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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2012

"Big price changes occur when market participants are forced to reevaluate their prejudices, not necessarily because the world changes that much."
– Colm O'Shea

To paraphrase Charles Dickens, the first half of 2012 was a tale of two quarters. The first quarter represented the strongest start for equity markets since 1998. Even the Nikkei Index in Japan, a chronic laggard, logged its best first quarter in 24 years. Gains in all markets were largely driven by a reduction of fears about Europe and optimism about strengthening global economic growth.

Alas, this newfound serenity was short-lived as renewed concerns about European sovereign debt levels resurfaced in the second quarter calling into question the staying power of the Euro itself. Add to this a slowdown in China and India and speculators were quick to head for the exits erasing some of the gains posted by markets in the first quarter or, in the case of resource heavy markets like Canada's, all of them.

For the six-month period ending June 30, 2012, the total returns in Canadian dollars for the Standard & Poor's 500 Index and the MSCI World Index were 9.61% and 6.41% respectively, while in Canada, the S&P/TSX Composite Index returned -1.53%.

Despite Canada's poor showing, we are pleased to report that portfolios managed by Commodari Antinori Group posted excellent results. Our limited exposure to energy and resource stocks, combined with a healthy representation outside of Canada – primarily through the ownership of U.S.-domiciled multi-nationals – proved to be just what the doctor ordered. As usual, please find enclosed for your easy reference your personalized *Portfolio Review* detailing both your holdings and performance.

GIVE ME SHELTER

As Europe and the U.S. struggle with serious fiscal challenges and the economic stress that various policy responses will inevitably entail, the consensus for the global economy has gone from bad, to good, then back to bad again.

Where sentiment will lie in the future and what headlines will prevail next week, next month or next year is anybody's guess – we are not clairvoyant enough to know. Although we do understand that economic and political issues weigh heavily on the minds of our clients, our primary concern, as investors, is finding ways to intelligently keep our capital working for us in today's difficult environment.

On the one hand, we could adopt a so-called tactical approach, choosing to enter and retreat from equity markets based on quantitative or, more likely, subjective factors. The idea is to participate in good markets and, when anxiety and fear rises, to exit and simply wait for a better time. But how will we know when to return? Last we checked, markets

never send out an all-clear signal. Alternatively, we can turn to stop-loss orders and other ill-conceived risk minimizing strategies to try and limit a potential loss, or as many have already chosen to do, we can simply sell our stocks in favour of bonds.

As it often feels safer to just fall in line with the rest of the herd and to go along with conventional thinking, in this issue, we thought we would explore some of these newly rediscovered *"truisms"*.

BUY & HOLD – R.I.P.

In volatile periods, stock price movements can sometimes become completely divorced from what is going on fundamentally in the underlying business, reflecting the anxieties of investors rather than how the companies are actually doing.

In times like these, it is the belief of many an investor that playing in and out of a stock is a money-making proposition. On the surface, we would agree, but unfortunately, success using this method requires two correct calls – when to sell and when to buy back in. We believe that being accurate in both predictions is a low probability event and, when multiplied over months and years, the chance of success is remote.

Add to this the very simple truth we seldom see discussed - the effect of taxes. If you're going to buy something which compounds for 10 years at 9% per annum and you pay one tax at the very end, the results are very different than if each year you traded in and out of that same investment, but had to pay taxes every year on the profits earned. We will spare you the arithmetic, but suffice it to say, if you sit back for long stretches of time in great companies, you get a huge edge simply by taking advantage of the way the tax code is written.

Our job then is two-fold. First, selecting the right companies to invest in, and second, determining the right price to pay for them. If we get the latter right and, assuming the businesses we buy are good ones, they will do most of the work for us. In other words, if we own an interest in a good business, time is on our side.

This does not mean we bury our heads in the sand after we've punched our ticket. Investing is a dynamic rather than a static process. Our client portfolios today are not exactly the same as they were 10 or 15 years ago. Overpriced securities were sold, positions were rebalanced, and harvested profits – along with new capital – were reinvested into undervalued assets.

BONDS – RESIST THE SIRENS SONG

In Greek mythology, the Sirens were dangerous and devious creatures, portrayed as femme fatales who lured nearby sailors with their enchanting music and voices to shipwreck on the rocky coast of their island.

Today, the sirens sing a seductive melody about the safety of bonds. We continue to believe that investors who are trying to reduce risk by selling stocks and buying bonds are probably increasing their risk of losing money. Having talked about this in detail in past issues of our commentaries, we won't rehash our views again here - if you failed to archive your copies, don't worry, they are available on our website.

