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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2014

"In this game, the market has to keep pitching, but you don't have to swing. You can stand there with the bat on your shoulder forever until you get a fat pitch."

– Warren Buffett

Following a stellar performance in 2013, equity markets blissfully continued their advances during the first half of this year. Neither tensions in the Ukraine nor signs of slower growth in emerging markets could slow the advance. Indeed, most major developed equity markets reached record highs during this period.

After lagging significantly last year, our native market, the S&P/TSX Composite Index, registered a total return of 12.86% and was among the best performing bourses for the six-month period ending June 30, 2014. Elsewhere, the total returns in Canadian dollars for the Standard & Poor's 500 Index and the MSCI World Index were 7.48% and 6.86% respectively.

Portfolios managed by the Commodari Antinori Group performed well within this enthusiastic backdrop and this despite elevated and growing cash levels. It is important to note however that if the market insists on pushing valuations ever so higher, this achievement will be harder to repeat since we will continue to trim back stocks which we assess to be fairly priced thus building even larger cash reserves. Inevitably, these reserves will act as an anchor to short-term results.

Simply because we are prepared to accept the short-term discomfort that comes with holding cash in what, for the moment, appears to be a runaway market does not mean we are masochists. As long standing clients can attest, we experienced much of the same discomfort in 2006 and 2007 and were subsequently vindicated in 2008 for having done so. Ultimately, we know that superior results are achieved by avoiding catastrophic losses and that today's cash reserves will eventually be used to seed tomorrow's outperformance. The fact that we can wait for and choose the perfect "pitch" increases our odds of success dramatically!

UNFORCED ERRORS – RESIST THE CALL TO ACTION

The defining trait of any successful individual is drive. Talent and intelligence are certainly important but, as Calvin Coolidge once noted, nothing is more common than unsuccessful men with talent and unrewarded genius is almost a proverb. No, without drive, success is seldom achieved.

Because a majority of our clients are successful entrepreneurs, this tidbit of information clearly comes as no surprise to any of you. You all know how hard you had to work to make your business succeed – many of you did so only after the second and sometimes third attempt. So why the need to remind you of something you already know?

Simple, because the same drive that propelled you to success in the business world can also lead to failure in the investment one. Clearly, none of you just sat back waiting for the phone to ring, you all went out and *"made things happen."* However, when it comes to passive investments, like those made in the stock market, you do have to sit back and wait for the right opportunities to present themselves.

Unfortunately, the impulse to act can sometimes be hard to resist and is often encouraged by the investment community. Indeed, twenty-four hour financial news coverage, armies of economists and battalions of experts are all welcomed by Wall Street because the endless parade of information they produce generates a frenzy of activity. Long trades, short trades, puts, calls, straddles – the trade itself irrelevant so long as an action is taken. In an industry where "activity" generates the commissions that keep it afloat, what other behavior would you expect!

With today's anemically low interest rates and many stocks now fairly priced, our patience and resolve will be tested. Rest assured, we will never take action simply to transact for the sake of it. Making illogical and potentially destructive trade-offs by assuming higher risk for lower returns is not what you pay us for.

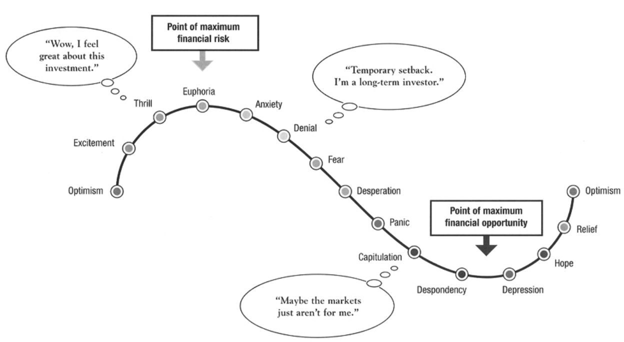
GREED, FEAR, AND THE CYCLE OF EMOTIONS

At Commodari Antinori Group, we have been bullish on stocks for well over five years now. Unfortunately, the majority of investors have only recently begun to follow suit. Fearing they will be left behind, investors who were once bearish have slowly started to throw their money into stocks in an attempt to join a party now in its sixth year.

As we wrote in our last issue, we believe that stocks remain reasonably valued at these levels however, those joining the party at this stage should be forewarned that the market will be hard pressed to deliver the same results over the next five-year period. This makes sense because as investors slowly turn bullish, asset valuations rise and in so doing, reduce the mispricings that lead to higher than normal returns. The opposite is also true. When most investors are bearish, asset valuations tend to be low and future return opportunities high.

