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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2015

"We just keep swimming and let the tide take care of itself."

– Charles T. Munger, Vice Chairman, Berkshire Hathaway FY15 Annual Meeting

We forgive you for yawning. After all, compared to recent memory, the first half of the year was rather uneventful – at least until late June when the saga surrounding Greece stirred up some concerns and with it, a jolt of stock market volatility.

In the past, worries like deflation in Japan or fears of an economic slowdown in China would certainly have given investors something to think about. Prior to the Greek "crisis" however, markets seemed almost indifferent as they shrugged off economic concerns and sputtered along, albeit insipidly, like an old Buick in need of a tune-up.

When all was said and done, for the six-month period ending June 30, 2015, the total returns in Canadian dollars for the Standard & Poor's 500 and the MSCI World Index were 8.99% and 10.84% respectively while in Canada, the S&P/TSX Composite returned 0.91%. Interestingly enough, net of currency, returns for the S&P500 and MSCI Wold Index came in at a much more subdued 1.23% and 2.95% respectively.

Portfolios managed by the Commodari Antinori Group posted comparable results for the period. Despite making forward progress, when seen through the lens of a six-month eyepiece, results were uninspiring. We are neither pleased nor disappointed with these short-term results and remind readers that to be successful in the investment arena, it pays to always be farsighted. For that purpose, the lens of choice remains a telescope!

EVOLVING RELATIONSHIP SAME COMPASS

This summer marks an anniversary at Commodari Antinori Group – our first year as discretionary portfolio managers. While insignificant as a milestone, we bring it up because we want to acknowledge that while the nature of our relationship with clients may have changed, it was a natural evolution of our practice. Not a revolution.

Rest assured that the principles that have always guided our investment decision-making process remain firmly rooted in our DNA and will forever continue to be diligently applied on your behalf in the construction of portfolios. In this edition then, we thought it would be timely to review our most valued tenets.

TRUE NORTH – OUR CORE PRINCIPLES

Our long-standing approach to investing has always been based on a few core principles. First, we try to own the common shares of high-quality companies with good earnings growth prospects. We look for superior returns on invested capital and, for those returns to be sustainable well into the future. Unfortunately, as evidenced by some of our past purchases, the last part of this requirement is sometimes particularly tricky to assess.

Second, we try to buy these companies at prices we believe underestimate their real value. Because great companies are usually already recognized by the market, this criterion dramatically narrows our field of potential candidates. Thus, many of our purchases involve buying companies that are undergoing temporary difficulties and are therefore out of favor.

Third, when we find the first two elements together, we take a sizeable position in the company. And finally, we seek to hold these investments for many years and do so provided that the fundamentals remain sound and earnings prospects favorable. This means that we will generally hold an investment even if it faces some short-term challenges, or if its "sector" falls out of favor, or if it gets a bit ahead of itself. We will however sell some or all of a position if we feel its valuation has reached levels which appear excessive relative to likely earnings prospects.

GETTING YOUR BEARINGS

With more than three decades of combined investment experience between us, we have seen many market cycles and think it is fair to say that in addition to having our core investment tenets tested over the years, they have also been confirmed in the process. Needless to say, we learned a great deal along the way.

Today, with opportunities scarce and sentiment riding high, it is fitting that we go back to the beginning to outline what is meant by the term "investor" and show how it works in contradistinction to the term "speculator." In its simplest form, investing is an operation which, upon thorough analysis promises safety of principal and an adequate return. As Ben Graham put it, everything else is speculation.

It is worthwhile to note the radical change that occurred in the use of the term in only a short few years. After markets were hit by a financial tsunami in 2008, sentiment turned decisively negative and all common stocks were widely regarded as speculative in nature. We did our best at the time to defend the merits of equity investing and encouraged readers to take advantage of the unprecedented investment opportunities available at that time.

Fast forward to the present and our concern is the opposite. Today, confidence has risen to the point where people freely use the term "investor" to apply to anybody and everybody in the stock market. In today's language, everyone who buys or sells a security has become an investor regardless of what is being bought, at what price or for how long. We sound the alarm and remind readers that they would be wise to forever remember there is a distinction!

Keep in mind that throughout history, stock purchases of any kind are always regarded as highly speculative or risky at a time when they are selling at the most attractive levels. This was the case in 2008-09, right before stocks were poised to begin one of the greatest market advances in recent history. Conversely, the fact that stocks have now advanced some 250% from their lows - and in some cases, are now at dangerously high levels as judged by past experience - has now transformed them into investments and the entire stock buying public into investors. Go figure.

SAFELY NAVIGATING TO YOUR DESTINATION

As many market indices, including the Dow Jones Industrial Average, continue to hit all-time highs, the window of reasonably priced securities continues to shrink. This in-and-of-itself will dampen future returns as further market advances are less likely until earnings are allowed to catch up to current valuations. Compounding the matter further is the growing cash balance that has been accumulating in client accounts given the lack of attractive buying opportunities. At the risk of sounding repetitive, this cash will act as an anchor to short-term results.