We will add, however, that today bonds are not being priced solely on their intrinsic value. A "fear and loathing" premium has been built into the price. Fear of the unknown and loathing for equities are dangerous emotional responses to recent experiences. As we have previously written, successful investment is a direct outcome of a rational process and emotion should never corrode this process. Ultimately, fundamentals prevail.

STOP-LOSS ORDERS - STOP THE INSANITY

A little over two years ago, on May 6, 2010, for about 15 minutes, stock markets across North America experienced some of the oddest trading we've ever seen. In that short timeframe, markets declined significantly - some in excess of 5% - but then made an about face and erased all of those losses.

It was during this erratic behaviour that we witnessed something truly astounding. Procter

& Gamble, a household name, fell from $63 to $39 in just a couple of minutes and then, just as quickly, its share price nearly fully recovered.

After extensive inquiries into the cause of this *"flash crash,"* market authorities cited stop-loss orders as one of the culprits. Reflecting on those events, we are struck by how illogical market participants can be.

A stop-loss order is simply an order placed with a broker to sell a security when it reaches a certain price. The thinking behind the order is that it eliminates the potential of a complete loss of value. In the case of Proctor & Gamble, an investor who owned the shares – presumably because he believed they were worth more than $63 – could have chosen to enter a stop-loss order at say, $40. This means that when the stock briefly traded below $40 on that May afternoon, the shares would have been sold.

Consider how absurd this notion would be if applied to other assets. Let's say that a homeowner believes his house is worth $630,000. He instructs his realtor to constantly monitor bids for the house. As long as at least one bid is above $400,000 he'll do nothing. But, if at some moment in time, nobody is willing to bid at least $400,000, then the house is to be immediately auctioned off to the highest bidder.

Obviously, no one in their right mind would behave in such a way. It is no way to sell a home, a car, a piece of art, a business, or any other asset. Yet that's the equivalent of equity stop-loss orders.

We do not believe in rolling the dice and applying arbitrary mechanical rules to sell-out our positions for us. At Commodari Antinori Group, fear does not dictate our actions - a rational appraisal of a company's real intrinsic value does. Rest assured that we will not hesitate to sell a business when it surpasses our appraisal of its worth and conversely will make full use of limit orders not to sell, but rather to buy undervalued businesses when they reach our ***buy*** price.

PORTFOLIO DEVELOPMENTS

As value managers, we often explain that we aren't forecasting a giant change in the fundamentals of companies we invest in, but rather we expect the stock price to increase significantly when investors change how they think about our companies.

When we bought Home Depot several years ago, investors were worried about the state of crisis in the housing market; we were focused on their strong market share, solid balance sheet, and well-covered dividend. Today, the stock price has nearly doubled from our original purchase price and we have begun trimming our stake in this business.

In terms of meaningful new buys, earlier this year we began purchasing Corning in client accounts. Many of you instantly recognized the name as the inventor of CorningWare®, but were unaware that over its long 150 year history there have been several other great technologies that can be traced back to them – the most notable of which is fiber optics. In some respects, you can think of Corning as a materials science research lab.

Over the last decade, the business has transformed itself, and they are now recognized mainly for their display technologies business. This unit makes the glass that sandwiches the microelectronics for LCD TV's and the like. Unfortunately, the reality of consumer electronics is that nobody has found a good way of selling more TV's except for lowering the price. As a supplier, Corning feels this pressure and thus pricing has declined over the last several years. To compound matters, last year the three major glass makers oversupplied product – allowing manufacturers to get the better of them – and Corning suffered from a contract dispute with one of its customers.

With capacity now reduced by 30%, we think Corning finally has things under control in their display business. But that is not the reason we were attracted to the name. We purchased Corning because of the growth in the company's other business segments which, when combined, are

as large as the display business. These segments appear to be overlooked by the market because of the difficulties Corning is currently experiencing in display technologies. This difficulty has led to a sharp decline in its share price and provided us with a large enough margin of safety to take a position.

We are confident that perceptions will eventually change and, when that happens, we stand to make a handsome profit from our investment. In the meantime, we are quite comfortable owning this cash flow positive and well-run business.

CONCLUDING THOUGHTS

At Commodari Antinori Group, we believe that investing is about process and discipline. Accordingly, we place heavy emphasis on company-specific research and valuation. Our conservative approach has endured the test of time and, going forward, it will continue to deliver pleasing results.

The appetite for equities remains apathetic. This is not surprising in light of the volatile market performance over the past few years. The believability and faith for buying equities remains quite low. In fact, lately it appears that investors are basing investment decisions more on emotion than analysis. We are adamant that this is not the proper approach.

In our view, after assessing the relative valuation of various asset classes, equities are very attractive and results should silence the skeptics in the years ahead. The benefits will be enjoyed by those who maintain a disciplined and process-oriented approach.

As always, we thank you for investing with us and for your continued confidence.

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