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DELIVER CLEAR AND CANDID ADVICE

Michael Preto, CFP®, CIM®

We at Hillside have a commitment to deliver clear and candid advice to you and your family. Our advice is to think of your investment portfolio as a collection of businesses and not a portfolio of stocks or securities. You've hired a management team, us, to find and purchase parts of several businesses for which you own. Understanding how a business works will help you become a better owner, which will make you wealthier and stress less thereby bringing you more enjoyment from life moving forward.

In order to better understand the dynamics of operating a business, let's walk through an example in detail. To keep things as simple as possible, let's pretend your business (I should say 'our' as we own the business right alongside you) sells lemonade. To start the business, we had to open our first stand, and to do this we had to buy some equipment and some ingredients. The money we spent to start the business is called shareholders' equity - we took money and invested it in our lemonade business and now we, the owners (or shareholders in the case of a company), own, aka have equity in, what the business purchased.

After 1 year of selling lemonade, we achieved revenues. Revenues are the amount of money we generated by selling lemonade to our customers. Revenue is the first line item in our income statement, an annual statement summarizing the income and expenses of our business, and is often referred to as the "top line." It costs money to produce and sell lemonade. If our revenue, or top line, was higher than our costs, then we made a profit. Profit is often referred to as the "bottom line" as it's the last item on the income statement. For the purposes of this letter, profits, free cash flow and cash earnings all mean the same thing. In the case of our lemonade business, we made a nice profit- we generated more revenue selling lemonade than we did producing and selling it. After making a profit, a couple of things need to happen:

1. **Give each other a high five because profit is good**. Not all businesses are able to produce a profit, even if they generate lots of revenue. Yes, there are lots of very big businesses which trade on the stock market which generate lots of top line without producing any bottom line. They spend more money to produce revenue than the revenue itself and as such they lose money. Think Peloton and Docusign.

2. **Determine how to allocate the profit**. We could:
    a. Take the profit out of the business as a dividend and go on a fishing trip.
    b. Leave the money in the business so we can open another lemonade stand and hopefully produce more profit.
    c. Leave the cash in our business' bank account and let it sit there.

Let's assume we choose option b or c. Now the amount of profit we left in the company becomes retained earnings- profit or earnings the company made which was left inside the company and not paid out as a dividend. Retained earnings are added to the shareholders' equity. In the case of our lemonade stand, our shareholders' equity is comprised of the money we originally invested to start our lemonade stand and the profits we made and left in the company after our first year of business.

After another few years of generating profits from our one lemonade stand, we realize there's a bunch of cash in the business' bank account not doing anything. We put our heads together and decide to invest some of this cash and open another lemonade stand. Pleasingly, our second stand is profitable after the first year of operation and we have further profit which we also keep in the business and increases shareholders' equity.

The increase in profit we generated by opening another lemonade stand is the incremental return we generated by making the investment in our business' second lemonade stand. The money the business, we, spent opening the second stand is the incremental invested capital. As owners, we want to generate healthy returns on any additional money we choose to reinvest in the company. In other words, healthy incremental returns on incremental invested capital is a very good thing!

After another couple of years of this we realize if we had more cash in our business, we could open more locations with the hopes of generating more profit. We have a couple of choices, we could:

1. Go to the bank and ask them to lend us money. This would then become debt capital. We would then have creditors, people we owe money to, which would have to be repaid according to the terms of the loan.
2. We go to some of our friends and tell our story and ask if they'd like to become owners in our business. We would have to agree on what our lemonade business is worth

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and how much of the business they would purchase. If we came to terms, they would become part owners in the business and we would have to share our profits with them moving forward. This new influx of money, or capital, would become equity capital and would also be added to the shareholders equity.

Let's assume the bank would only be willing to lend us money at a high interest rate because we were new and so we decided to go with the second option. We use the capital we raised from our friends and opened 7 lemonade stands in the next couple of years- all of which were profitable. We decide to go back to the bank and show them our recent income statements and ask if they'd like to lend us money at better terms- we see more opportunity which we want to capitalize on. They agree and so we take on some debt to open another 7 stands.