For the last several years, it seems the world has been awash in a sea of liquidity caused by artificially low interest rates. This unprecedented level of free flowing cash has stimulated demand for virtually all financial asset classes and is helping to fuel global mergers, acquisitions, and initial public offerings (IPOs). Incidentally, the latter is approaching 2007 peak levels.

Needless to say, the result has been an across the board rise in financial asset prices and valuations, and an extraordinary decline in equity market

volatility. In fact, Bloomberg recently reported that this is the longest stretch the Standard & Poor's 500 has gone without as much as a 2% daily decline since February 2007[1].

The market's advance has engendered a somewhat worrisome degree of confidence and complacency among investors as they continue to shrug off valuations to take on increasing risk with lower expected returns. Until now, this willingness to take on increased risk for marginally better expected returns has paid off, but that will not be the case forever. In general, as value investors, we tend to add the most value when we are being well compensated for the risks we are bearing. This is not one of those times as equities markets, for the most part, are pretty fully valued. While we are still uncovering undervalued securities from time to time and cash reserve levels have receded somewhat, bargains still remain scarce. It's anyone's guess how long investor confidence can be sustained in the face of advancing asset prices and shrinking risk premiums. For our own and our fellow shareholders' money, we remain cautious.

PORTFOLIO DEVELOPMENTS

Given the limited opportunity set available in global equity markets, it should come as no surprise that portfolio additions were quite modest so far this year. Rest assured, we have not soured on equities and do have a long list of desirable targets. Unfortunately, at this time, they are simply not available at prices we believe make sense.

Behind the scenes, we experienced a frenzy of activity with holdings like Diageo, Energizer, Intel and Visa - to name but a few - all involved in major acquisitions. Needless to say, we have been quite busy digesting the business ramifications of these announcements and will keep you posted. In the meantime, here are some noteworthy developments.

Precision Castparts – A relatively new addition to client portfolios, Precision Castparts (PCP) was founded in Portland, Oregon circa 1949 and is a worldwide manufacturer of complex metal components and products, including castings, forgings, fasteners and airfoil castings for jet engines and power turbines.

We like PCP because it is led by a long-tenured CEO who is known for aggressively pursuing operating efficiencies and because they are the only company in the world that can produce large diameter highly corrosive resistant pipes as well as powdered metals used in large aircraft engines. The latter is especially appealing because the aerospace industry continues to grow and FAA certification requirements make it difficult for competitors to enter the market.

For many years, PCP stock traded at a significant premium to other aerospace and industrial peers, but recent weakness has brought the share price to more attractive levels. Recently, management reduced their earnings per share guidance from $16 per share down to $13 but we think this is only temporary and may be at the lower end of the spectrum. Considering PCP's organic growth prospects and their ability to add value through acquisitions, we believe the current valuation is being overly punitive and were pleased to get the opportunity to buy this best-in-class company at a price that implies it is only average.

Ritchie Brothers – We originally staked a position in this world-class auctioneer of industrial and agricultural equipment back in April of 2013. As many of you may recall, at the time, we paid $19.99 per share and felt that at that price we got a wonderful business at a fair price – not a cheap one.

In the short time that we have owned Ritchie Brothers', earnings increased by over 30% while their share price appreciated by over 75%. We are very pleased with the progress of the company and believe that Ritchie Brother's model will continue to deliver satisfactory earnings growth well into the future. That said, based on valuation, we felt that Ritchie Brothers stock price had reached a level which appeared excessive relative to likely earnings prospects, and thus we trimmed a quarter of the position at just under $36 per share.

Becton Dickinson – Becton Dickinson's (BDX) merger with rival CareFusion (CFN) is still in the works. Last year, the two companies announced the transaction under which CFN holders would receive $49 in cash and 0.777 of a BDX share for each CFN share owned. The deal is expected to close in the coming

months. In the meantime, we are reviewing our appraisal for the combined entity.

Potash – Following its 1997 failed attempt to gain a toehold in the European market, Potash is taking a second kick at the can with its recently announced proposal to buy German based K+S AG for $8 billion. We like the deal - assuming Potash is not forced to sweeten the offer – because it will likely spark consolidation in the chemical industry and, that should eventually help bring excess capacity under wraps.

CONCLUDING THOUGHTS

Investing is not about magic formulae. It is about assessing and comparing the odds of making and losing money. At Commodari Antinori Group, our goal is not to be right all the time, but rather to make fewer mistakes and less costly ones than the investing crowd – time and compound interest will take care of the rest.

Who better personifies this than Warren Buffett? Already a millionaire in his twenties, scaling the charts of the Forbes World's Wealthiest nonetheless took time. Indeed, approximately $70 billion of Mr. Buffett's $73 billion fortune was accumulated well after his 60th birthday.

Mr. Buffett is, of course, a phenomenal investor whose talents few will replicate. But the real key to his wealth is that it was not created overnight, but rather over two-thirds of a century.

Wealth grows exponentially – a little at first, then slightly more, and then it snowballs for those who stick around the longest. We are in no hurry!

See you on the beach and thank you for your continued support and confidence.

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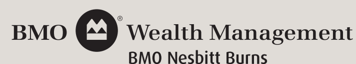

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[1] Bloomberg, *Big Days Dying Off in Stocks With No 2% Move Since December*, June 23, 2015