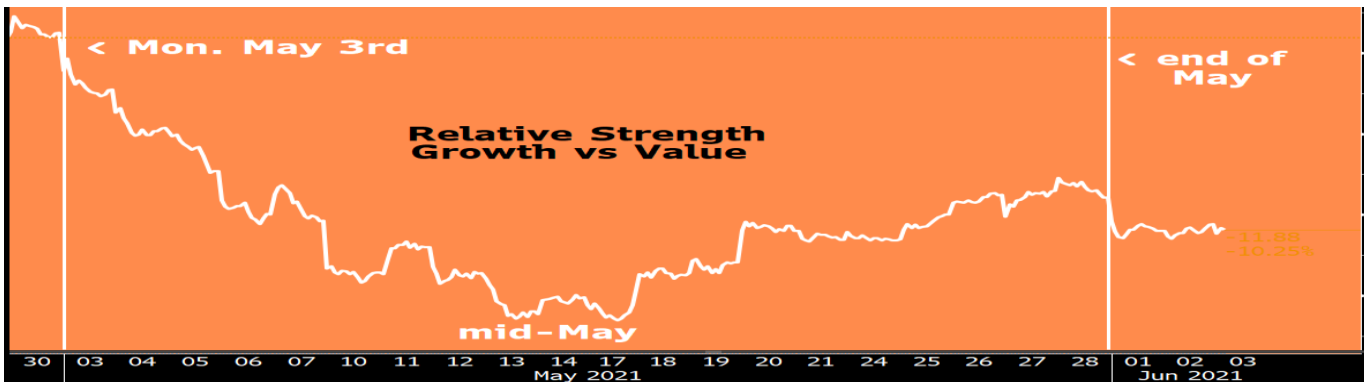
FORGE FIRST
ASSET MANAGEMENT INC

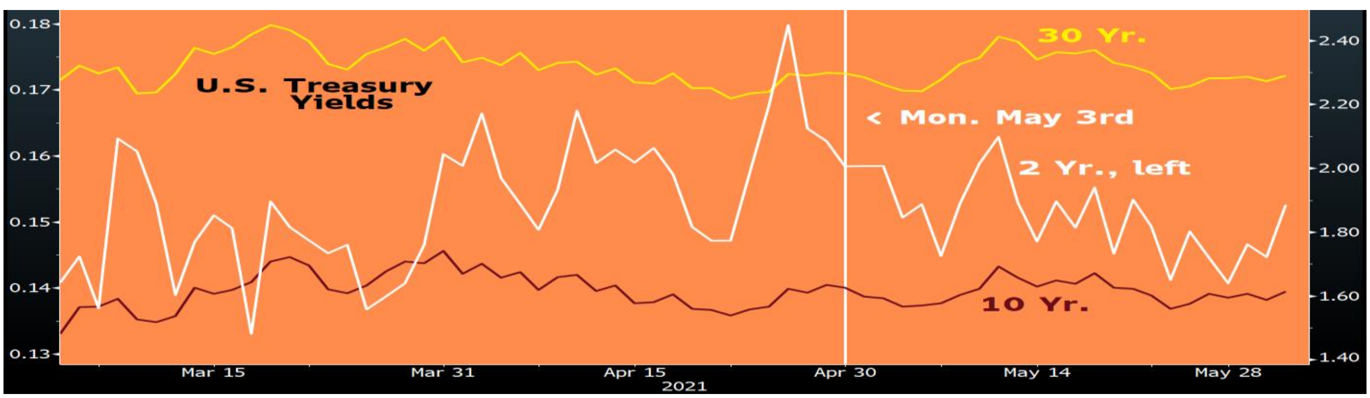
June 7, 2021

## May 2021 Commentary

With America shifting to a 'getting back to normal', no mask stance, investors began May 2021 exhibiting a 'risk on' attitude, enabling stocks to advance strongly out of the gate. As can be seen from the 1st graph below, the general trend of the past seven months (since Pfizer's vaccine news of Nov. 9th) favouring value, cyclical and 're-opening' stocks, continued during early May. By mid-May, the combination of a weak U.S. jobs report and hotter-than-expected pricing data south of our border, triggered a rethink among investors, catalyzing the 2nd factor reversal year to date. Judging by the lack of reaction in bond yields shown in the 2nd graph below, it's apparent that, for now, investors chalked the miss on jobs to timing and have given the Fed a free pass on its 'transient' attitude towards inflation. Most equities recovered, though value bettered growth, yet lingering investor uncertainty made a sustainable rise through 4,200; a tough nut to crack for the S&P 500 through the time of writing of this note.



