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PRICES ON THE RISE

VIDEO #1: UNDERSTANDING TODAY'S HEADLINES

Kate, James, and Craig highlight what exactly inflation is, why it is dominating the headlines today, and how it compares to deflationary pressures.

Kate Mostowyk (KM): So, James, I am just going to start with an easy one for you. And just hoping you can talk about what exactly inflation is, and why it is dominating the headlines today.

James Arnold (JA): So, inflation quite simply is the rate of increase in prices over time. So, to think about an example of that, anyone who goes into the grocery store and buys a box of cereal, if that box of cereal costs more today than it did a year ago, that would be a very simple example of inflation. Using the same example of a box of cereal, another way that there could be inflationary pressures there is if the amount of cereal in the box was actually reduced over that period of time, and the price was the same. So

that's actually a trick that food companies have been using for years to sort of hide inflationary pressures within their products. Now, why has inflation been dominating the headlines recently? It's primarily because the CPI index, or the Consumer Price Index, which measures inflation, has generally been explained to us as something that should come in around 2% annually year over year.

> **The CPI is sort of by definition a very broad measure of prices in the economy. And what that means is that it doesn't really represent any single individual in the economy."**

So, we should expect to see price increases of 2%; however, over the last several reporting periods, we've seen numbers in Canada north of 4%; in the U.S. numbers north of even 5%. And so these are inflationary prints that we have not seen for a very long time. And that is why inflation is currently dominating the headlines.

KM: You mentioned the CPI index, and I saw today it was just reported that the September CPI index has increased to about 4.4% from August, which was at about 4.1%. Should we actually be paying attention to the CPI index?

JA: So, whether or not we should be paying attention to the CPI index is a bit of a complicated question. The short answer is: Yes, we should be paying attention to the Consumer Price Index. It is a broad measure of all prices in our economy. It is one of the primary tools that policymakers use to assess the economy and determine what to do with things like policy interest rates. What we need to be careful of with the CPI, though, is applying that directly to our own life or our own situation. The CPI is sort of by definition a very broad measure of prices in the economy. And what that means is that it doesn't really represent any single individual in the economy.

And for a lot of people, it actually tends to differ quite significantly from their own personal situation. And I thought it might be helpful if I could give a few examples of why the CPI differs from our own situations or our own expectations.

So anyone who's been living in Canada, specifically Toronto or Vancouver, over the past little while has heard ad nauseum about the increase in real estate prices. And one would generally expect that to filter through into a cost-of-living calculation, and it doesn't really. And there's a reason for that. It's because the CPI considers a house purchase to be an investment and not consumption. And so house prices directly are not included in the CPI. CPI uses a different data series to try and impute increases in housing prices, and that's called owners' equivalent rent. And so it's basically the idea of: If I were not living in the house that I own, what would I be able to rent that house for?

So, that's how it tries to get housing price data into the CPI. The problem is that, over time, owners' equivalent rent has significantly understated the increase in real estate prices broadly. Using the U.S. as an example (they have very good data on this information), owners' equivalent rent has understated the house price index according to a specific housing price index by approximately 1% annually for 35 years. So, the compounding effect on that is pretty significant. So, somebody looking to buy a house in Toronto may look at the CPI and say, "Oh, well, it's 4% or something, but housing prices are up 20% in the last year. How does that make any sense?" The reason is because the data series that they use within the CPI is significantly different than actual housing price data.

Another point of contention within the CPI that I think we hear of a lot is from parents of university-aged children. Costs for university have been increasing steadily – not only tuition, but room and board, food, textbooks, etc. However, this makes up a very, very small component of the CPI, approximately 2% of the calculation, whereas for a lot of families with one or perhaps multiple children in post-secondary education, that cost may represent a much more significant portion of their income. And so, again, the connection between the actual CPI number and any individual's situation is tenuous at best.

KM: Perfect, thank you. So just wanted to kind of go to the other side of the spectrum with deflation. And, Craig, you're our resident expert on deflation after all your years investing in Japan. So, Craig, can you tell us exactly what deflation is? And is it something that we also need to be worried about right now?

