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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2013

"The best investors are like socialites. They always know where the next party is going to be held. They arrive early and make sure that they depart well before the end, leaving the mob to swill the last tasteless dregs."
– The Economist (1986)

We remain bemused spectators to the continual twists and turns of Mr. Market. As usual, he provided good theatre and, in the first half of 2013, rekindled a romance with equities long since forgotten. Indeed, his worries of just a few short months ago were cast aside as global equity markets forged ahead - some hitting new highs along the way. Despite losing some steam in June after Federal Reserve Chairman Ben Bernanke warned that stimulus efforts could be tapered in the future, Mr. Market regained his nerve in the final days of the month and so, the romance continued.

When all was said and done, for the six-month period ending June 30, 2013, the total returns in Canadian dollars for the Standard & Poor's 500 and the MSCI World Index were 20.33% and 15.01% respectively, while in Canada, the S&P/TSX Composite returned -0.88%. Looks like our wholesome Canadian charm failed to get Mr. Market's *mojo* going.

Luckily, when it comes to matters of romance, we are happy to report that your portfolio managers know a thing or two on the subject. After all, it's our job to introduce your hard earned money to only the most deserving of businesses and rebuff the advances from suitors of lessor stock. What we are looking for is lasting love, not a passing fling.

As positions we setup in years past continue to mature and blossom, our matchmaking talents become easier to appreciate. Indeed, so far this year, portfolios managed by the Commodari Antinori Group appreciated significantly and widely exceeded their respective benchmarks.

After such strong results, we wish to remind you, however, that there will be periods when returns will be more subdued. We say this not to scare you, but rather to taper your expectations somewhat – especially after such strong results.

ALICE, THE MAD HATTER & WAYNE GRETZKY

With sentiment no longer universally fearful, many who abandoned equities in recent years have begun to slowly migrate cash and bonds back into stocks. We welcome this move, as it brings with it an upward re-evaluation of the prices people are willing to offer us for, what in most cases, are companies we were diligently buying several years ago at much lower prices.

Back then, stocks were cheap and hard to pass up. Especially for investors like us who are constantly on the look-out for great value. The only catch to

this financial nirvana was that you had to be willing to act contrary to the crowd – an uncomfortable feeling for most. Indeed, being a value investor requires the willingness to do what is unpopular and the discipline to stick with your decision while the majority of investors are going in a different direction.

Think of it like being the first to arrive at a party. Despite a great venue and a charismatic host, not knowing for sure if others will arrive leaves you feeling awkward. After those first few uncomfortable minutes – minutes that seem to last for hours – guests do start to arrive however, and the uncomfortable feeling you once felt subsides. The party eventually gets hopping, people start feeling good, bottles of wine get drunk, cigars get smoked and the line between sensible actions and folly get blurred. At this point, not wanting to overstay your welcome, you decide to leave early and are once again left feeling uncomfortable – this time because you know you have left behind what may be remembered as a helluva party.

Speaking figuratively, when the equity party gets too loud, our practice is not to keep dancing, but rather to walk away from the dance floor and find the next party. While we remain optimistic about the long-term prospects for our companies, Mr. Market's recent love affair with equities has brought with it a reappraisal of valuations. This means that finding significant new mispricing's in our markets is a much more difficult proposition today and, going forward, we are more likely to be net sellers than buyers of equities. In doing so, we realize that we may miss the last few minutes of a wild party but do not mind because we know, as Wayne Gretzky famously observed, that great hockey players don't play where the puck is but rather, where it is going to be.

TRUE NORTH STRONG AND… LAGGING

Amid the renewed enthusiasm for equities, Canada is a notable laggard – again. Thankfully, we have been advising clients to look outside of Canada for investment opportunities ever since we urged readers to *"look beyond Canada to reduce risk, enhance returns and access under-represented sectors"*† in our January '07 commentary.

Before you give us more credit than is due, or think your managers made some fortuitous market call – several months early in retrospect – we feel the urge to come clean and admit that the recommendation was more the outcome of necessity than of design.

As you know, despite being relatively open minded in our search for investment ideas, we have several filters in place that narrow our investment universe relatively quickly. Two of the most stringent of these filters are the requirement that companies in which we invest possess high returns on capital and relatively low capital expenditure requirements. This means that just about everything commodity and material-related – things like oil, gold, steel or potash – fail to get **our** *mojo* going, and are quickly discarded. Thus, given the nature of the Canadian landscape, where nearly 40% of companies do not make the cut, we have no choice but to broaden our investment horizons and in so doing, look elsewhere.

