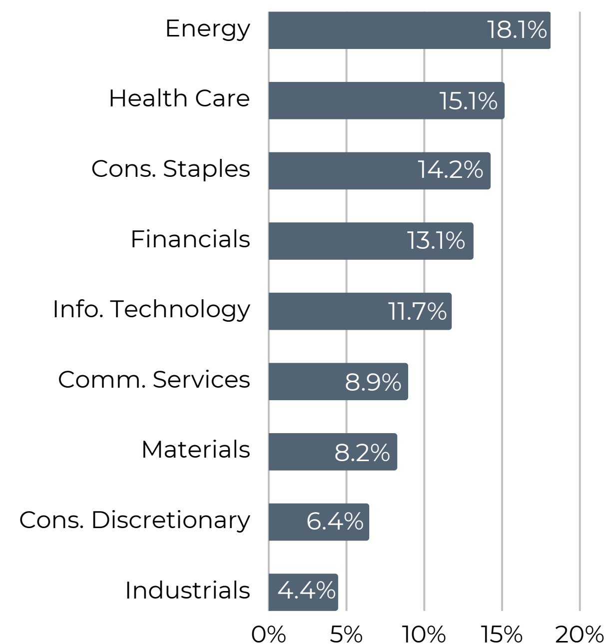
Regional Breakdown

EQUITIES



Sector Breakdown

EQUITIES



As at March 31, 2023

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TALL OAK CAPITAL APPRECTION POOL

Q1 2023

Top Positions

EQUITY	%
Activision Blizzard Inc.	3.4
Newmont Corporation	2.1
Novo Nordisk AS S/ADR	2.1
McDonalds Corp Ltd	2.0
Cameco Corp	1.9
Suncor Energy Inc. New	1.8
UnitedHealth Group Inc.	1.7
Berkshire Hathaway Inc. Cl A	1.7
Johnson & Johnson	1.7
Microsoft Corp	1.7
Canadian Natural Resources Ltd	1.6
Intact Financial Corp.	1.5
Freeport McMoran Inc.	1.5
Devon Energy Corp New	1.5
Autozone Inc.	1.4
Schlumberger Ltd.	1.4
Taiwan Semiconductor Mfg Co S/ADR	1.3
Pepsico Inc.	1.3
Costco Wholesale Corp.	1.3
Eli Lilly & Co	1.2

FIXED INCOME AND ALTERNATIVES	%
Picton Mahoney Special Situations Credit	4.3
Invesco Agriculture Commodities Fund	2.0
Royal Bank Bond USD 24Nov2023	1.7
Horizons High Interest Savings ETF Cl A	1.3
Four Quadrant Global Real Estate Partners	1.2

DIVERGING MARKET EXPECTATIONS

Global markets experienced a strong rebound in the first quarter, although it wasn't without volatility. Interest rates in the US and globally saw some of the largest and fastest movements in decades. Despite this, large-cap technology stocks remained resilient during this period of volatile interest rates. Lower rates at the long end of the yield curve generally benefit long-duration assets with long term growth.

Rates have been kept low in recent years as central banks around the world have lowered rates and implemented quantitative easing in response to various economic crises. However, as inflation spiked in 2021 and 2022, these same central banks have raised rates at a pace and magnitude that many long-duration stock valuations could not sustain. It is often said that the Fed will raise rates until something breaks, and the failures of Silicon Valley Bank and Signature Bank of New York may have signaled that breaking point for many market participants. Despite this, the equity market responded positively to the dramatic drop in interest rates across the curve.

On the short end, the 2-year Treasury note in the US moved violently and excessively, comparable to only three major market events in recent history: 9/11, the peak of the Global Financial Crisis (GFC) and the Covid-19 outbreak in March 2020. This level of volatility suggests the bond market's concern about the future of the economy, indicating challenging economic conditions ahead.