Craig Pho (CP): Yeah, the topic of inflation is interesting to me, because I've been investing now for more than 20 years, and

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what I have experienced has been not inflationary pressures, but deflationary pressures. And really, it’s the opposite of what James is saying: it’s prices sort of in decline year by year, maybe not by large amounts, but a steady sort of drumbeat of price declines. And I guess you should be worried about that too because, as owners of companies, it’s very difficult to grow when the prices of your products and services are in decline. You have to offset those price declines with volume growth, and that’s difficult to do in a competitive environment.

But it’s interesting how the central bank community, policy-makers in general, view deflation as sort of something that we as a society can’t handle. It’s very damaging, I think, to the banking and financial community when you think of the assets in which you own, particularly housing, falling in values. That is something that is pretty devastating for consumer confidence. And the other aspect, just quickly, that’s interesting is there’s a psychological element to all of this. When you expect prices to increase, you perhaps make purchasing decisions in advance of when you actually need product. We see companies now ordering perhaps more than what they would need because they expect prices to rise. And in deflationary times, it’s the opposite. People delay purchases because they feel like they can make those purchases at less cost down the road. So, there’s this sort of psychological element that factors into all of this.

KM: James, I’m going to come back to you. I know this is sort of the million-dollar question you’ve written about it in past commentaries. I think we’ve all read: Is inflation temporary? Is it permanent? We see the words everywhere, anytime there’s a headline about inflation. So how much of the current increase in the rate of inflation do we believe is temporary versus permanent?

JA: Well, it’s impossible to put a number and say half of the inflation we’re seeing right now is temporary or transitory or sustainable or permanent. But I do believe that a lot of the inflation that is currently being driven by supply chain issues will dissipate over time. Now, I’m not saying that prices are going to go back down to what we saw a couple of years ago, but I do think that they will stop increasing at the pace that we’re seeing currently. To take one example of that, this is a little bit of a U.S. centric example but, used car prices have just absolutely shot through the roof throughout the course of the pandemic, and there’s sort of two primary causes to this. One is the global chip shortage, which has reduced automakers’ ability to produce new vehicles. And the other is a shift in consumer preferences away from public transportation. And, so, the demand for used cars has gone up significantly, and their prices have gone up significantly as a result. But used car prices cannot continue to increase by 20% year after year. That’s just not a sustainable situation.

And, so, once we’re through the other side of the pandemic, preferences may change, they may not. But as the global chip shortage gets sorted out, you can expect that new car production picks up again, and that will alleviate some of the pressure on used car prices. So that’s just one example of why I think some of these supply chain issues will eventually dissipate. The big wildcard at this point, though, in my mind anyways, is the extreme government policy that we’re seeing. And this is both fiscal and monetary. And traditional economic theory tells us that both of these expansionary policies should be very inflationary. And whether that winds its way through the system and ends up in consumer prices, we just can’t tell at this point. Coming out of the global financial crisis, we really expected that the extreme monetary policy enacted at that point would lead to significant inflation and it never did, at least not in consumer prices. There was significant asset price inflation. That’s been the case in equities, bonds, real estate, you name it.

But that just hasn't really shown up in consumer prices. And so while we continue to expect, based on academic theory, that it will, we just don't know. And so that's the real wildcard in my mind as to sort of the next level of where we see inflation going. And another thing to remember is that there are a lot of very **long-term trends** or long-term cycles that are at play sort of beneath the surface of these issues that we can more tangibly grasp at. Craig mentioned that in terms of Japan demographics have a huge impact on economic activity. But demographics is a very long-term cycle and can take decades to change.

And so it can be tough to see what's going on beneath the surface when we're sort of tied up with things right now like fiscal and monetary policy and supply chain issues. So, I think breaking it down into what is temporary and what is permanent or sustainable is really just too difficult. I think we need to look at all the factors and determine what's sustainable, what's not, and what might be happening underneath the surface as well.