In the search for lasting love, it pays to know where to look – or, in this case where not to. Unfortunately, most Canadian investors continue to weigh our relatively small and over concentrated home market too heavily in their portfolios. This is akin to a drunk searching for his keys under the lamppost. He searches there, not because he is likely to find his keys, but rather because there is light.

BONDS – AGAIN? REALLY?

Our resident archivist informs us that we have written about bonds four times in the past few years. Confident that we have yet to reach a level of punishment sufficient enough to drive clients mad, we thought we would keep the streak alive in this issue. After all, practice makes perfect right?

This time around, we will begin our consideration of bonds with an analogy aimed at helping readers

understand the importance of selecting which investments to use at the right time. For this purpose we will compare two life saving devices - a life raft and a parachute. Clearly, under the right circumstances, both can save your life. However, if you need to eject from a plane, a life raft most likely will not do you much good. Conversely, a parachute would not be much help on a sinking ship.

With this analogy firmly in hand, let us now examine the two driving forces compelling most people to buy fixed income investments. They are; one, the desire to protect one's capital and two, the need to offset short-term expenses with a preset cash flow stream. Although there are sometimes other forces at play, the two noted above are by far the most common.

So, where does the parachute and life raft come in? Simple, unlike the last thirty years – where rates steadily declined – today's low interest rates have nowhere to go but up. This, coupled with the likelihood of inflation going forward, has created an environment in which the *life-saving* characteristics of bonds will be of little use to investors looking to preserve their capital.

Simply put, because the starting coupons for bonds are low and face the very real prospects of price erosion as rates rise, bonds with fixed income and principal payments denominated in those dollars have nowhere to go but down. No need to take us on our word, just look at the DEX Universe Bond Index. Year-to-date it is in negative territory and, in June alone, lost 2.0% of its value. Clearly, people clinging to bonds to protect their capital had better think twice. From our vantage point, they are clenching parachutes when life rafts are in order.

For those of you that require the cash flow stream we wrote about earlier or do not have long-term investment horizons nor the stomach for stock market fluctuations, don't worry, your bond portfolios have been built to float, but clearly are not the best vehicles for an Atlantic crossing.

COMPANY DEVELOPMENTS

As you know, we believe that our returns in the stock market are inextricably tied to the underlying fundamentals of the businesses we own. Those fundamentals are enduring and, for the most part, have improved dramatically over the last four years. Among the diverse group of companies that make up client portfolios and, ultimately, are at the heart of our performance – past, present and future, here are just a few recent highlights.

- BERKSHIRE HATHAWAY -

Earlier this year, Berkshire, along with private-equity firm 3G Capital, agreed to purchase food giant H.J. Heinz for cash of $72.50 a share. The deal, in which 3G Capital would be the primary supervisor of Heinz, is likely to close in the third quarter of 2013. Clearly, Buffett believes that everything truly does go better with Heinz. We tend to agree and believe that acquisitions like these, combined with gradually strengthening economic conditions, will continue to push Berkshire's earnings higher for many years to come.

- RITCHIE BROTHERS -

A relatively new addition to client portfolios, Ritchie Brothers with its more than 110 locations in over 25 countries is the world's largest auctioneer of industrial and agricultural equipment. While they are 10 times larger than their nearest competitor, sales account for only 4% of the estimated $100 billion used-equipment market. International expansion in places like Austria, Dubai, Australia and most recently Beijing, China – where they held their first unreserved auction in April – should allow the company to capture some of the estimated 50% market share currently held by private sellers. Indeed, recent auction results and attendance – both online and local – continue to hit new highs leaving us very optimistic as to the company's future.

- ABBOTT LABS -

In early January, Abbott completed the spinoff of its pharmaceuticals business AbbVie. With the spinoff now in the rearview mirror, Abbott is well-

positioned going forward as a more balanced and diversified medical products company. The new Abbott, now leaner, is comprised of four major operating segments: Nutritional, Diagnostics, Medical Devices, and Established Products Division. This simplified business model should bring with it significant room for margin expansion and growth going forward.

CONCLUSION

Recent stock market movements have brought with them a renewed exuberance. What this implies is that in a rising stock market, with fewer new opportunities, we will end up with more cash reserves, which will be a drag on returns.

As we have mentioned many times in the past, since we do not lower our investment bar simply to stay invested, our conservative approach typically outperforms in difficult markets but will lag in exuberant ones. This is something we are willing to put up with because we know that the business of investing is won by not losing.

We hope that we have earned your confidence with our track record, and that you share our excitement about the future prospects for our companies. We never take your trust for granted, and will continue to work hard to earn it every day.

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Source: † Commodari Antinori Group, Investment Commentary, Volume I, Issue 1.