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COMMODARI ANTINORI GROUP
SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2011

> *"A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty."*
> *– Sir Winston Churchill*

The first half of 2011 was not without its share of front page news. Floods in Australia, earthquakes in New Zealand and Japan, overthrown governments in Tunisia and Egypt, civil war in Libya, continued unrest in the Middle East and, most recently, European sovereign debt worries. Any more bad news, we may have to buy shares in Eli Lilly, the makers of Prozac.

Despite all this doom and gloom, rising corporate profits spurred stock prices higher for most of the period until finally reversing direction in late April and returning some of their gains – in the case of the Canadian market by nearly 7%.

For the six-month period ending June 30, 2011, the total returns in Canadian dollars for the Standard & Poor's 500 and the MSCI World Index were 2.82% and 2.42% respectively while in Canada, the S&P/TSX Composite ended the period up only 0.16%.

Enclosed for your easy reference is your personalized *Portfolio Review* detailing both your holdings and performance. As we often point out, much of the value we add is in protecting capital during down markets and not necessarily outperforming in bubbling ones. On that note, we are delighted to report that we lived up to our billing and handsomely outpaced our respective benchmarks. Not owning names like Research in Motion (RIM) and Sino-Forest (TRE) made that job easier and highlights what we have always known. Notably, what matters most is not hitting home runs all the time, but rather minimizing your cumulative errors. For owners of RIM and TRE, those errors amount to losses of 54.92% and 82.27% respectively for the year.

THE GOLDEN RULE OF INVESTING

Whether you invest in real estate, dabble in the stock market, or prefer to hold bonds, one inescapable constant in all investment operations is that low prices increase future returns. To put it another way, "merchandise well bought is half sold" – an adage familiar to many of you in the distribution business.

Because price is set by people, who are both fallible and emotional, it can be subject to all sorts of influences beyond the pure economic characteristics of the underlying asset. In some cases, the influence of emotions like euphoria and panic can become so dominant that prices become irrational. This is dangerous because most people tend to chase what has already gone up and get out of what has already gone down.

In this issue, we thought we would take a closer look at the dynamics surrounding real estate, common stocks and bonds. We do this not to try and pinpoint the best investment, but rather to try to avoid the worst. Let's get started.

BRICKS & MORTAR

There is no shortage of fanfare these days surrounding real estate. With property prices in Quebec surging 153% over the last decade it is fair to say that enthusiasm and expectations are high. The question is will robust returns for real estate continue into the future? The last time we had such a strong showing was in the 80's and that was quickly followed by a decade where returns increased by only 10% - far short of the 21% rise in inflation at the time.

One thing is certain; from a psychological standpoint real estate is a tough asset class to compete against. Unlike equities or bonds, it offers investors something tangible – grass to mow, doors to slam, and cabinets to open and close. While comforting to some, it should be noted that the tangible features of this asset class do not reduce the inherent risk of the investment - the only thing that can do that is the price you pay. Pay too high a price and you stand to lose money.

As our neighbors to the south can attest, real estate clearly is not immune to this iron law of valuation and does experience periods of negative returns – sometimes dramatic ones. An important takeaway from this and other real estate collapses is that investors should never look to the selling price of comparable properties to value a property. Remember, emotion can pull prices to extremes of euphoria and panic regardless the asset.

To keep emotions in check, it would be wise to shine a light on valuation. To do so, we will focus on two metrics – affordability and price-earnings ratio (P/E). First, affordability. History has shown that over time price increases in real estate are sustainable only if they move in tandem with disposable income. At present, home prices in Canada are listed at 5.5 times the average disposable income per household. This metric is now well above the historical average of 3.5 times and signals that caution is warranted.

Turning our attention now to the P/E ratio, our hope is to gauge how attractive this asset class is relative to other investment opportunities. In the case of housing, a crude P/E ratio can be constructed by taking the average MLS residential price and dividing it by the average annual rent for a three-bedroom apartment. Based on year-end 2010 data, we calculate that the average three-bedroom dwelling in the Greater Montreal area trades at 29.5 times earnings. Stated differently, real estate offers an earnings yield of 3.37%. Given the risks associated with the investment, this yield is clearly nothing to write home about.

COMMON STOCKS

As an asset class, stocks have nowhere near the same fanfare they experienced at the turn of the century. Back then, spirits were high, the future was bright and stocks were expensive. A stark contrast to what we are experiencing today.

Despite this reversal, the one constant that remains and that distinguishes equities from other investments is the unmatched liquidity that this asset provides. No lengthy sales process, inspections or financing hurdles needed here. A simple phone call or click of the mouse is all that separates you from your money. Unfortunately, it is this very feature that is often to blame for investors lackluster results.

Think about it for a moment. Contrary to less liquid assets such as real estate, where investors have little difficulty looking at things over the long haul, equities are rarely extended that same courtesy. Instead, success is measured minute-to-minute and day-to-day. People are so impatient that they move from one investment fad to the next and rarely take the time to research, understand and most importantly, hold onto a business and allow it to grow.