Source: Bloomberg



Source: Bloomberg

Each of our funds at Forge First delivered positive net returns last month. The Series F of our Long Short Alternative Fund gained +2.32% after fees, boosting its year-to-date net return to +10.78% and its trailing 12-month net gain to +28.85%. While Materials and Energy generated the majority of portfolio returns during May, Financials and Technology also made respectable contributions. In fact, 14 of the top 15 single stock contributors were resource stocks, an interesting juxtaposition from April 2021 (Series F up +2.65% net) when only five of the top 15 performers were from Materials and Energy, as Technology, Financials and Industrials dominated the leaderboard that month. Our Long Short Alternative Fund exited May 2021 with gross exposure of 124% and delta-adjusted net exposure of 56%.

| | YTD | 1 mo | 3 mo | 6 mo | 1 year | 2 year* | Since Inception* |
|---|---|---|---|---|---|---|---|
| Forge First Long Short Alternative Fund Series A | 10.38% | 2.24% | 4.84% | 13.35% | 27.73% | 15.34% | 13.11% |
| Forge First Long Short Alternative Fund Series F | 10.78% | 2.32% | 5.07% | 13.84% | 28.85% | 16.40% | 14.11% |
| | | | | | | | |
| Forge First Conservative Alternative Fund Series A | 7.40% | 0.24% | 2.59% | 11.28% | 24.69% | 12.20% | 11.44% |
| Forge First Conservative Alternative Fund Series F | 7.81% | 0.32% | 2.83% | 11.79% | 25.86% | 13.22% | 12.42% |
| | | | | | | | |
| TSX Total Return | 14.44% | 3.44% | 10.01% | 16.42% | 33.83% | 14.45% | 11.44% |
| S&P 500 Total Return (US$) | 12.62% | 0.70% | 10.72% | 16.95% | 40.32% | 25.83% | 20.17% |

*****Annualized | Inception date: April 24, 2019

The Series F of our lower volatility Conservative Alternative Fund gained +0.32% after fees during the month, such that its year-to-date net return sits at +7.81% and its rolling 12-month net gain is 25.86%. This 14th consecutive month of positive performance was driven by contributions from each of the capital growth or common equity sleeve and the alternative strategy or multi-asset sleeve of this fund. Positive attribution in the capital growth sleeve was driven by positions in the Consumer, Materials, Energy and Financial sectors. The 3rd sleeve of this portfolio, asset protection, detracted from performance during the month. The Conservative Alternative Fund exited the month of May with gross exposure of 107% and delta-adjusted net exposure of 44%, split 36% in the capital growth sleeve, 15% in the multi-asset sleeve, and -7% in the asset protection sleeve.

As regular readers know, the investment team at Forge First utilizes a 'buy and hold' strategy of owning free cash flowing companies, agnostic of style, complemented with a diversified short book and a portfolio of listed options geared towards additional protection. We own well-known, secular growth stocks including Visa Inc (V.US), Microsoft Corp. (MSFT.US), and Facebook Inc. (FB.US), but also short cycle, value-oriented securities including Cenovus Energy Inc. (CVE.CA), Stelco Holdings Inc. (STLC.CA), and Nutrien Ltd. (NTR.CA). This balanced approach has enabled us to successfully navigate the factor choppiness that is likely to persist through the summer months as investors remain uncertain about inflation and future positioning of monetary and fiscal policy. Hence, while many investors have been challenged from the perspective of performance by this factor volatility, our team has merely found it to be frustrating on the occasional trading day.

One other comment about balance speaks to one of the differences between our two funds. While each of our funds sticks to the same 'rule book', that includes limiting small cap exposure to no more than 10% (small cap defined as a market cap <$1B), not owning privates and not holding any large sector or single security weights, our Long Short Alternative Fund and Conservative Alternative Fund often target their respective goals via different paths.

Unlike the multi-asset nature of the Conservative Alternative Fund, the Long Short Alternative Fund is a portfolio of equities complemented with a book of listed options. The Long Short is more directional and is accepting of the higher volatility often associated with resource stocks, though we note that, in line with its volatility mandate, the standard deviation of the Long Short Alternative Fund remains below the volatility of the market. During March of 2020, we pivoted a large allocation of the fund towards secular growth stocks that had 'gone on sale' in the U.S. marketplace, purchasing a list of companies including Home Depot Inc. (HD.US), Nike Inc. (NKE.US), and Mastercard Inc. (MA.US). Then during August 2020, we began to trim these allocations, repatriating the capital back to Canada, to initiate (or add to) positions in companies that included Interfor Corp. (IFP.CA), Stelco Holdings Inc. (STLC.CA) and Tourmaline Oil Corp. (TOU.CA).

