ANNUAL 2022 COMMENTARY

Evolve Future Leadership Fund

LEAD seeks to provide investors with long-term capital appreciation by investing primarily in a diversified mix of equity securities of companies located domestically or internationally that are determined to be leaders in sectors that stand to benefit from medium and long term economic trends.

TSX **LEAD**

ETF TICKERS: LEAD (HEDGED); LEAD.B (UNHEDGED); LEAD.U (USD)

The highest inflation levels in four decades and the biggest interest-rate hikes in a generation held back the economy in 2022, marking the worst year for stocks since 2008.[1] More specifically, U.S. inflation rates closed the year out at 6.5% on a year-over-year basis, and the federal funds rate increased by 4.25% since the start of the year to 4.50% at year end.[2,3] In fact, concerns of a recession loomed over the economy during the year following multiple consecutive quarters of negative GDP growth coupled with other macroeconomic factors such as the pandemic, supply chain issues, soaring energy prices, and geopolitical tensions from the Russia-Ukraine war. Unsurprisingly, these challenges have negatively impacted all asset classes. To illustrate, the S&P 500 Index returned -18.13% over the year. Large capitalization companies, specifically richly valued growth companies and technology companies whose valuations soared during the pandemic, were particularly hurt by these trends having sold off significantly. With the portfolio focusing on investing in future leading companies within the technology, finance, healthcare, and entertainment sectors, many names within the portfolio have sold off during the year due to these macroeconomic factors.

In past recessions throughout history, healthcare stocks were seen as more likely to outperform than the broad market due to the fact that their products are viewed as essential regardless of economic conditions. In fact, in the last four recessions since 1990, consumer and healthcare stocks were the only two positive sectors in the S&P 500, according to CFRA Research.[4] As a result, many healthcare companies reported stronger earnings than expected during the year. Eli Lilly and Company, a holding in this Fund, reported solid third quarter 2022 earnings in November, when they announced that revenue had increased by 7% on a constant currency basis driven by volume growth of key growth products. The company's third quarter earnings per share (EPS) increased 32% to $1.61 on a reported basis, and also announced one of the strongest product launches in its history with its launch of Mounjaro that led to $97.3 million in U.S. revenue in the quarter.[5] Pfizer, another holding in this Fund, reported Q3 2022 revenues of $22.6 Billion, a decrease of $1.4 billion, or 6%, compared to the prior-year quarter, attributing 2% of the decrease operational decline, and the other 4% to the unfavorable impact of foreign exchange. The pharmaceutical giant also raises and narrowed its Full-Year 2022 Adjusted Diluted EPS Guidance from $6.30 to $6.45 to $6.40 to $6.50.[6]

Banks and financial services providers typically perform well in a rising interest rate environment such as the one experienced in 2022. More specifically, financial institution revenues are typically positively correlated with higher interest rates because the net margins on the bank's loan book increases.[7] Unfortunately, the earnings results of U.S. banks released throughout the year were more reflective of the challenging macro-economic environment than this trend. In its third quarter 2022 earnings report, JPMorgan Chase & Co., a holding in this Fund, reported net income of $9.7 billion, down 17% compared to the same quarter in the prior year. However, net revenue was $33.5 billion, up 10% year-over-year, while net interest income (NII) was $17.6 billion, up 34% driven by higher interest rates. Diluted earnings per share (EPS) were $3.12 compared with $3.74 in the third quarter of 2021.[8] The Goldman Sachs Group, Inc., a holding in this Fund, reported third quarter earnings which surpassed analyst expectations, driven by strong bond-trading results. The company said profit fell 43% to $3.07 billion year-over-year, or to $8.25 per share, exceeding the estimated $7.69 per share. For comparison, EPS was $7.73 for the second quarter of 2022. Net revenues were $11.98 billion for the third quarter of 2022, 1% higher than Q2 2022 but 12% lower year-over-year, driven by lower net revenues in Investment Banking and Asset Management, partially offset by higher net revenues in Global Markets and Consumer & Wealth Management.[9]

The challenging operating environment was also reflected in the earnings reports of technology companies throughout the year. Alphabet, a holding in this Fund, reported weaker than expected third quarter earnings and said it would significantly decrease headcount in the following quarter. Alphabet reported EPS of $1.06 as compared to analyst expectations of $1.25 and missed revenue estimates of $70.58 billion when they reported revenue of $69.09 billion. Revenue growth slowed to 6% from 41% in the same period of 2021, driven by a decrease in digital advertisement spending globally.[10] Microsoft, another holding in this Fund, reported first fiscal quarter 2023 earnings in October, announcing EPS of $2.35 per share as compared to analyst expectations of $2.30. Revenue also surpassed analyst estimates of $49.61 billion when Microsoft reported $50.12 billion for the quarter. However, cloud revenue missed expectations and Microsoft gave weak earnings guidance for the upcoming quarter.[11] Apple, also a holding in this Fund, announced financial results for its fiscal 2022 fourth quarter ended on September 24, reporting record September quarter revenue of $90.1 billion, up 8% year-over-year. Apple also reported EPS of $1.29, up 4% year-over-year, and exceeding analyst estimates of $1.27. Apple did not provide guidance for its first fiscal quarter of 2023 but did say that it has slowed the pace of its hiring and it looking to make cuts ahead of a possible recession in the next year and as interest rates rise, similarly to other large capitalization technology companies.[12]

The same sentiment was also reflected in the entertainment industry, where inflation and decreased consumer discretionary spending impacted the performance of companies within the sector. Meta, a holding in this Fund, published its third quarter 2022 earnings results in October reporting that revenue had declined by 4% year-over-year, while expenses had simultaneously increased by 19% and headcount increased by 28%. The social media company also fell short on earnings per share (EPS) when it reported $1.64 per share, missing analyst estimates of $1.87.[13] Electronic Arts (EA), another holding in this Fund, announced financial results for its second fiscal quarter ended September 30th in November, announcing diluted earnings per share of $1.07 vs. $1.02 at the end of the same quarter in 2021. Total net income was also up slightly at $299 million vs. $294 million as compared to the same period. In fact, the quarter marked several milestones for the e-Gaming company, including growing their EA player network to more than 6000 million active accounts at quarter end, and their most successful launch in franchise history with the launch of FIFA 23 with more than 10.3 million players joining the game within the first week. EA also repurchased 2.6 million shares for $325 million during the quarter, bringing the total for the trailing twelve months to 10.0 million shares for $1.295 billion.[14]

Performance Attribution

For the twelve month period ending December 31, 2022, Lilly Eli & Company made the biggest contribution to the Fund, followed by Twitter Inc. and AbbVie Inc. By weight, the Fund's largest holdings were Meta Platforms, Inc., Novo Nordisk A/S, and Pfizer Inc.

Sources:

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