

Paul Buligan

00:00: Hello, everyone and welcome to Burgundy Talks. I'm your host, Paul Buligan, Vice President and Senior Institutional Relationship Manager at Burgundy. This is where we take a deep dive into Burgundy's investment approach and thought process in order for you to become more informed investors. Today's session is an update with Doug Winslow, Vice President and Portfolio Manager for U.S. equities at Burgundy. Doug will discuss the rollercoaster of a year so far, the disruption of technology, and value investing in today's environment. Finally, he will look ahead amid micro uncertainty.

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Paul Buligan

1:09: Hi, Doug, and welcome. Thanks for joining us here today.

Doug Winslow

1:16: Great to be here, Paul.

Paul Buligan

1:18: I wanted to start by talking about the beginning of the year and what took place. To say the year has been unprecedented seems like a cliché, but it's actually pretty accurate when you consider the things that we've witnessed and never before seen. We start off with the most notable thing, which is the global pandemic leading governments around the world to largely shutter the global economy; massive layoffs and furloughed workers leading to unemployment rates reaching 14%, which I guess we've seen, but you'd have to go back to the Great Depression; the S&P 500 falling by 40% in a little over a month; the size and speed of stimulus programs by central banks and governments around the world; and then, of course, we've seen the swift rebound in the S&P 500, reaching all new highs in five months led by a small group of mega-cap companies. Meanwhile, we're still in the midst of the pandemic and seeing a resurgence in new cases. With all these unprecedented events taking place, Doug, can you give us your perspective on how you've managed the portfolio through all of this?

Doug Winslow

2:25: Quite a year, as you mentioned. Well, like many others, we found communicating via video conference to work fairly well and so we've adapted. Even though we haven't been traveling, I think we've maintained a good rhythm of connecting with companies, and that's important for us because we want to align with management teams that we believe are good partners and think long term. And we also want to stay up to date with these companies and companies on our Dream Team and watch list.

Doug Winslow

2:54: For new opportunities in the market panic we generally start with the portfolio and what we know particularly well, where could we add quickly with the portfolio names. Next, we look to the Dream Team, the best companies that can handle the most pain are the companies on the Dream Team, and then more broadly on our watch list to look at other opportunities, other opportunistic buying, within our watch list. This downturn was really remarkable as you mentioned. It was the fastest bear market in history and the fastest rebound in history.

3:34: That initial leg down was fairly synchronized. Money was really just exiting the market, so we were optimistic that we'd have a lot of opportunities within our Dream Team. These stocks did sell off, but the valuations certainly were nowhere close to what we would see in a typical bear market, generally speaking. That was somewhat surprising and disappointing. I imagine you'll want to come back to this area for more discussion. Overall, our turnover within the portfolio did pick up as you'd expect, although we thought in mid-March that we'd be much more active still.

Paul Buligan

4:09: Well thanks, Doug. Burgundy portfolios have typically done pretty well in previous market downturns, but this year has been a bit more of a challenge. Can you give us your perspective on why it's been more of a challenge this time around?

Doug Winslow

4:24: Yeah. We are disappointed by this type of performance in a downturn. I want to be clear on that. Having said that, this was not a typical downturn. S&P 500 is up for the year as we speak. You could argue it was just a very dramatic hiccup in the U.S. large cap space. Some areas like travel and hospitality are facing depression-like end markets still, but overall consumer spending, which is the main driver of the U.S. economy, has now rebounded fairly well. Consumer spending is up year over year in the U.S., consumer retail spending. Now, why is that?

5:09: Well, there's been unprecedented stimulus, pace and amount directed at the economy. The stimulus has been both on the monetary and the fiscal side. The pace at which the federal government distributed support really was remarkable in a partisan political world in the U.S. It shows the U.S. can still act quickly in times of need. Lower interest rates and providing credit support on the monetary side was also equally important. The flow of credit is like the circulatory system of the economy. In mid-March, this was freezing up, but within weeks, the normal flow of credit was restored.