At that juncture, based on our financial modelling, these securities (and others) were able to be purchased at enormous free cash flow yields and deep discounts to what we estimated to be the intrinsic value of these companies. From that time, while the Long Short Alternative fund endured a degree of volatility from the growing allocation to these 'early cyclicals', given our philosophy towards position sizing, the overall adjusted beta or standard deviation of the fund didn't deviate from its historical range. Of course, year to date, this basket of securities has been amongst our largest winners. More recently, as these cyclicals have garnered strong investor interest, we have begun to layer on some protection against selected names.

In contrast, the Conservative Alternative Fund is a less directional fund and is more focused on purchasing shares in companies that have a 'long runway' of compound growth in both earnings and free cash flow via organic and high ROIC reinvestment opportunities. This fund seeks to buy these companies, so called "compounders", when they are mispriced in the market. The majority of the equity exposure in the capital growth sleeve of the Conservative Alternative Fund fits this profile.

Besides the fact that each of the two funds uses the same 'rule book', the common link between them is their focus on free cash flow. We would add that the preponderance of common equities in the Conservative Alternative Fund is also in the Long Short Alternative Fund. It's just that the percentage allocation to any security may be different. Dye & Durham Ltd. (DND.CA) and Revolve Group Inc. (RVLV.US) are two good cases in point of commonly owned "compounders".

Both companies are exemplary long positions, with strong track records and forward prospects for above average growth in earnings and free cash flow. The shares in Dye & Durham appreciated last month after management announced 1) an indication to take the company private, and 2) a strategic review process to evaluate alternatives. Shares in Revolve Group rose on the back of both a strong earnings report and similarly bullish forward guidance. In both cases, the funds utilized listed option strategies to improve the risk/reward profile of the long positions we held in each company. During May, our long call, short put positions catalyzed the majority of the gains in Revolve Group, while for Dye & Durham, we used price strength around the corporate news to replace a material portion of our common equity exposure with a call option position. Looking ahead, we believe our willingness to tactically use listed options for both offence and defence will become of increasing importance.

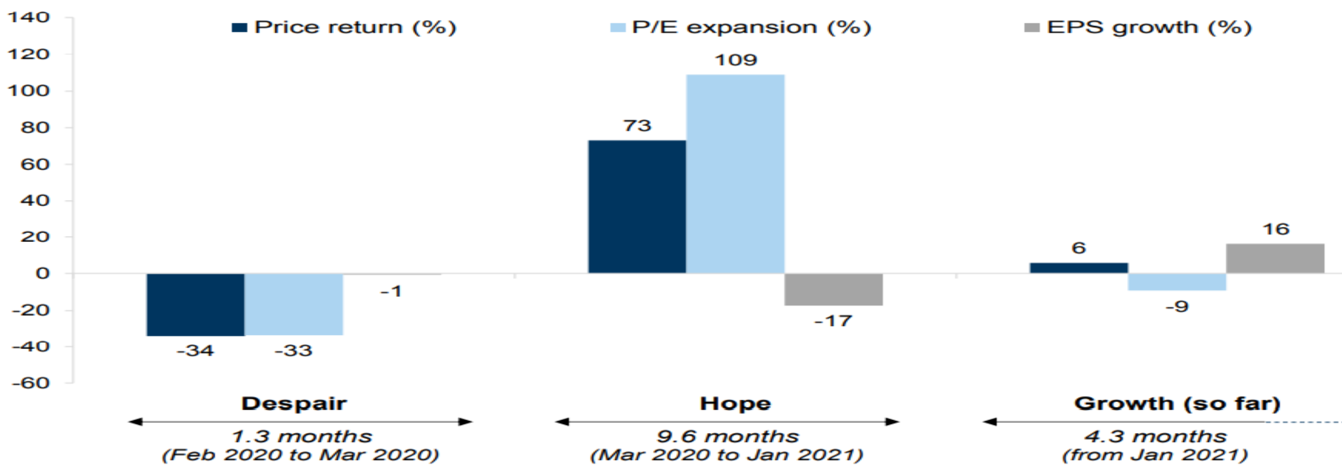
In our 2021 Market Lookahead Commentary published on January 12th, we expressed the view that equity markets would move higher into the Spring of 2021, thanks to declining equity volatility, continued policy accommodation and interest rates that would not rise enough so as to hurt growth stocks, let alone broader markets. We went on to suggest that cyclical, value and 're-opening' stocks would outperform growth (or GARP stocks), while GAAP (growth at ANY price) stocks would underperform all equities. Today, with the S&P 500 at roughly 4,200, we believe equities are approaching full value given the currently supportive macro backdrop. While we foresee modest additional upside to broader averages, we believe we're approaching the point in time when price dispersion between securities will increase and security selection or alpha will drive returns.


