Quarterly Manager Letter

Q3 2023

Current News and Updates

COMMENTARY

Our Balanced Composite returned -2.5% in Q3 bringing our year-to-date return to +0.9%. Investment performance in the third quarter of 2023 was characterized by ever-increasing government bond yields. This, in turn, had a ripple effect on risk asset pricing. As a recent Bloomberg article states:

> *The importance of Treasuries helps to explain why the bond-market move matters to the real world. As the basic risk-free rate, all other investments are benchmarked against them, and as the Treasury yield rises, so that ripples out to broader markets, affecting everything from car loans, to overdrafts, to public borrowing, and the cost of funding a corporate takeover.*

The rise in bond yields should not have been that surprising. Perhaps the truly perplexing issue is why they were so low to begin with. In the US, the Fed funds rate is at its highest level in decades, and guided to stay that way, all while the budget deficit has blown out dramatically. Meanwhile, nominal growth continues at levels in excess of both the Central Bank's implicit long-term forecast trend, and the average of the post Great Financial Crisis decade. The simple fact is that the longer-term trend of nominal growth is at its highest level in more than twenty years - and where that goes, bond yields tend to follow. What is surprising however is the magnitude of the negative impact that slight increases in bond yields are having on the equity market. While higher bond yields result in a reduction of the present values of future cash flows, it does so in a non-linear fashion, much like the impact of interest rates on bond prices.

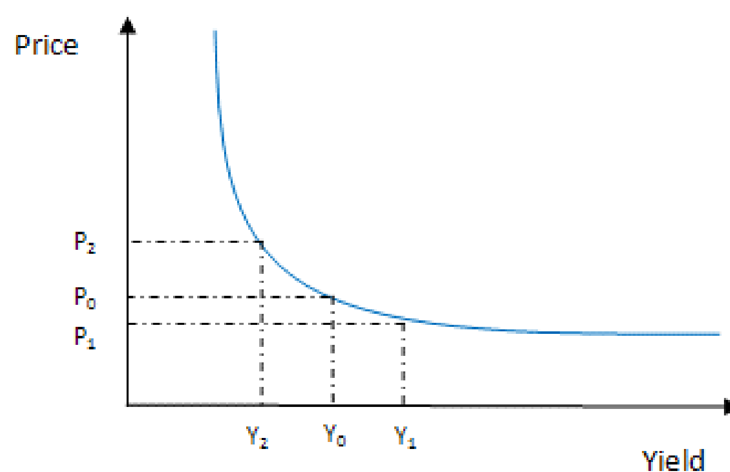

Figure 1: Price-yield relationship

Regardless, in Q3 the S&P staged by far its worst quarter of the year returning -3.7% while the TSX returned -3.1%. Smaller capitalization stocks, as represented by the Russell 2000, fared much worse returning -5.5% in the quarter.

Should one believe that central banks are at, or near, their terminal rate, as we do, then it stands to reason that the negative impact of higher rates on equities should have also reached its peak. What remains to be seen is the impact that higher yields will have on economic activity and corporate earnings. Up to this point, the damage has not been as great as feared. However, as stated in a previous commentary, we are in an interesting environment, and we continue to believe that it is prudent to be prepared for a mild recession over the coming quarters. In practical terms, this means holding higher cash balances and making sure that you understand the economic sensitivity of your holdings. We continue to position client accounts for volatility, fading expensive stocks in the service sector, moving towards more liquid names, and focusing on quality at a reasonable price and free cash flow yield.

Aventine Canadian Equity ("ACE") Fund

The ACE Fund returned -8.6% in Q3, bringing the funds year-to-date return to -7.6%. We continue to manage the portfolio by balancing longer term value with near term earnings predictability and high-quality themes. As a result of the current macro environment, namely higher interest rates, nearly all investment strategies struggled to perform during the third quarter. When you have defensive companies like Telus, Hydro One and Brookfield Asset Management down anywhere from 10% to 15% this year it's hard to drive confidence elsewhere. Encouragingly, the weighted market capitalization of the fund is now greater than $20 billion (up from ~$2 billion) as we manage through this period of higher uncertainty. We have seen several positive developments over the past couple months including accretive acquisitions (GDI-TO & TOY-TO), catalysts such as divestitures (PLC-TO), and strong sales (GIB/A-TO), however, in this environment very little is causing any excitement and positive price reaction.

2023 has not been the bounce back year that we anticipated from a market price perspective, but importantly, the fundamentals have improved at the aggregate level for our portfolio, indicating that the gap between intrinsic value and market price of our holdings continues to grow. For unitholders, this means future expected returns continue to meaningfully expand. We continue to show patience, but in cases where we can be active on the realization of value, we have been very busy.

Aventine US Equity Fund

The Aventine US Equity Fund underperformed its benchmark in the quarter returning -4.9%, and -0.5% on a year-to-date basis. The result was somewhat surprising given the defensive nature of the portfolio, however, during the quarter we witnessed unprecedented selling in traditionally defensive sectors including utilities and consumer staples. In Q3, the Utilities sector was down 10% and Consumer Staples retreated 7%. Moves of this magnitude are rarely seen without a significant market crash, but can occur as yields increase, as these stocks are often considered bond proxies. What this price action ignores, however, is the true financial performance of the underlying company's operating assets.