VIDEO #2: BURGUNDY'S APPROACH TO EQUITY AND FIXED INCOME INVESTING

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Kate, Oliver, and James discuss how inflation is affecting Burgundy's companies and explore its impact on portfolio construction.

Kate Mostowyk (KM): I am going to move to Oliver now. And thinking about everybody being somewhat worried about inflation, let's kind of move into thinking about how are you thinking about inflation through the lens of our portfolio companies? And what impact are you seeing in the current environment?

Oliver Cardoso (OC): Well, we're seeing impact in a lot of different ways. It's affecting just about all of our portfolio companies, particularly those that deal with moving hard goods from one place to another or manufacturing anything out of hard material inputs. And there are three main categories where we see inflation manifest in our portfolio companies. The first is in the form of commodity price inflation. If you're a manufacturing business and you make anything that requires a raw material, that's an input to your manufacturing process, then you're buying commodities. That could be steel, lumber, oil, what have you. And there's been quite significant inflation in the prices of those commodities since before the pandemic. For example, the price of oil is up almost 60%. The price of steel is up almost 60%. The price of lumber is up a little over 50%, even though it's come back down from peaks that we saw just a few months ago. Edible oils have more than doubled, which are a very important input to a lot of food processing for various foodstuffs. So, commodity price increases have resulted in an increase in the cost to manufacture the stuff that our companies make.

And the key point here that we're looking for when we look at the earnings results of our portfolio companies is to see whether they can pass on that raw material cost inflation to their customers in the form of higher prices. And pretty much across the board, we see that our portfolio companies can. It's a feature of businesses that we screen for in particular and do a great deal of deep due diligence to try to determine that our companies have before we make an investment. I'll illustrate with a couple of examples. So, we own, for instance, in our [Burgundy] U.S. Small Cap Fund, a company called Armstrong World Industries. Armstrong is in North America far and away the leader in commercial ceiling tiles. So just about any office building or commercial building that you've ever been in will have a form of ceiling tile that Armstrong sells, and they have over 60% market share in the United States for commercial ceiling tiles.

Well, because Armstrong is suffering from some increasing costs as a result of commodity price inflation, they've passed already to their customers over the last couple of quarters three very significant price increases. The same is true with another company we own called **Simpson Manufacturing**. Simpson makes structural connectors that are used in the manufacture of buildings, so a very significant import for them is steel. Steel is up 60%. They've passed two very significant price increases to their customers over the last couple of quarters to at least offset the increasing costs of those raw material inputs. A second category where we're seeing the effects of inflation in our portfolio is in labour costs. As I'm sure a lot of people in the audience have been reading about and hearing on the news, it been very difficult for a lot of companies in a number of different industries to staff their operations and hire people. This has been particularly true, we've found, in any kind of service industry – so think about retail, restaurants, hospitality, leisure.

> “And the key point here that we’re looking for when we look at the earnings results of our portfolio companies is to see whether they can pass on that raw material cost inflation to their customers in the form of higher prices.”

One example is a company that we own called Cedar Fair. Cedar Fair manages 12 amusement parks in North America, including Canada’s Wonderland, just outside of Toronto, which they own. And they’ve commented that it’s been actually very difficult to get staffing levels up in their amusement parks to reopen them as the economies have emerged from lockdown. And they’ve had to raise wages for their staff by upwards of 40%, just to keep the parks staffed at a safe level as they accept new guests. The third category where we’re seeing inflation manifest in the portfolio is in the form of supply chain disruption. The most obvious example of that is that freight costs are rising, right? Oil prices are up. And so, it costs more to move goods around. But it’s compounded by the fact that the trucking industry has a massive shortage of drivers.