Source: Bank of America Merrill Lynch

The mid-May 2021 Bank of America Merrill Lynch Fund Manager Survey (FMS) highlighted that 69% of surveyed fund managers held the belief that the global economy had entered a period of 'above trend growth' and 'above trend inflation'. In the minds of fund managers, inflation had replaced a 'taper tantrum' as presenting the largest 'tail risk' for markets. It will not be until after the COVID-19-related U.S. Federal Government unemployment assistance plan (CARES Act) expires this Fall that we will learn whether labour markets are tight enough to cause 'transient' inflation to evolve to the more sustainable and dangerous demand-pull type of inflation. While this jury remains out, for now we believe the price discovery implicit to the 'internetization' of the economy is enough to forestall inflation becoming a problem for markets.

However, it is also the view of the team at Forge First that the rate of positive acceleration in U.S. economic growth, corporate earnings and policy accommodation will peak this Summer. This view implies the forward rate of change of these variables is set to decelerate.

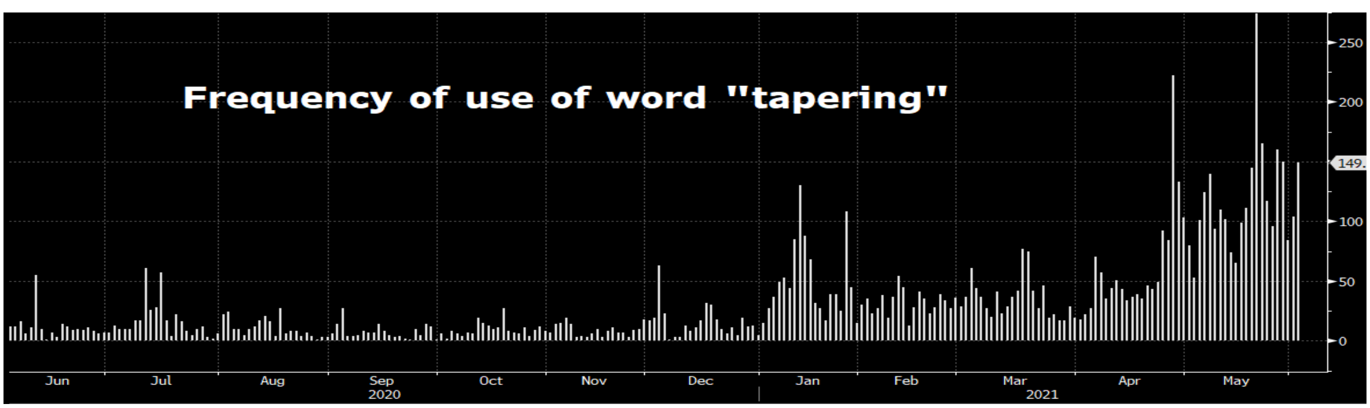
Concurrent with the acceleration of these three variables since March 2020, a period that Goldman Sachs refers to as being the 'hope' phase of a market cycle, the middle column of the chart below highlights that 109% of the 73% increase in the price of the S&P 500 was attributable to a rise in the P/E multiple of the market. In contrast, EPS fell 17% during this period. The 3rd column on the right side of this chart suggests that year-to-date through the middle of May, the start of the 'growth' or 3rd phase of the market cycle, the S&P 500 has advanced 6% with 16% of the rise being attributable to improved earnings, while a contraction in valuation has subtracted 9% from the return.




Source: Goldman Sachs

While post-Labour Day 'herd immunity' should enable the EU to catalyze improved synchronous global growth, the weight of the discussed U.S. variables is likely to more than offset this upside. As a result, we believe macro tailwinds will begin to turn into macro headwinds during the 2nd half of 2021, causing a shift in the symmetry of the risk versus reward outlook for broader equity markets as valuations become vulnerable to further contraction.