5:51: Now we can argue that this excess liquidity has spilled over into the stock market and potentially distorted some of the valuations in that sense. We've been cautious taking in too much growth and in this market that is a challenge. The so-called COVID beneficiaries, especially within technology, are riding high and this momentum can feed on itself for a while, but it can be a dangerous thing for current investors when the train ultimately stops, so this backdrop is challenging for us. While the S&P is up this year, led by technology, it should be noted that the median stock is still down. So it's a

fairly concentrated market and that tends not to be where we do best.

Paul Buligan

6:40: That's a good point. When I look at the U.S. large cap portfolio, you own companies like Microsoft, Google and Facebook, some of the COVID winners that you referenced. Having ownership in those three companies, why hasn't the portfolio performed more in line with the index since the recovery?

Doug Winslow

07:07: There are a few dynamics, of course. I'll say up front that we had travel exposure heading into the pandemic. That's been a part of performance issue this year. This has been the worst type of recession for those companies. Now with regard to technology, we owned relatively less and the mix within technology has lagged the broader technology sector. We very much believe in the power and scope of the digital revolution. You mentioned Microsoft, Google, and Facebook. Those three companies have strong growth dynamics, deep moats and each company trades at an attractive price on a standalone basis and very attractive relative to other opportunities, not just in technology, but other companies that we consider to be Dream Team. All three of those have done well this year with Google, parent company Alphabet, being the laggard.

8:12: It's still nicely positive for the year, those three companies, but it's lagged some of the high flying names within technology. Those other names include Apple and Amazon. Those are the biggest weights in the index and they've outperformed. Other technology companies like Adobe, Nvidia, Salesforce and many other cloud software companies have also added meaningfully to the index returns. These are mega caps that are up 50% to 100% this year. Other sizable companies have doubled or tripled, very unusual circumstances and very tough to repeat, ultimately, so there are some very lofty valuations out there.

8:58: These cloud companies are catching multiple narratives that are really turbocharging these short-term price moves. Apple is a company that we've owned in the past. We owned it going into this year. We sold it earlier this year. It's one where we think the valuation is a bit out of line. The multiple is higher now than any time since the iPhone launched. That's had a big win this year, but, ultimately, we think that that relative to the other technology names we own will reverse, but it's that mix within technology and then the overall amount we've had in technology. Then also, as I mentioned, the travel exposure has unfortunately clipped us this year as well.

Paul Buligan

9:49: Just to get back to the beginning of the year and the downturn, traditionally we've been active buyers when there's been a correction in the market and we've always followed Warren Buffett's adage of, "Be greedy when others are fearful." When the S&P 500 was down about 40%, were

you able to find some attractive buying opportunities?

Doug Winslow:

10:11: We did do some things. We could have done more, in hindsight. We added to existing names, including Facebook and Alphabet. As I mentioned earlier, we were really focused on the Dream Team. We thought that this was going to be the chance to buy those elite companies within the watch list. We were thinking that the environment could really reset those high multiples. Those high multiples implied really high expectations and we thought those expectations would come down and those multiples would come down. We came close to several things. Our engagement and interest was up.

10:49: As you know, we like that type of environment to enter new positions. We were surprised at where those companies bottomed. We weren't waiting to pick a bottom, but we wanted to be careful that the assumptions and the return profile made sense. We were in the middle of a pandemic after all. It's easy to forget that now and looking back with March and April period, how much of a change this was for society. These companies rebounded strongly and if anything have higher multiples than before the pandemic. Yes, in some cases, the outlook might actually be better now for their businesses. It also means people are willing to accept lower returns on a go-forward basis.

11:30: The current industry environment clearly plays a role here as well. I imagine we'll want to come back to that topic as well. In any case, we were surprised we didn't get more opportunities in our price range within the Dream Team. There was more dislocation in other areas. As you'd expect, areas like cyclicals or companies whose balance sheets maybe weren't in the best shape. So we did some things there. A good example here is Carrier. Carrier is a global provider of HVAC ventilation and air conditioning equipment and services and also a provider of commercial refrigeration and fire and security solutions.

12:12: The company was spun out from United Technologies in the first week of April. It was bad timing for them, but good timing for us. It's a good business. You need a good network of partners, advocates and to have a strong name recognition and reputation to support demand. That replacement demand also drives a solid recurring base, so it was spun out with elevated debt level. Revenue was going to face headwinds and it was orphaned, in a sense, after the spin-out. It was a cheap price and we also saw an opportunity as an independent company to implant various operational and strategic changes.

