GFI Investment Counsel Ltd.

Preserving and growing family capital™

"History doesn't repeat itself, but it often rhymes."
– a quote often attributed to Mark Twain

Fourth Quarter 2019 Commentary

Good Opportunities Fund

The Fund generated a return of 4.6% over the fourth quarter, and gained 33.9% in calendar year 2019.

Near the end of 2019, we sold our investment in SiteOne Landscape Supply and purchased shares of Microsoft Corporation. SiteOne is a wholesaler and distributor of landscape supplies, including irrigation equipment, fertilizer, flowers, plants, lighting and stone, to professional landscapers and golf courses. SiteOne's business is cyclical. Homeowners typically cut back on landscape spending during a recession. And while we're not predicting a recession, we must always invest as if a recession is possible at any moment. Since we initiated our investment in SiteOne, the company's debt has climbed, and we felt that such a high debt level for a cyclical company was not an ideal capital structure.

Microsoft has an attractive business model and trades at what we believe to be a reasonable price. The software industry requires very little capital reinvestment to grow. Microsoft can grow profits at strong rates, while still paying shareholders a dividend and buying back shares.

There are three main pillars to Microsoft's business. While Microsoft has well-known businesses like LinkedIn, Xbox and GitHub, the three main drivers of Microsoft's profitability are Office, Windows and Azure.

Most people are already familiar with Office and Windows. Whether it's Outlook, Word, Excel or PowerPoint, people who work in an office environment generally spend hours each day on Office apps on their Windows-run computers. Microsoft's Office suite is likely to grow with the global economy. It has very little corporate competition, and even most corporate Apple users are Office customers.

In a few niche industries, mostly in arts & design (as well as with students), Apple has a strong software position. But for most industries, Office and Windows dominate the corporate environment. Given the work disruption and training required, it would not make sense for most businesses to switch their operating system or Office suite to a competitive product.

Windows is a very profitable, albeit low-growth, business. The consumer market for computers is declining as a result of smartphones and tablets being good substitutes for this larger hardware. The corporate business for Windows, however, continues to grow.

That said, the real high-growth gem for Microsoft is Azure (last quarter it grew 59%). Azure and Amazon Web Services ("AWS") are the two leaders in cloud infrastructure. Companies are moving away from storing and managing their data and applications on premise. They are instead increasingly outsourcing this function to datacentres run by AWS and Azure, which are more secure, lower-cost and more flexible.

Azure is a distant number two to AWS, but is growing faster than the industry and will probably have doubled its market share, from ~9% to ~18%, between 2016 and the end of 2020.

Once businesses move their data and applications to cloud providers, switching away becomes a multi-year, very disruptive project and is an unlikely corporate endeavour. Furthermore, both AWS and Azure have been very successful in moving away from just being storage sites for data, and are now cross-selling higher-margin tools and software to their clients. This has made their cloud businesses very profitable and sticky. We believe the shift to the cloud will last a decade or more, which means Microsoft has a long runway of above-average growth despite already being a US$1.2 trillion company.

Microsoft also has an attractive financial model. Selling incremental software has very low marginal cost. We are partial to sticky, profitable software businesses because of the strong operating leverage they exhibit. In fiscal-year 2019, Microsoft grew its revenue 14%, but income increased 23%. In its first-quarter 2020 results (released in October 2019), revenue increased 15% and income was up 32%.

Our estimates show that even at more moderate revenue growth rates, the underlying profit growth at Microsoft can be attractive to long-term investors. We look forward to owning the company for years to come.

Thank you for continuing to trust us with your assets. We ask, as always, that you please give us a call if you have any questions or concerns that you would like to discuss.

Daniel Goodman, CFA
President and Chief Executive Officer

Effie Wolle, CFA
Chief Investment Officer

A redemption charge may be charged on units tendered for redemption within the first year following their purchase at the rate of 2.5% during the first 90 days. 2% during days 91–180 and 1% during days 181–365. See "Redeeming Units – Short Term Trading Fee" in the Fund's Offering Memorandum.

The above performance figures are net of management fees and performance fees. Please review the Good Opportunities Fund Offering Memorandum for detailed descriptions of strategies, objectives, and risk factors. The above is provided for informational purposes only and is qualified in its entirety by the Fund's Offering Memorandum. Past performance may not be indicative of future results and there is no assurance that any of the Fund's investment objectives will be met.

We have cited a common index used in Canada for general comparison with our fund. However, our fund may not necessarily be representative of the index used and the volatility of our portfolio may vary substantially compared to this index for reasons which include, but are not limited to: (i) our fund may hold or have held a larger percentage of small cap securities and a higher concentration in specific securities and industries; (ii) our fund may use short selling and leverage strategies and hold private investments.

The S&P 500 (CAD) Index measures the total Canadian Dollar return of the broader U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries and assumes reinvestment of dividends.

Please contact us for more information at:
GFI
45 St. Clair Ave. W., Suite 1000
Toronto, Ontario, M4T 2T5
Tel: 416.488.8825
Toll-Free: 866.955.5300
Email: info@gfiic.com