Now it had a big shortage of drivers before the pandemic, but what’s ended up happening is that consumer behaviour has changed, right? Ecommerce has taken off. Online shopping has accelerated relative to the behaviour that we saw prior to the pandemic, and that means that more things need to be moved. And that puts greater demand on the shipping industry and puts greater strain on the existing truck drivers who already had a difficult job, most of whom are also older. And so as a number of these older truck drivers decide that they’re not going to deal with this anymore and they’d rather retire, it’s been very difficult to find a new generation of young truck drivers who are willing to take on that job. So, the cost of freight is significantly higher. And that means that it’s harder for companies to move their goods around. But the supply chain disruption question goes deeper than that.

There have been labour shortages of ports, which can’t handle the throughput of goods that are travelling from one country to the other. It’s been difficult for some companies to get ahold of empty containers to ship their goods internationally. Actually, what was often the case before the pandemic was that the U.S. being a net importer of a lot of goods, particularly from Asia, they’d be receiving a lot of full containers coming from across the Pacific. And then there’d be a glut of empty containers in the United States.

So, it was very easy for companies to get ahold of empty containers in order to export their goods then to other countries overseas. Now what we’re seeing is because of the shortage in labour and trucking, in particular for moving containers around, the major overseas shipping companies are finding it more economical to take an empty container that’s on the West Coast in the U.S. and ship it back to Asia empty so they can fill it again in Asia for it to then export products to the U.S. than to move it around within the U.S. so that American exporters can get hold of an empty container, fill it with their goods, and then send it overseas.

And that’s something that we really haven’t seen much of before. And so what that means is that companies can’t move things around. If companies can’t move things around, then their customers, who are likely also other businesses that rely on their products to manufacture a finished end good, can’t complete the manufacturer of the finished end good. And it’s creating delays across the board. And combined with the increase in demand that we’ve seen sort of across industries, that means that prices have gone up to compensate.

KM: Perfect. Thanks, Oliver. So now that we’ve sort of got a view from the equity side, James, I’m going to come back to you. And I’d like you to sort of share with us how the Burgundy Fixed Income team is thinking about inflation. And what is important as a Portfolio Manager in this particular higher-than-usual inflationary environment.

James Arnold (JA): Thanks, Kate. So my focus as a Portfolio Manager is always to protect our clients’ capital. And inflation, particularly higher-than-expected inflation, tends to be bad for fixed income returns. This is due to the fact that higher

inflation generally leads to higher interest rates, which, of course, leads to lower bond prices. And in an effort to protect clients from this, we've got a few levers that we can pull. The first is reducing our exposure to longer dated bonds. So longer dated bonds are, generally speaking, significantly more sensitive to movements in interest rates. And so, higher rates leading to negative returns will be felt most at the long end of the yield curve with longer dated bonds. And, so, where possible, we've reduced client exposure to these types of bonds. The other thing that we can do, and we have been doing, is diversifying our Fixed Income portfolio into more corporate bonds, both investment grade and high yield.

And this serves two purposes. Number one, corporate bonds tend to be shorter in tenor, and so they are less sensitive to movements in interest rates. And they also come with a higher yield spread, if you will, on top of government bonds, and this is to compensate for the risk of default. So, what we do have to do in this case, is pay quite a bit of attention to the specific companies and their credit risk profile and their risk of default. And we do that in much the same way as our colleagues do on the equity side in order to mitigate that risk.

KM: Oliver, thinking about this current environment, how are you thinking about portfolio construction, and have we made any changes due to these higher inflationary pressures right now?

OC: So we really haven't changed the way we think about portfolio construction. I think the core fundamentals of the way we invest and the businesses that we choose to invest in will remain unchanged and probably set us up very well to perform in an inflationary environment or otherwise. The same principles that we employ in the United States in our U.S. Small Cap Fund are also the principles that Craig will employ in his Burgundy Asian Equity Fund, even though Japan has experienced deflation for a significant amount of time and the United States hasn't. And the principles that matter here are investing in very high-quality businesses that are very well managed so that they can adapt to changing circumstances. As James alluded to, we really don't know how this is going to shake out in the medium term or in the long term. And so having companies that are dominant in their industries, that are well-positioned to adapt to changing circumstances, is going to be a winning strategy for us as it has in the past.