Paul Buligan

12:55: Even though you weren't able to pick up a lot of new names within the portfolio, I imagine you're still pretty active, rebalancing and adding to already existing positions?

Doug Winslow

13:08: That's right. The turnover really picked up in that period. It's calmed down now. We still have a little bit of volatility here and there, but that turnover has come down. Now, having said that, we're still fairly early on in the pandemic. The worst of the health crisis, at least in terms of being able

to manage it within the health system, now seems to be past us, but there's still more to go. So we'll be ready if and when volatility picks up again.

Paul Buligan

13:40: When we went into 2020, the market was already priced at a high valuation multiple, but then COVID happened and U.S. interest rates fell to new historic lows and the index valuation went even higher. Do these levels of interest rates justify valuations?

Doug Winslow

13:57: Well, this is one of the most important questions right now I think. Interest rates do impact discount rates, so that certainly can impact valuations. If the market was looking for, say, an 8% annualized return with some risk and then now accepting 6% annualized returns, that difference can be brought forward to today's price, just like you would see in a bond. So you are willing to pay a higher price. Using that bond example, 4% coupon bond in a 1% or 2% bond yield world is worth a lot more than the original face value. So you benefit from that reset, but then it means from that point forward, you're accepting a lower return profile and that bond example, again, if you buy that bond today, you are now expecting 1% or 2%.

14:50: That same dynamic, I think, is at play with equities. It's a hell of a ride when it resets higher. Of course, that can go the other way as well. And with equities, there are a lot more variables. With the Fed bond buying, you also see money that was in those bonds, now it's a search for a new home and some yield. Certainly, that seems to spill over into equities, so there's new demand for equities as well. Low interest rates also tend to boost the valuations of growth companies the most because most of their value was in the outer years. That outer year value is worth more in this environment.

15:32: For example, you wouldn't worry as much about extending an IOU today as you would if, say, you can get 10% at the bank. Does that justify these current market valuations? If we really think that these interest rates will stay this low for a long time, for 30 years, then equities are quite valuable. Of course, 10, 20, 30 years is a long time. The iPhone was only introduced 13 years ago, so a lot can change, of course, and more variables impact equities than bonds. Equity holders get what is left after all costs, including corporate taxes and all of that can change as well.

Paul Buligan

16:17: But that's just sort of the interest rate and discount rate perspective. If nothing changes with companies earnings and growth rates or given that we're still in the midst of a pandemic and there are still a number of risks that exist out there in the marketplace, with the risks and the interest rate backdrop, what are the risks to the valuations that we see in the market today?

Doug Winslow

16:44: We think about risks in three ways: business risk, something fundamentally changing with the business; financial risk, a business not being able to support itself or anything in financing, and then also, valuation risk. This would be the worry now would be the valuation risk that this can

cause and so, as I mentioned, there's a reset. In bonds, it's very clear. You have distinct coupons and distinct time to maturity, so you have this reset higher. That reset can happen the other way. So the valuation risk is there. The timing of these things is always unknown. We do worry about that. We think that that is something that, ultimately, will play a role in the market going forward. We just don't know when that will occur.

Paul Buligan

17:40: One of the things that you look for in companies is a moat around the business or companies with a barrier to entry. Technology has really disrupted many of the traditional barriers and made them much less reliable than they have been in the past. How do you assess these and factor in barriers to entry in an era of technology disruption?

Doug Winslow

18:05: Disruptions is a very important topic and it's something that I think maybe gets overused. Some people lump all change as disruption, but in terms of business analysis, we look at disruption through the lens of how it delivers a product or service. So disruption, in our minds, is providing that product or service at a lower cost or a more convenient fashion. This is really disruptive to incumbents because they have real trouble fighting back, given their legacy infrastructure and higher cost method of business. That's what's so disruptive. It's a different business model, a different way to deliver the product. Sometimes part of the model is changing with this disruption, but other important variables are also tied to the customer and those remain. So we need to understand all of these factors. It's a process, generally, and happens over a period of time.