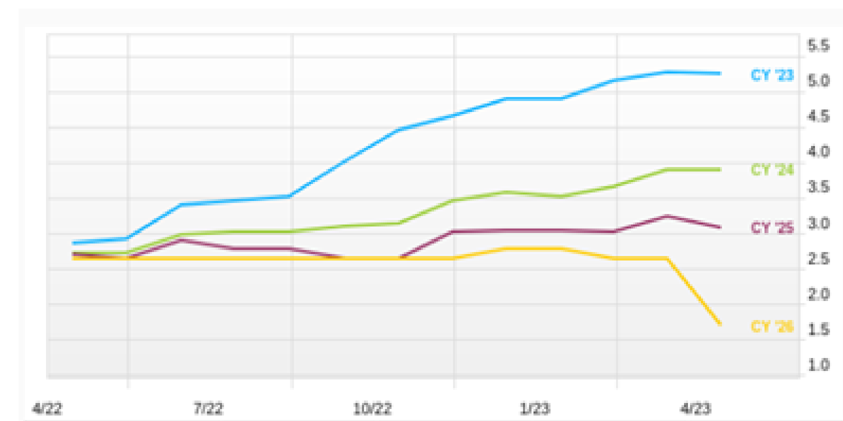
Moreover, as we have previously noted, there is a significant divergence between the Federal Reserve's communications and the market's forward rates. The market is pricing in large interest rate cuts for this year and next, with at least five cuts of 25 basis points expected by April 2024, as seen in the green line on the chart below. However, it is challenging to assume that this is entirely equity positive in the current economic environment.

US 2-YEAR TREASURY NOTE YIELD

Source: FACTSET, Period 30-Dec-22 to 18-Apr-23

FEDERAL FUNDS TARGET RATE

Policy Rates - Calendar Year Trend



Source: FACTSET Economic Estimates, 17-Apr-23

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Economic growth and inflation will need to slow considerably for this outcome to be realized, and it is difficult to envision the Fed cutting rates with such a tight labor market. Despite signs of slowing wage growth, the bond markets are pricing in a substantially different outcome from what the equity market is anticipating, as the Fed remains steadfast in their stance of higher rates for longer.

Our stance on inflation remains unchanged. There are structural forces at play in this cycle that have been absent in recent history. While a significant slowdown in economic activity may mitigate inflationary pressures, we maintain our view that as we navigate through this cycle into the next, the structural changes in inflationary pressures, or more specifically, the deflationary pressures of the past will diminish, resulting in a higher lever of inflation than we have become accustomed too.

Defensive, capital preservation-first approach

This dichotomy is at the heart of our decision-making process where we are focusing on high-quality, high-free cash flow generative businesses with reasonable valuations. Our defensive, capital preservation-first approach is at odds with the market's latest behavior, which has hurt our near-term returns. Nevertheless, we remain confident in our approach, as we do not believe the environment is such that investors should be overly aggressive in their positioning. We will discuss in more detail later in the report in the outlook and positioning section.

ECONOMIC CLIMATE

OVERVIEW AND ANALYSIS

In the first quarter, the Canadian and US economies showed strong performance with robust consumer spending, stubbornly high inflation, strong employment, and a stabilized services sector. Despite five consecutive months of contractionary industrial production in the US (a negative indicator), the North American economy remains in expansion. However, later in the quarter a banking crisis emerged that could have a significant impact on growth as tighter lending standards feed through the economy.

According to Morgan Stanley strategists:

> "[We've witnessed] the largest two week decline in lending by banks on record, as they simultaneously sell mortgages and Treasuries at a record pace to offset deposit flight. In fact, since the Fed began raising rates a year ago, almost $1 trillion in deposits have left the banking system."

This matters because it impacts the velocity of money and bank lending is crucial to the world's largest economy. While $1 trillion in deposit outflows sounds alarming, it is important to note that this is on a base of over $17.5 trillion. Most of this money is making its way into money market funds, where the owners of this capital are earning returns on their cash of nearly 5%, compared to the paltry 0.25% many banks are paying. Deposits are cheap funding for banks, so they need to do something to stem the tide.