Take a look at the chart below. It depicts the range of emotions that a typical investor experiences as the market moves through its inevitable cycle of greed and fear. How we respond to these emotions determines whether or not we as investors will be successful, or simply add our names to the long list of poor souls who repeatedly buy high and sell low.

The cycle of market emotions



It is unclear where we stand in the current cycle – we would guess somewhere between excitement and thrill. One thing should be duly noted however, now is not the time to lower one's margin of safety requirement just to try and participate in the late innings of the game. For the patient investor, opportunities will always present themselves allowing us to put capital to work on our terms. Until then, we continue to hold healthy cash balances in client accounts and will continue to free up more as the market slowly marches upward and closer to a euphoric state.

RETURN OF THE ANIMAL SPIRITS

Given the theme of our latest commentary, it is quite fitting that as we sit here today to write to you, the wearable sports camera maker GoPro Inc. is making its debut on the Nasdaq Stock Market (GPRO.O).

Company founders, having originally valued the business at $2.96 billion (U.S.), sold a portion of their stock to the public yesterday via an IPO at $24 a share. Today, investors swiftly moved that valuation higher by as much as 30 per cent. Clearly, they must know something that company founder and CEO, Nicholas Woodman, and his family did not. After all, as GoPro's biggest stockholders, what other explanation could there be for them to have sold a portion of the company for thirty percent less than the market says it's worth.

Obviously we are being sarcastic! Having yet to make any significant profit or pay a penny of dividend, GoPro is now valued at nearly $5.5 billion dollars and trades at 59x its forward earnings. So, what is causing investors to chomp at the bit for this stock and other perceived "new technology" names like Twitter, Netflix and Tesla Motors? What else but exuberant expectations about accelerated levels of growth and profitability.

We sincerely hope these companies deliver on their lofty expectations. Unfortunately, at their current valuations, it appears as if euphoria has taken over and the chances for investment success become a high stakes gamble – one that risks ending badly for many.

PORTFOLIO DEVELOPMENTS

While mispricings are less abundant in today's market, they do exist. Besides trimming a number of our names slightly during this period, we also initiated a new position and took advantage of market weakness to add to an existing name. The latter, IBM, now our largest holding throughout client accounts warrants further discussion.

There has been lots of doubt on Wall Street in recent months regarding IBM and its prospects. First, let us begin by agreeing with the pundits and acknowledge that IBM has many headwinds to overcome in the short-term.

That said, at 10x earnings and 11x free-cash flow, as an investment, the valuation is not demanding. So long as the company is consistently buying back stock - which they are - at these levels we do not need the business to do extremely well for it to work out for us as an investment.

In terms of the company's long-term prospects, we think they are making the right moves.
The trouble with IBM is that they have been so successful in the past completely dominating mainframes but, unfortunately, today that is not a business that is growing. Despite this huge anchor behind them, they are seizing on new opportunities such as their move to the cloud.

This past year they made lots of progress on that front by purchasing SoftLayer. The acquisition gives IBM infrastructure that can be delivered as a service so they can compete with the likes of Amazon in the small/medium size business IT market. Additionally, over the last 18 months, they have built a promising infrastructure service platform. This will allow them to put their market leading middleware software on top of that infrastructure and deliver it as a service in a way that large companies can connect all the systems that they built in-house over the years with new ones.

We think IBM is on top of things technologically and management is taking action to improve on the long-term prospects of the company. That said, you have to remember that they are a large company and they have a significant base of business that will not move very quickly. In the meantime, we think they are doing the right thing by buying back lots of stock at these low valuations and continue to increase our position in the company.

CONCLUSION

For us, GoPro serves as a convenient reminder that stock market prices at times can, and do, become significantly delinked from underlying value. While we do not believe that to be the case for the equity market as a whole today, valuations have climbed significantly over the last six months and many stocks, including some of our own, now trade at fair to full value.

Truth be told, we have been hoping for a healthy "market pullback" for the better part of a year now and are somewhat surprised we have yet to experience one. That said, we see no danger valuation wise in any of the businesses we currently own.

Going forward, we will continue to apply our proven investment strategy and invest in market leading companies with a history of profitability, strong balance sheets, and good management teams – but only when they are absolute bargains.

Thank you for your continued support and, enjoy the sunshine and ocean breezes!

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