In the US Equity Fund, our largest detractor in Q3 was undoubtedly Brookfield Infrastructure Partners (BIP-US), which was down approximately 20%. As discussed in previous commentaries, BIP owns critical infrastructure assets around the globe including transmission and telecommunication lines, toll roads, ports, and pipelines. The company has a long history of strong capital allocation and FFO growth. For example, since 2012, BIP has grown FFO per share at an 11% annually and per share distributions at 9% annually. We are confident in the Company's ability to maintain this growth profile in any market environment. We also appreciate the irreplaceable nature of BIP's assets and will be adding to our position as we believe it is meaningfully undervalued.

Conclusion

What's the most important price in the global economy? The price of a barrel of oil? A microchip? Maybe a Big Mac? In fact, the price of money is more important than all these measures. For more than three decades, it was falling, and now it's going up. This is a big change. How high it goes remains to be seen, however we believe that the fallout from the rapid increase in interest rates over the past several years is still ahead of us.

At Aventine, we believe that North American central banks are done raising rates. That is not to say that the yield curve won't gyrate, however we believe that the path of interest rates, over the medium term, is lower. While inflation remains sticky, much of this has to do with non-core measures such as food, and gasoline – costs which act to slow growth and tighten financial conditions. When you combine this with record interest payments, increasing consumer debt levels, waning consumer confidence, and two major wars, the risks to the economy are great. In this late-cycle environment, it is essential that we remain focused on investing in companies with large barriers to entry, pricing power, and a clear pathway to earnings growth. We are confident that our focus on quality, stability, and valuation should be the winning strategy as we approach 2024.

Specifically, we have been focused on the compelling opportunity that has emerged for defensive dividend growth equities, especially given our view regarding the path of interest rates. The earnings predictability of these sectors alone should cause the sector to stand out over the coming quarters. We have been very active on this front across all our equity strategies, and particularly for clients who require more income from their accounts. As a reminder, given the dividend tax credit in Canada, a dividend is worth considerably more on an after-tax basis than income from either a bond or a GIC. For example, Telus paying a 6.5% yield is more attractive on an after-tax basis than a GIC paying 8%.

	Yield	Tax	After-Tax Distribution	After-Tax Yield
Telus	6.50%	$ 25.35	$ 39.65	4.0%
GIC	8.00%	$ 42.40	$ 37.60	3.8%

**Assume $1000 investment in each*

If you would like to learn more about the opportunities we have on the income side, please do not hesitate to reach out.

Thank you for your continued support of Aventine as your Investment Manager and Investment Counsellor. Please do not hesitate to reach out to learn more about our investment strategies. We are always excited to discuss our clients' accounts with them and how we may be of greater value.

Best as always,
James, Jim, David, Shannon, and Nicho

Contact Information

	Email	Phone
James Telfser	jt@aventine.ca	647-695-8063
Jim Pottow	jp@aventine.ca	647-694-6262
David Pepall	dp@aventine.ca	647-557-6382
Shannon Vadovic	sv@aventine.ca	647-697-3533
Nicho Hart	nh@aventine.ca	647-557-2487

Aventine Performance Update
September 30, 2023

Aventine's Partners and their families are among the largest investors across each of our strategies.

Aventine Balanced Composite
Inception: June 1, 2009

Aventine Balanced is our core portfolio for separately managed accounts following a "balanced" mandate. It is an actively managed, endowment-style portfolio that offers investors diversified exposure to a broad variety of markets and asset classes. This diverse portfolio produces below average volatility and high income generation as we include asset classes such as private debt, mortgages, traditional and non-traditional fixed income, all-cap equities, alternatives and portfolio protection through prudent risk management strategies.

AVENTINE
INVESTMENT COUNSEL

	Q3	2023	
Aventine Balanced Composite	**-2.5%**	**0.9%**	
Annualized	**3 Year**	**5 Year**	**Inception**
	3.1%	**2.8%**	**6.1%**

Additional performance information and disclosures on composite construction is available upon request.

We encourage new clients to join Aventine by investing in our customized portfolio solutions which are tailored to your specific goals.

To learn more about how our independent approach to managing wealth differs from traditional models please feel free to contact us anytime.

WEB: AVENTINE.CA | EMAIL: INFO@AVENTINE.CA |PHONE: 647.697.3533

This email communication is intended to provide you with information about the Aventine Balanced Composite (the "Composite"), the Aventine Canadian Equity Fund and the Aventine Dividend Fund (the "Funds") managed by Aventine Management Group Inc. The Funds are distributed by prospectus exemption in various jurisdictions across Canada, please contact Aventine Management Group Inc. to discuss if you may be eligible to invest. Important information about each Fund is contained in its Offering Memorandum which should be read carefully before investing and may be obtained from Aventine Management Group Inc. upon request. The Offering Memorandum does not constitute an offer or solicitation to anyone in any jurisdiction in which such an offer or solicitation is not authorized, or to any person to whom it is unlawful to make such an offer or solicitation. All investors should fully understand their risk tolerance and the suitability of the Composite and the Funds prior to making any investment. Rates of return presented for all periods greater than one year are the historical annualized compound total returns for the period indicated. For periods less than one year the rates of returns are a simple period total return. Rates of return do not take into account income taxes payable that would have reduced net returns. The performance presented for the Funds is the performance of the target series of F Class units. The value of the Composite and the Funds is not guaranteed and will change frequently. Past performance may not be repeated. All credited third-party information contained herein has been obtained from sources believed to be reliable at the time of writing, but Aventine Management Group Inc makes no representations as to its accuracy.

Copyright © 2023 AVENTINE MANAGEMENT GROUP INC., All rights reserved.

Our mailing address is:
#3400, 2 Bloor Street West, Toronto, Ontario M4W 3E2