According to Morgan Stanley strategists:

BANK DEPOSITS CONTINUE TO FALL AS MONEY MARKET FLOWS INCREASE

Ultimately a Headwind

Source: Bloomberg, Morgan Stanley Research, 02-Apr-23

The recent banking crises in the US and Europe stemmed from two issues. First, the inadequately managed duration risk in their capital portfolios. When faced with with deposit withdrawal requests, banks were forced to sell long-duration bonds at a loss due to the rapid increase in interest rates over the last year. Second, the industry's reliance on net interest margin for profit (achieved through low deposit rates and high lending rates) has left banks slow to raise deposit rates assuming that depositors won't seek higher returns elsewhere.

As we look towards the future, we maintain our underweight stance on banks, given our belief that a combination of deposit outflows and heightened regulatory scrutiny will ultimately limit their long-term return potential. Our primary concern lies in the gradual deceleration of lending growth, as lending standards tighten. In a recent exchange, the Fed Chairman was queried about the effects of such lending standards tightening on future Fed policy. His response is as follows:

> "...There's so much uncertainty... It is too soon to determine the extent of these effects, and therefore too soon to tell how monetary policy should respond" - Fed Chair Jerome Powell

The Federal Reserve is in wait-and-see mode but was confident enough that the inflation dragon was not felled to raise rates by another 25 basis points after the regional banks collapsed. The Bank of Canada remained on hold but reiterated that they may need to do more tame inflation. Market expectations are for another 25-basis point raise at the next meeting in May, with the market expecting this to be the last raise with the next move being down.

Short-term interest rates are not generally volatile, but this year has been an exception. The market started to price in lower rates at the beginning of the year, but a hawkish Federal Reserve meeting in early February caused the two-year Treasury yield to rise from 4.08% to 5.06% by the first week of March. The ensuing banking crisis pushed rates aggressively lower to 3.7% by the end of March, which is a significant move typically seen only during severe crises like 9/11, the global financial crisis, and Covid shutdowns.

Despite the volatile interest rate environment, the equity market sailed through the quarter almost unscathed. However, it is important to note that the bond market's pricing implies a significant slowdown in economic activity that will likely impact corporate earnings. As such, we believe that the equity market may have gone too far in pricing in rate cuts, and it may be premature to do so.

EARNINGS EXPECTATIONS

According to FactSet, global earnings expectations are on a downward trajectory, with S&P 500 earnings anticipated to drop by -4.6% in Q1 2023. Current projections for the year place the S&P 500 at 18.9 times this year's earnings or as of the time of writing, with expectations for the year now at $218.65. The last 12 months have seen a decline of 12.2% in expectations for 2023 earnings. Despite this, the market still anticipates a year-over-year earnings increase of a mere 1.3%.

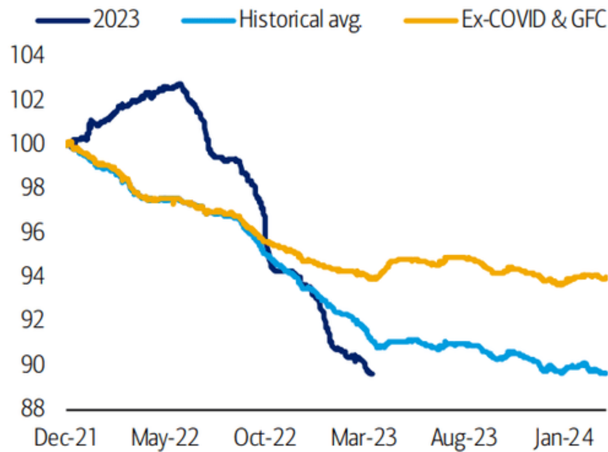
Given the persistently falling earnings expectations, we expect market valuation limits to be closing in. As we have been emphasizing for several quarters, high valuations in a challenging economic environment can be perilous to one's financial health. Although the markets have begun the year with a flourish, we anticipate earnings expectations will continue to decline. Thus, we remain broadly positioned in companies with low earnings variability and supportive valuations, despite their underperformance in Q1.

The Valuation chart below demonstrates the next 12-month earnings expectations in yellow and NTM valuation (P/E) in blue. Valuations have moved well off bottom, but with falling earnings and a potential recession looming, it remains to be seen if EPS has fallen enough.