Ok, now we've been in business for some time and have 16 lemonade stands, we're profitable, we have other shareholders in our business, and we owe money to the bank. With our profits we now have a couple of more options to add to 3 mentioned above (pay a dividend, reinvest the profit in our business or simply keep the cash in the back):

1. Pay down the debt we owe the bank.
2. Buy back the shares of the business our friends bought.

These are the same 5 options publicly traded companies have, there's nothing else. The decisions we face with our lemonade business are the same decisions facing the management teams of publicly traded businesses. These management teams work for you, remember, you're a business owner. If you have someone working for you, it's helpful to know how good of a job they're doing.

One way to measure how well a company is being managed is to measure the annual profit the business makes against its equity or net worth. What we are calculating here is our business' return on equity: the annual profit divided by our business' net worth or equity. If a business can continually maintain a high ROE, without taking on excessive debt, we know we have a pretty good business which is being well managed.

Remember there's a difference between what someone is willing to pay for our business today and what the underlying assets of the business are worth, less the liabilities. Think of it this way- a company's equity would be the money left after it closed operations, sold all of its assets and paid off all of its creditors. We always use a company's equity, not what someone else is willing to pay for the business, when we're measuring its ROE. After all we wouldn't want the measurement of management's skills to be dependent on a factor completely out of management's control.

If the management teams of the businesses we own decided to pay out all profits as dividends, so that you could go on a bunch of fishing trips this year, the business may not be around for us to go on a fishing trip next year. Remember *measured generosity is sustainable*. If businesses are too generous in paying out profits to their shareholders, then their generosity becomes unsustainable and the business may start to falter and problems start to develop which can be hard to stop. In 1979 Warren Buffet famously quipped "turn arounds seldom turn".

As we presented in our recent Portfolio Management update to you, the businesses you own are operating very well (please keep reading for further detail on this); yet, what people are willing to pay for your group of businesses is down by ~20% so far in 2022. (As a side note - this 20%

The Del Vicario boys' lemonade stand business named "Danny's Roadside Oasis".

decrease has nothing to do with the performance of these businesses, but rather because of speculation that these businesses will struggle in the future due to rising interest rates and inflation.)

So, back to our lemonade business. We continued to open new stands, generate more profit, and run a healthy business. We eventually wanted to take our business across the country and we decided to take the business public so we could raise a meaningful amount of equity capital needed to fund the expansion.

People can now buy and sell shares on the open market. Then investors in general started to feel skeptical about the future because of rising interest rates. Some people, strangers to us who only know our lemonade business as a stock symbol, didn't think the business would be able to operate as well moving forward and started selling their shares in the lemonade business, which then caused more people to sell shares, which is causing the shares to drop further in price. You as an owner have 3 choices:

1. Fall victim to the fear and sell your own shares as well.
2. Don't do anything
3. Buy more shares from the fearful people at depressed prices.

If you go with option 1, which I'm sure as an educated business owner you know is the wrong choice, what are you going to do with the cash you get from selling the business? Go research another business which is also operating well, but down in price for the same reason the lemonade business is down? Go buy a business whose price is temporarily holding up well because of a rare and unpredictable event (oil/gas up in price because of a supply disruption)? Wait for the price to drop even more and then buy it back? Trying to time when people are going to stop being scared is impossible to do consistently. If you get it right once, you think you're smart and can do it again and eventually you're wrong; then what?

Options 2 and 3 make a lot more sense. We know the business is operating well, have no plans to sell our shares because we have confidence in the company's future. The best thing we can do is to continue to make good business/management decisions and once the general market sentiment settles down, the share price will recover. We can then choose to sell a share or two if we want to go on more fishing trips.

This is where all of our focus lies, making sure you are the proud owner of several high-quality businesses which have a history of operating at a very high level, are currently operating at a very high level and are positioned to continue to operate as such into the

future. This approach is timeless and adhering to it is not always going to be easy. When it gets tough, remember to focus on the operational metrics via our look through analysis (see sidebar for more details), and continue to live and enjoy life. Bad Dad joke aside, we can always turn lemons into lemonade!

PORTFOLIO UPDATE: UNCOVERING THE EFFECTS OF RE-INVESTMENT AND BUYBACKS

Jason Del Vicario, CFA

"The first rule of compounding: Never interrupt it unnecessarily."