19:13: We also need to distinguish what's truly disruptive and what isn't. It's not easy, but it's also what makes our job interesting. I don't think we change how we evaluate businesses. We want to understand how demand is created and how it's delivered to the customer. That's part of how we evaluate businesses. The pace of how quickly things change – can move in direction, especially in a digital transition – is something that's important. We have learned in this digital world that we do need to move more quickly with a sale in that type of environment. So we do need to have these triggers in place to be able to move more quickly when we see some of these changes happen. This is a unique period for disruption because the digital revolution and on-demand computing is touching almost everything in the economy. So this is a unique period. But fundamentally, how we approach our business analysis, I don't think needs to change.

Paul Buligan

20:22: Looking at some of the best disruptors out there, when you take a look at companies that have been incredibly successful, like Amazon leading the adoption towards trends like e-commerce being a very successful disruptor, do you think that justifies the high prices that we're seeing in those companies?

Doug Winslow

20:44: Well, it certainly can. If you are the leader in this disruption and you have a good thing going and you have this long runway ahead of you to take that value from the incumbents, that is very valuable. The problem

often is people get most excited right where it's nearing the end of the growth capture and so that's the problem, is we know a lot of this is going to happen for a while. The question is, how long and the growth rates as well. Making sure you're aware of what you're paying is the most important thing. I think that gets lost sometimes with these companies is there is, ultimately, an end game, an end state to these companies and so what you pay just has to make sense relative to the assumptions.

Paul Buligan

21:38: Thanks for that, Doug. In particular, I wanted to mention my Amazon question. There is no doubt that Amazon has been extremely successful, but it also trades at extremely high valuation. Does their success justify the current valuation they trade at?

Doug Winslow

21:56: Maybe. That's our issue. There's a lot of uncertainty around how much they can earn. There are a lot of questions around that. Retail tends to not transport very well across geographies and people put a lot of growth numbers around some of those assumptions. People put a margin placeholder in the outer years, which is a big question mark. There's a lot of value with Amazon. We're certainly not ignorant to Amazon. In March it was on our radar, but the entry point and the assumptions are very important, and we have to look at it with the current reality. At this price, is it still attractive? When I look at Amazon, I look at the example with Walmart. Walmart was an unbelievable stock in the 1980s and 1990s. The stock increased over four hundredfold. The share price continued to move higher in the late '90s and actually, the market multiple peaked around the start of 2000.

23:12: At that time, it peaked in the high 50s. In the 2000s, the decade of the 2000s, it was still a quite a successful operational decade for Walmart. Earnings more than tripled between 2000 and 2010, but the share price at the end of the decade was 20% lower than where it was at the start of the decade. It's also interesting to me that the multiple hit its peak right when the growth rates started to decline. So Amazon can be a very successful business over the next decade, but not be a good stock. So I think there's a parallel to Walmart there that the cart is ahead of the horse right now. Amazon also has this other business, Amazon Web Services, which we actually think is the most valuable business. So Amazon Web Services is really the infrastructure for on-demand computing and it's a lot more than that on top of that, but that's very important.

24:27: The infrastructure for on-demand computing, that's a very big market. We would say bigger than the retail piece. People focus on retail, but we think that is maybe the more valuable piece, so that's where we have an easier time attributing value to Amazon. But beyond that point, we're much more comfortable owning Microsoft. It benefits from similar trends with its on-demand computing business, but it also has an incredible enterprise software business and the valuation we think makes a lot more sense. So we think Microsoft stands out from a valuation perspective relative to Amazon at this point. With Amazon, valuation risk, we think is a real risk. It's easy to forget that in this environment, but there's a lot of assumptions right now baked into the share price and so you're not just

going to benefit alongside earnings growth in the future.

Paul Buligan

25:28: I want to switch for a moment, Doug, and just talk about value investing in these days. The past few years have been a bit of a challenge for value relative to growth and we've seen them one of the largest periods of under-performance of that discipline. I'm often asked the question, "Is value dead?" What do you say to that?