Global earnings also remain under pressure but we have found valuations outside of north America to be increasingly compelling.

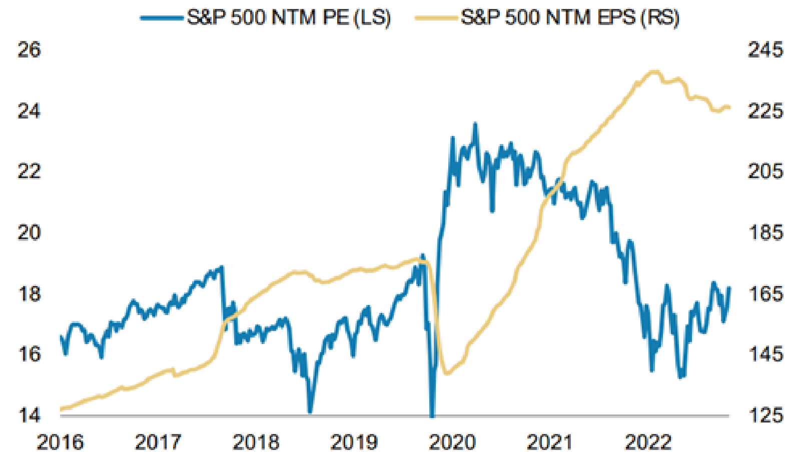
2023 CONSENSUS EPS IS FALLING OFF THE CLIFF, -13% SINCE JUNE 2022

S&P 500 historical FY2 EPS revisions v. 2023 consensus EPS



Source: BofA US Equity & Quant Strategy, FactSet; 2023 as at 09-Apr-23
Note: historical average based on 2001-2002

VALUATION BOUNCES HIGHER AS EPS CUTS CONTINUE



Source: FactSet, Morgan Stanley Research 31-Mar-23

Navigating the current economic environment has been a challenge, as the importance of certain economic indicators continues to shift in out of importance over time. Our top-down approach relies on a weight of evidence methodology, taking into account macroeconomic and leading indicators, leading economists' projections, and successful market strategists. We also consider market-based signals, such as what prices tell us about the current economic situation and its impact on risk assets.

In the global bond market, recessionary fears have been building, particularly following the banking crisis in March. While the credit market appears stable, the equity market has seen a rerating despite flat or falling earnings. This has made broad equities less attractive, especially given the signals from the bond market. We believe a well-balanced portfolio that diversifies across asset classes, sectors, and regions offers a better risk-reward ratio. In a market environment like Q1, which is highly concentrated and has low breadth, diversification was actually a hindrance. That's why our focus remains vigilant to risk and carefully positioning our portfolio in companies that we believe offer the best long-term opportunities for sustainable, risk-adjusted returns.

Since late last year, we have been overweight bonds, particularly short-duration, investment-grade Canadian and US corporate bonds. Yields for these bonds have reached levels that were appropriate for the risk level, something that was not adequately reflected in bonds or fixed income assets for a number of years.

Our focus has increasingly been on companies with high free cash flow and yield within the value cohort. While our investment philosophy traditionally favors growth stocks, we recognize that paying the right price for growth is crucial to long-term returns. As markets became more expensive, we shifted towards GARP (growth at reasonable price) strategies and added value positions, mostly from cyclical stocks to balance our exposure.

We sold our positions in Amazon, Apple, Google, Meta, and even Nvidia in late 2021 and early 2022 due to excessive valuations and, in some cases, deteriorating fundamentals. While the market proved us wrong in the short term, we remain cautious about chasing the last bull market's winners. The dichotomy between the bond market and equity market, as well as the limited breadth of the S&P 500 returns, highlights the challenges we have faced in 2023.

Apple

In the case of Apple, we grew concerned about the company's valuation relative to its long-term growth potential. While we hold Apple in high regard as one of the world's leading companies, the high valuatoion,

APPLE STOCK PRICE, JUN-21 TO APR-23

Source: Logarithmic 21-Apr-23

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along with the fact that almost a quarter of their sales come from China and most of their production occurs there, made the risk-reward unappealing in the medium term.