– Charlie Munger

I will often ask Mike & Amanda 'what are clients saying?... how are they feeling?' Mike responded the other day with something I think is important enough for me to address in our monthly newsletter. He said someone had mentioned to him that shareholder returns beyond the rising price of a security (or their portfolio) are invisible and thus difficult to grasp. This is a fair comment; Steven and I often talk about share buybacks or incremental returns on incremental invested capital as something to covet but it is understandably difficult to appreciate what we cannot see.

First, I think we can all agree that focusing on companies that produce free cash flows (extra cash that isn't required to maintain or grow business and can be returned to shareholders) and growing those cash flows makes sound financial sense.

Below is a reminder why we favour profitable companies. The Goldman Sachs Non-Profitable Tech Index is down over 70% from its mid-2020 highs. No thanks. By definition, a business cannot compound our capital if it doesn't earn a profit!

COMING SOON: HILLSIDE'S LOOK-THROUGH ANALYSIS ONLINE

Twice a year we will be updating the look through analysis of Hillside Co. Hillside Co. is a notional company comprising of the weighted average of the businesses (stocks) that represent the stock portion of our 3 Hillside flagship portfolios (Conservative, Balance & Focus).

These updates will be posted on our website this summer.

We believe in providing clear and candid advice. We provide this analysis to enable our clients to make sound personal financial decisions which will lead to realizing their big meaningful dreams!

Our group of businesses (the 25-30 stocks we own) all produce free cash flows. All our CEOs face the same set of options in terms of deploying this excess cash (in order of preference):

1. Re-invest in the business
2. Buy back shares
3. Pay a dividend
4. Pay down debt
5. Keep as cash

Of the options above, the only one we 'see' as shareholders would be #3: pay a dividend. We receive a share of profits in our account; we can see it, touch it and it'll buy us a loaf of bread. We can 'eat' dividends sort of speak.

However, as shareholders, by far the very best option would be for the CEOs of the businesses we own to re-deploy the capital back into the business at high incremental returns. Next best would be for our CEOs to buyback shares assuming the return of this activity exceeds that of re-investing. If none of these activities will generate suitable returns, then we'd like the capital returned to us in the form of dividends so that we may re-deploy it ourselves.

Given the low-rate environment and the fact our companies do not carry a lot of debt we won't address 4) and 5); suffice to say these aren't tremendous uses of our capital (but better than lighting the money on fire!).

When we talk about aligning ourselves with proficient allocators of capital, it is precisely these decisions that we pay particular attention to when deciding which businesses to invest in.

This begs the obvious question: **how can we appreciate re-investing in the business and share buybacks if we can't 'see' these activities?**

I am going to reference a slide we presented in our June 9th Portfolio Update client presentation to answer this question.

Here are the metrics of "Hillside Co." which is a weighted composite of all the equity (businesses!) positions we own:

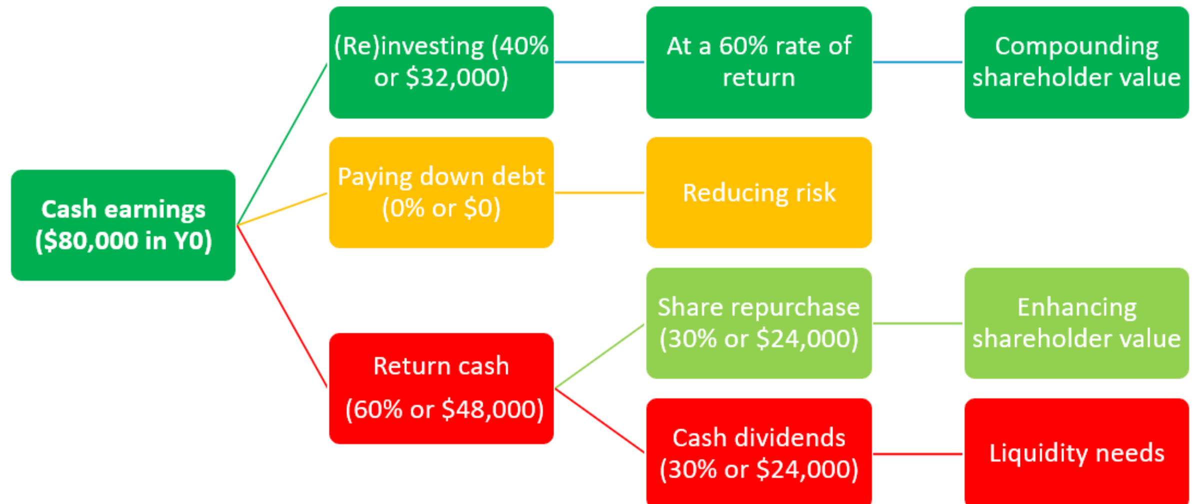
Hillside Co.