Doug Winslow

25:51: Well, I think first, for us, it's important to distinguish that we're not a traditional value investor in that we like growth. We want growth, but we need to have conviction that that growth can be sustained and it makes sense relative to the price. We want quality with a margin of safety. The future is hard to predict and so we want a buffer for that uncertainty. If you're too optimistic, you will lose money. Buffett has a great quote: "You pay a high price for a cheery consensus." And, ultimately, trees don't grow to the sky, as we discussed in the last question. Ultimately, there is an end.

26:42: It's certainly an education to see such high sustained growth rates for these large companies. It really is remarkable how long some of these companies have been able to sustain these growth rates, but in the end, even here, trees ultimately do not grow to the sky. There have been other periods of time where this intense focus on growth has occurred, most notably, the Nifty Fifty period in the early 1970s. This was a period when there were 50 companies that people thought were unstoppable. These were bulletproof businesses and they had a long runway ahead of them and really there was no price you couldn't pay.

27:26: These included tech companies like IBM, Xerox, Digital Equipment, but also companies like Avon and Polaroid, if you can believe that Polaroid was within that group at that time. This is an example where investors really ignored the fundamental valuation metrics and even companies that did well, ultimately, like Xerox. Xerox tripled their earnings over the next decade, but it was a lower share price 10 years later from the early 1970s to the early 1980s. So I think that just reinforces the point that the price you pay really is critical to the return on your investment.

Paul Buligan

28:06: When you describe our investment approach of not being value, but quality value and at Burgundy, we're also contrarian investors... When we review terms that describe one's philosophy or approach, what are your thoughts on the term, growth at a reasonable price?

Doug Winslow

28:23: Well, it depends what we mean by reasonable. I kind of laugh when I say that because it makes me think of Bill Clinton when he said, "It depends on what the definition of is, is." But the definition of reasonable really is important. It's natural to try to bucket or categorize certain things, but there's, as usual, a nuance to that. So the concept can be taken to an extreme: What exactly is reasonable? Reasonable is a fungible term. We very much want growth. We just want to pay less than what we think it's worth. I want to wear Canali suits, but I want to buy them when they're on sale. I'd say growth has taken on new meaning in this digital world, so it's

fair to say there's a sharper focus on growth and what's driving growth.

29:22: I would say, looking at our Dream Team, we always want to have our pencil ready because you never know when the market will provide an opportunity. These companies in the Dream Team are companies that have, we think, a good growth environment. So for example, in late 2018, we initiated a position in Facebook as it was experiencing some volatility around the news of the Cambridge Analytica data breach. So we had Facebook on our radar when we bought Facebook at an attractive price and continue to own it today.

Paul Buligan

29:59: Acting as a contrarian and buying Facebook when the opportunity was right. Maybe we could switch gears and just talk about U.S. politics for a second. It's pretty timely and the U.S. is facing a pretty dramatic choice between two different policy directions in terms of trade, regulation and taxes. How do you think a democratic administration would affect the portfolio and the markets going forward?

Doug Winslow

30:25: It's a big topic. These things generally have more of an impact on a short-term basis in the market and tends to look like big volatility at the time, but in the grand scheme of the impact on companies is not that material. The way we approach it, in any case, is avoiding areas that can be unduly impacted by policymakers. The great thing about the U.S. is that there's a lot of things we can invest in that they can do well regardless of who's in the White House. By design as well, there are limitations to how much a president can do, at least with regard to domestic policy.

31:09: There are, of course, some areas that can face a greater impact, such as healthcare and that's an area where there's already more direct involvement. We don't expect a major impact on the portfolio. Maybe there will be some opportunities to come out of this with the election-driven volatility as well. Short term, the market hates uncertainty and that's one of the reasons given why the market has rebounded as the gap has widened between Biden and Trump, in that there's less uncertainty on a contested election, potentially. But companies can adapt to policy and rules, so clarity is really important. It's the uncertainty that's the issue. It's interesting too that the market doesn't seem to be reacting to the potential for higher corporate tax rates and that would have a direct impact on corporate earnings, so there are a lot of variables.