Meta

As for Meta (Facebook), the company's fundamentals were deteriorating. Younger users were leaving in droves, and Instagram was struggling to keep pace with Snapchat and TikTok. Additionally, the CEO was spending an unlimited amount of shareholder funds on a massive investment in the metaverse, which represents the next generation of social media. While our thesis initially proved correct, both Apple and Meta stocks rocketed upwards in the first week of January on the belief that the Fed would pause, and long-duration assets would have improved prospects.

META STOCK PRICE, JUN-21 TO APR-23

Source: Logarithmic 21-Apr-23

If you review the 2-year Treasury yield charts in this report, you will see that the moves higher in both stocks coincided with the move down in yields. Lower yields typically benefit long-duration and growth stocks. To their credit, Meta engaged in a massive cost-cutting exercise to shore up their fundamentals and improve profitability, which we believe is a credible plan. However, we prefer a cautious approach and will wait and see how large-scale restructuring plans work, as the first effort is usually not the last. Moreover, it remains to be seen what impact the cuts will have on an already deteriorating revenue line. Companies don’t typically shrink themselves to greatness.

We are highlighting these two names to underscore the fact that numerous large companies have bounced heavily on the hope of a change in interest rate policy. While this may indeed be the case, our risk appetite, which translates into taking risk with our clients' capital, was not sufficiently skewed in our favor to chase these market leaders. Our experience tells us to avoid chasing the last bull market winners.

These two examples represent what has transpired in early 2023 across large tech and the rest of the market. Less than 20 stocks represented the vast majority of returns in the S&P 500, with 480 stocks either not beating the market or ending down. Furthermore, the dichotomy between the bond market, leading indicators, and just about every macro indicator pointing to a slowdown, and the equity market are symptomatic of the challenges we faced in 2023 thus far. Our mix of growth at a reasonable price, quality compounders, and value cyclical stocks was on the wrong side of market risk in the first quarter.

From a thematic perspective, our Energy transition thesis hurt returns to start the year, as did our positioning in healthcare and healthcare providers. We had excellent returns in our semiconductor companies,

OUTLOOK AND PORTFOLIO POSITIONING

but we did not own enough large-cap technology, which we believe to be either outrageously valued or with poor fundamentals, to offset the poor returns from the above-mentioned large exposures.

In the first quarter, our focus on fundamentals, valuation, risk management, and capital preservation had a negative impact on our performance. Despite a barbell strategy that included high-quality healthcare companies, excellent consumer staples, and a smattering of idiosyncratic positions, the fund underperformed significantly. This was especially disappointing given our outperformance to the market's benchmarks and peers in 2022. Our job is to capitalize on favorable market conditions, but we misread the situation at the start of the year with our view that a banking crisis and tighter lending standards would lead to lower profit growth did not pan out. As the market continued to grow stronger, our approach proved costly.

At Tall Oak Capital, we believe in preparing for all eventualities, and we constantly re-evaluate our positioning and investments to build resilient, long-term portfolios that generate above-average returns for our clients. Although we face a challenging environment for the remainder of the year, we are confident that the collection of assets we have invested in has the potential to deliver positive returns through the course of the year. Our portfolio consists of outstanding businesses with high free cash flow, strong balance sheets, and long-term structural growth, which we believe will remain resilient to future market turmoil.

As we move forward, we will continue to evaluate each investment in the context of our long-term mandate of capital appreciation and maintain a keen eye on capital preservation when we believe that . risks are elevated. While there are inherent risks in the unknown, our experience tells us to be cautious when the equity market is exuberant, and the bond market is worried

Amidst the current economic landscape, we do see encouraging signs, including a robust labor market, a reduction in labor demand pressures, and an increase in real wages for the lowest 20% of income earners, among other stabilizing factors. While these positive trends may take some time to fully permeate and override the prevailing economic conditions, we remain vigilant to risks and alert to any conditions that may require us to re-evaluate our defensive position.

Thank you for your continued trust and confidence,

Your Tall Oak Portfolio Management Team

DISCLAIMER

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