	Return on Equity	Debt to Equity	3-yr CAGR in Cash Earnings	Cash Earnings Yield
Focus Growth Model	63%	0.5x	26%	7.9%

Source: HillsideWealth June 2022

In plain English this means that our group of businesses generate nearly $80,000 (7.9%) per $1m of capital invested in cash earnings. This amount has been growing at 26% compounded over the past 3 years and as a percentage of the equity capital invested in the company represents a return of 63%. It is also important to note-our group of business don't use a lot of debt capital to produce these returns.

But what happens to the $80,000 of excess capital?



Source: HillsideWealth June 2022

By now we know the very best use of this excess capital would be re-investment in the business. I think we can all agree a 60%+ return is a beautiful thing. Alas, our companies either don't need this much capital to maintain or grow their business or there simply aren't unlimited opportunities for them to generate these elevated returns on re-invested capital. We therefore see the ~40% of the capital is re-invested. The remaining ~60% is returned to shareholders in the form of dividends (~40%) and share buybacks (~20%). While we only 'see' the former (cash deposited into our accounts) the latter increases our share of the business without us having to lift a finger because the capital is used to reduce the share count.

The way we 'see' the effects of re-investment and buybacks is the value of the shares of our businesses rising over time. While we cannot control what the market will pay for this healthy and growing cash stream in the short-term we remain confident that over time we will be well rewarded investing in Hillside Co. – a concentrated collection of high quality, predictable businesses.

THE HILLSIDE FACTOR^(Y) FOCUS: PREMIER ANTI-AGING: FINDING BLUE OCEANS WITHIN RED OCEANS

Recently, we welcomed the second Japanese company for the year to join "Hillside family" as one of our portfolio companies (in HillsideCo.). Tokyo-based Premier Anti-Aging engages in developing and marketing cosmetic and skincare products mainly in its home market.

In 2009, self-described "anti-aging freak" Kiyoshi Matsuura started his business with the mission to help people defy age to "unleash time." The company expanded exponentially thanks to the success of its flagship cleansing balm product DUO. It then went public around two years ago and was at once one of Japan's most popular stocks.

As you may have imagined, we often find attractiveness among fast-moving consumer-goods brands from an equity investment perspective. They are easy-to-understand businesses generating high-frequency, repeatable, small-ticket, cash-rich transactions in a relatively stable industry. Premier Anti-Aging shares all these characteristics. Even better, the company has built its subscription-based, direct-to-consumer business model. Customers pay a subscription fee to receive the product in mail periodically. Based on our calculation, the company generates approximately 2/3 of the total revenue through its proprietary e-commerce channel, thereby cutting out the middle man (i.e., the traditional retailer) and saving costs. It also harvests valuable data and insights from directly dealing with customers that could help nurture brand loyalty and product innovation for the long run. Our source indicates the majority of the e-commerce sales are coming from subscription accounts (as opposed to one-time purchases) with a low cancellation rate as well as repeat customers.