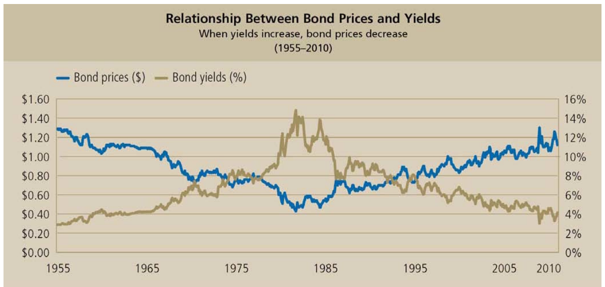
The result is often years of inferior performance in what should otherwise be a profitable endeavor. For instance, if you owned the S&P 500 at the end of 1999 and held it through December 2009, you would have lost 9.02% over the period whereas had you been more selective and tuned out the noise, you could have owned great franchises like Saputo, Canadian National Railway or Becton Dickinson which over the same period delivered total returns of 320%, 422% and 235% respectively.

Looking forward, what are the chances of identifying another Saputo or Becton Dickinson? Using valuation as our guide, we would say that our chances are good. After all, Value Line recently reported the P/E ratio of all stocks listed on the S&P 500 to be 16.4. This means that based on current valuations, we can expect the market to yield 6.09% - not bad considering a 10 year government bond is only yielding 3%. Compounding that number out over the next decade gives us a return just shy of 71%.

Even more encouraging is the fact that in the ten instances since 1928 that the S&P 500 returned less than 5% per year over a rolling ten year period, returns over the ensuing ten years averaged about 13% per year. This would bring our total return to 200%.

FIXED INCOME

Needless to say, given the steady decline in interest rates over the last decade, the returns on government bonds have been well above-average. Having discussed fixed income just two issues ago, we thought we would approach the topic differently this time around and have enlisted the help of the chart below.



Relationship Between Bond Prices and Yields
When yields increase, bond prices decrease
(1955–2010)

Source: Morningstar. Bond prices and yields are represented by the 20 year constant maturity U.S. Government Bond

As you can see, government bond yields now stand much nearer their 50-year lows than their highs. This is important because the best predictor of the future rate of return from a bond is the yield at which it is purchased. With this in mind, we can say with confidence that prospective rates of return from bonds are quite low.

For investors clinging to the security of bonds, we feel it important to point out that from 1955 to 1982, investors in bonds lost money on an inflation-adjusted basis. Beginning with the very low interest rates of the early 1950's and ending with the high interest rates of the early 1980s, bonds were a terrible investment. With interest rates now close to the levels that began that disastrous period, we believe bonds will prove to be poor investments going forward. To quote Jim Grant, at today's prices, bonds represent "return-free risk."

WHERE IS THE VALUE TODAY?

Today, value is to be found where it always is: in the assets that people do not want, that are not "performing," that have no momentum, and that are cheap.

You can succumb to the fanfare and buy real estate offering an earnings yield of less than 3.5% and considerable capital risk, clamor for high-priced bonds yielding little and providing an illusion of safety or you can buy first class businesses with earnings yields in the range of 6.0%.

For those that can ignore the lure of the crowd and separate stock market gyrations from intrinsic value, the choice is clear. Stocks offer the best risk-reward tradeoff and we believe that they are poised to outperform both real estate and bonds in the decade ahead.

PORTFOLIO DEVELOPMENTS

Portfolio activity was typically modest during the first half of 2011. One of our most active additions was Target Corporation, pronounced, of course, Tar-gét! This Minneapolis-based company operates 1,750 general merchandise stores in 49 states and the District of Columbia and recently announced plans to open stores in Canada via the purchase of up to 220 leaseholds currently held by Zellers.

Target has a remarkably strong management team – one of the best in the business - and their product mix caters to customers with slightly higher disposable household income than rival Wal-Mart. The merchandising business is tough but Target is very adept and has succeeded in developing a fervent following among shoppers in the United States. We are confident that they will successfully export this enthusiasm to Canada and believe that we will be well-rewarded over time for our investment.

On a separate note, we are pleased to report that the veil of uncertainty that allowed us to add Visa to portfolios last year at deeply discounted prices has now been lifted. On June 29, the U.S. Fed issued its final ruling on interchange fees. The news was not as draconian as Mr. Market originally feared and thus the share price moved up sharply. With this chapter now closed, we are even more excited about our investment and feel that an unencumbered and focused management team will have little problem improving on an already wonderful business.

CONCLUDING THOUGHTS

The foundational rules of investing are simple and should never be forgotten. As the cornerstones of success, they require that we always maintain discipline, avoid reacting to forecasts, maintain a long-term perspective and, above all else, never overpay for an asset.

At times, we realize that staying faithful to the above rules can prove difficult – especially when popular opinion goes against you. In such times, it is often helpful to project yourself into the future and think of what you wish you had done a decade earlier. More often than not, that thing is buying those assets that are unpopular and cheap today. Equities fit that bill now.

Thank you for investing with us and for your continued confidence.

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