Lael Brainard, a member of the Board of Governors of the Federal Reserve System, was quoted last week as saying the reduction in fiscal stimulus next year in the U.S. will be equivalent to 9% of GDP. Dallas Fed President, Rob Kaplan, has been increasingly vocal on a consistent basis that the Fed should begin 'tapering' (please see graph below) its bond purchases, assess the efficacy of the Fed's MBS buying program and be expectant that interest rate 'lift-off' is likely during the H2 2022 as opposed to some forecasts suggesting the first rate hike won't occur until as late as 2024. The bottom line is that the forward rate of change in monetary and fiscal accommodation in the U.S. will soon be negative, not positive.




Source: Bloomberg

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As a consequence of this setup, each of our two funds has modestly added to our existing hedge program, with the majority of our incremental protection targeting our resource sector exposure. While we remain medium-term constructive towards copper, we believe the price of the commodity and associated equities are ahead of themselves. When it comes to the energy sector, it seems the whole world is now bullish energy and we are not fans of crowded trades.

The bull thesis we wrote about several months ago that future oil supply would be unable to meet rebounding H2 2021 demand, has shown itself to be true. Global oil markets are currently subject to a multitude of cross-currents, but the bottom line is that years of under-investment in a very capital-intensive business has left the non-OPEC supply picture (2/3rds of global supply) in a precarious spot. This was the setup we had envisioned months ago when we suggested WTI oil was likely to trade above US$70. Hence, we still own Canadian Natural Resources Ltd. (CNQ.CA), Tourmaline Oil Corp. (TOU.CA) and MEG Energy Corp. (MEG.CA), to name a few of the energy holdings that constitute a roughly 20% gross long exposure in the Long Short Alternative Fund. However, I hasten to add that we also hold an approximate 8% gross short exposure in energy.

We continue to view Suncor Energy Inc. (SU.CA) as an underperformer and we are short shares of Suncor and Imperial Oil Ltd. (IMO.CA), just in case the state of Michigan is successful at shutting down the Line 5 pipeline. Also, given our negative outlook for U.S. refining margins, we are short HollyFrontier Corp. (HFC.US) and Marathon Petroleum Corp. (MPC.US). Post its massive refining capacity expansion, China has shown itself to be very willing to sacrifice margins for volumes, joining global refiners in beginning to target the U.S. as the clearing market for refined product. In addition, the paucity of RINs (renewable energy credits) is increasingly taking a bite out of the fat refining spreads that U.S. refiners enjoyed over the past half decade. Our funds own call options protecting each of these short positions.

Beyond the next few months, two additional issues could serve to fuel even higher oil prices. Both Royal Dutch Shell plc (RDS/A.US) and Exxon Mobile Corporation (XOM.US) were successfully targeted by a lawsuit and activist campaign, respectively, so as to force these giants to reduce their 'scope three' emissions. To the uninitiated, scope three refers to those emissions that are emitted by individuals using the products of a company, for example, a car rather than those emissions generated directly by the energy company.

Accomplishing what is being demanded of the companies is likely only to be achieved by a reduction in oil production. Hence, it is our belief that the much talked about supply additions from OPEC+ and Iran will be required so as to maintain a degree of balance in markets. Severe upward pressure on oil prices tend to arrive when traders begin to worry about how much excess capacity OPEC has left. It is our thinking that markets are currently looking at H2 2021 and 2022 requirements for significantly greater supplies from OPEC, yet there's very little capacity behind those increases. As a result, we will continue to own our high free cash flowing energy producers and roll puts as we see fit to do so, versus taking profits on the shares.

To return and recap on our outlook for markets, notwithstanding the COVID-related meltdown of last Spring, markets have had a good ride over the past few years, largely on the backs of significant accommodation (and of course a handful of monster tech stocks!). Looking ahead to the back half of 2021, we believe it is only a matter of time until markets take a pause in attempt to adjust to the onset of a reduction in the largesse provided by policy makers. Our track record shows that the disciplined strategy used by the team at Forge First has enabled us to successfully navigate rougher waters. Our goals remain to offer our investors a competitive net return and protect hard-earned capital when times get rougher.

Thank you for your business and interest in our funds. For more information, please visit our website at www.forgefirst.com or call us at 416-687-6771 should you have any questions.

Thank you,

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| Andrew McCreath | Daniel Lloyd | Keenan Murray |
| President and CEO | Portfolio Manager | Portfolio Manager |