32:09: I think zero interest rates and monetary stimulus are actually more important than who the president will be right now, at least from a financial markets' perspective. This leads me to a bigger topic. I've been reading some interesting articles lately and going forward, monetary policy will have less thump given where interest rates are currently. So we do need to think if there's truly going to be a dramatic change in fiscal policy going forward and will it be the truly dominant force to stimulate the economy? Monetary stimulus looks to have reached its limit, as I said, and so it needs to come from fiscal policy. And the mechanism for monetary policy within the economy for any spending happens indirectly, impacting the cost to

borrow. Whereas, fiscal stimulus has a bigger punch to the real economy and the cash can be directed to households, to businesses and delivered right to those most directly impacted.

33:23: The positive is central banks can move quickly, whereas fiscal policy tends to take time, but it's not clear we really see that dramatic change under a Biden administration. Generally, mainstream commentary from Biden; he has talked about some ambitious spending plans with regard to climate. He had a quote in April that Milton Friedman isn't running the show anymore. So you could get a full democratic-controlled Congress and White House and that is when you would see bigger policy shifts and big policy actions. But I think it's important to recognize it has to be a major regime change, similar to what you saw with Paul Volcker and the interest rate hikes and the attack on inflation in the early 1980s.

34:13: Are we in that type of change? Looking at whether it's a short-term boost in spending or whether it's a true long-term spending initiatives on major policy goals, meaning decisive moves with regard to lower inequality recovery missions. That type of fiscal spending by nature is inflationary, so I think we need to pay attention to it as if it were a major change, a major regime change. Now, it doesn't change how we look at things on a day-to-day basis with companies we're looking at. We're looking at companies that can adapt and do well and serve, provide real value to customers and can charge for that. But one thing it does expose is valuation risk with the real high flyers in the market.

Paul Buligan

35:14: Given that valuation risk and all the things that you just mentioned and also given where the market is today, what makes you excited about the portfolio?

Doug Winslow

35:24: Well, we own several companies now that we think are trading at pretty low multiples, between 11 and 16 times earnings. These companies are generally not that cyclical, leaders in their respective areas and well-positioned competitively. What they don't necessarily have is obvious growth opportunities, but we think they're still growing and within that group, some interesting upside optionality as well. One of our jobs is to find things that are overlooked and we think there's a group of companies right now that are leaders in their field, but overlooked because they don't really fit in the current market narrative. For the current well-recognized safe names or work-from-home names, you're reliant on growth continuing at a high rate and for there not to be a change with regard to how the market is putting a multiple on those earnings. Our companies can do well just naturally with the evolution of their business and growth and earnings and distribution of earnings through dividends.

36:37: One example of a company that we think is undervalued is Dollar Tree. The company operates over 15,000 stores under the Dollar Tree and Family Dollar banners. They do have some stores in Canada, but it's really a U.S.-centric retailer. The company serves a unique demographic and is

resilient through economic cycles, benefiting from down trading and a value orientation in tough times. The Dollar Tree banner is one of the most unique and successful concepts within U.S. retail and it's protected from some other changes within e-commerce. There are also interesting upside options, like introduction of a multi-price architecture, similar to what we see with Dollarama here in Canada and also to sprinkle some of their low price discretionary magic within the Family Dollar banners. So we think Dollar Tree is an example of a quality company at a discounted price and why we're excited about the medium-term outlook of the American equities fund.

Paul Buligan

37:47: That's a great example, Doug. Is there anything else you wanted to leave us with in regards to the portfolio?

Doug Winslow

37:54: Well, I think we have a good mix within the portfolio. We have technology companies, great technology companies, that we think have an attractive valuation relative to other things in technology, Google, Facebook, Microsoft. But we also have these other companies that are at, we think, attractive valuations even though they're leaders in their field. So I think we have a really good balance within the portfolio that should do well over the medium-term. Of course, we can adjust that as well, if we see more volatility, but I think we have good balance in the portfolio, balancing the different risks between business risk, financial risk and valuation risk. So that's something that I think stands out within our portfolio right now.

Paul Buligan

38:47: That's great. Thank you, Doug, and thank you for joining us today and sharing your time and perspective. Thank you to everybody that's listening today and we hope that you enjoyed the session. If you have any questions or comments, we'd love to hear from you. Please reach out to your investment counselor or relationship manager. Thank you very much.

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