By now, you have probably started to appreciate the unique business model of Premier Anti-Aging compared to mainstream fast-moving consumer goods conglomerates. You may also wonder how a startup-like player could survive and thrive in this intensely competitive, slowly-moving space. In our view, Premier Anti-Aging has the right team that has been doing a decent job in finding “blue oceans” within “red oceans.” For example, the total cosmetics market grew stably at merely 2%-3% on average a year in Japan for the last decade and is currently worth around JPY 2.6 trillion (*source: Fuji Keizai Cosmetics Marketing Handbook 2022*). However, the company carved out a niche within the JPY 128 million cleansing market, creating and growing the balm category through its DUO brand. Our source indicates many Japanese consumers would perceive cleansing balm as being the same thing as DUO in their mind (similarly to Vaseline and petroleum jelly). Our calculation points to an over 20% share of DUO in the cleansing market despite a scant 1% share in the total cosmetics market. DUO achieved an over 60% YoY sales growth in both FY2021 and FY2020. As of FY2021, DUO accounted for 86% of the company’s total sales. We would expect that revenue-share figure to steadily come down as the management shift resources towards newly launched brands such as CANADEL, currently sharing 3% of the JPY 131 million all-in-one (cosmetics + emulsion + essence) market.

Regarding the long-term prospect, we think the company may expand its business in multiple dimensions. Launching new products within or beyond cosmetics (e.g., supplements), alongside cross-selling, is one way. Further, many consumer brands “travel well” (think Coke), while overseas sales only represent less than 3% of total at Premier Anti-Aging at the moment. Lastly, we see a sizable room for margin improvement in light of the company’s asset-light operations (i.e., outsourced manufacturing) and what larger-scale peers have achieved.

Of course, no one can own a business without any inherent risk. In terms of Premier Anti-Aging, Mr. Market’s major concerns seem to lie in the decelerating (but still positive) growth and mounting inventory uncertainty. We feel both factors are short-lived and that “punishment” (i.e., a normalized price multiple of less than 15x) is way overdone for a high-quality company aiming to triple its revenue over the next 4-5 years. At the same time, we manage our risk exposure by appropriate valuation estimate and position sizing.

(A quick favor to ask – if you happen to use DUO and/or CANADEL, please let us know your feedback!)

MAY 2022 PERFORMANCE RESULTS

An overview of our three portfolios to date.

Performance to May 31, 2022	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	5 Yr**	Inception **
Hillside Conservative Growth*	**-11.68%**	**-1.60%**	**-9.73%**	**-0.78%**	**4.10%**	**5.37%**	**6.54%**
HCG Benchmark[1]	*-9.90%*	*-0.19%*	*-8.42%*	*-6.30%*	*3.47%*	*3.50%*	*3.94%*
Hillside Balanced Growth*	**-12.14%**	**-2.00%**	**-10.25%**	**1.80%**	**6.05%**	**6.86%**	**8.88%**
HBG Benchmark[2]	*-9.99%*	*-0.26%*	*-8.46%*	*-5.71%*	*4.86%*	*4.54%*	*4.67%*
Hillside Focused Growth*	**-16.17%**	**-2.23%**	**-12.98%**	**-0.53%**	**7.79%**	**6.61%**	**8.61%**
HFG Benchmark[3]	*-9.83%*	*-0.14%*	*-7.09%*	*-2.41%*	*10.24%*	*7.91%*	*7.39%*

Past performance is not an indication of future returns.

* Performance is presented gross of fees. **Inception: Sept 2, 2014. Results beyond 1 year are annualized.
[1] Hillside Conservative Growth Benchmark: 100% Vanguard Conservative ETF
[2] Hillside Balanced Growth Benchmark: 100% Vanguard Balanced ETF
[3] Hillside Focused Growth Benchmark: 100% Vanguard All-Equity ETF

Source: SIACharts.com

The performance presented in this portfolio report is hypothetical and does not represent a specific client account. Details regarding actual returns of an investment account are available from the client's advisor.

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Insurance products provided through iA Private Wealth Insurance.

Hillside Wealth Management is a personal trade name of Michael Preto and Jason Del Vicario.

Performance is calculated using month-end market values of the model portfolio. Since we use a model portfolio to calculate performance there are no client-initiated cash flows (deposits/withdrawals) to account for. Performance is calculated by dividing the change in the model portfolio's market value by the model portfolio's market value at the beginning of the performance period. Also, all income generated by the portfolio's holdings are held within the model portfolio in cash and is accounted for in the portfolio's month-end market value - this results in a total return measure of the model's performance.

Returns for periods less than 1 year are shown as periodic returns while returns for periods greater than 1 year are annualized. Returns do not include fees and actual returns experienced by an investor may differ from those shown. Past performance is not a guarantee of future results.