That said, we're always monitoring what's happening in market pricing of equities on a regular basis, looking for areas of exuberance to avoid and areas of excessive fear, where we might find opportunities to invest that the market for whatever reason doesn't appreciate. And, so, we have made some changes in the portfolio as a result of the current environment. For example, Penske Automotive Group is one of our biggest holdings in the U.S. Small Cap Fund, and it's a chain of auto dealerships. James just talked about how used car prices have been climbing very rapidly recently, and it's not a sustainable trend. We would expect that to reverse eventually when the auto OEMs [original equipment manufactuers] can return to full rates of production and the global chip shortage has abated. And when that happens, we expect that Penske Automotive won't perform quite as well as it has recently.

> **"...having companies that are dominant in their industries, that are well-positioned to adapt to changing circumstances is going to be a winning strategy for us as it has in the past."**

This year, the business is expected to generate over $13 a share of earnings. Prior to COVID, it was generating closer to $5 a share of earnings. So the pandemic and the related supply chain disruptions have been a real boon for the company, mainly because the shortage of new cars means that auto dealerships can now sell the cars that they do have at full retail price without any promotional activity, without any discounting. So they're generating much, much higher margins today than they used to. And we know that's not sustainable. So we've taken advantage of the recent run up in price at Penske to lower our weight somewhat. Even though it still reflects attractive value, we don't think this can last forever. And so we've altered our weight in Penske, and we've made some similar adjustments in similar cases in other areas of the portfolio. By the same token, we're finding opportunities in this market as a result of supply chain disruption.

There are new ideas that we're working on for businesses that for whatever reason are now temporarily disadvantaged, because they don't have access to inventory, or because their suppliers have been struggling as a result of supply chain disruption. And that has led to their share prices and valuations being, we think, unfairly depressed. So there are a number of new ideas that we're working on where we think the current environment will actually serve us well in the long term, because we have an opportunity to buy really high-quality businesses at unfairly cheap prices.

KM: I always think it's interesting that we can find opportunity in so much chaos. I know it's happened before, and I'm glad we're doing it now as well. ■

VIDEO #3: REMAINING VIGILANT INVESTORS

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Kate and Craig highlight what inflationary pressures and changing macro environments mean for quality investors like Burgundy.

Kate Mostowyk (KM): Craig, I'm actually just going to come to you to comment on that. You've got a lot of experience investing. So, what would you say to comfort those who are very worried about their savings and their portfolio?

Craig Pho (CP): To follow on what Oliver said, for a quality company in which we seek out and which would be the majority of our holdings, success would not be dependent upon the macro environment, whether inflation or deflation. It is not dependent upon inflationary pressures, nor is it dependent upon deflation. It's dependent upon the competitive advantage that we have identified being sustainable, and that allowing this company to continue to have success, vis-à-vis its competitors, and have opportunities to continue to grow and to create wealth. I think what is interesting about this topic is we haven't seen the sorts of pressures that James described for many, many years. And, in fact, perhaps even decades, since the real last dose of sort of steady, high inflationary numbers. And the kind of bottlenecks in the supply chain, etc. Even the labour-shortage issues have not been something that I would in 20 years have had a lot of experience in.

So we have to I guess as investors be vigilant in revisiting our original ideas and theses on companies and constantly test whether or not these businesses have the ability to adapt to the current environment. And I think it's a beginner's mindset. You have to believe that while we don't know what the future holds, that the companies that we own have an advantage and that advantage will be durable. And, therefore, the prospects for investment performance that will meet our clients and our expectations is intact. And, so, while we think we will do well investing in companies that have these characteristics, regardless of inflationary or deflationary pressures, that does not guarantee a strong relative position, because there are going to be industries that perform very well if inflation does take hold and is sustainable. And some of those businesses are underrepresented, certainly in the Asian portfolio which I run.

Commodities will do well, energy should do well, real estate, etc. But that doesn't mean that the companies that we actually own right now are going to do poorly. It's just they may do relatively less well than some companies that are more macro dependent on those factors continuing. ■

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