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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

INVESTMENT COMMENTARY: JULY 2016

"If we are on the right path, the only thing left to do is to keep walking"

– Buddhist Wisdom

We are hard-pressed to remember a period where macro worries have turned over so frequently, moving from one issue to another like a game of hot potato. In the first six months of the year, investors fraught over economic weakness in China, a recession in the U.S., negative interest rates, a presidential election and, most recently, a potential unraveling of the European Union.

This tsunami of worry unsettled currency, credit, commodity and equity markets alike, moving major stock market indices sharply lower early in the year. At one point, the Dow Jones Industrial Average posted its worst 10-day performance going back to 1897[1]. By mid-February however, worries settled down, oil found its footing and stocks began to recoup lost ground aided - in part - by the U.S. Federal Reserve Board's decision to leave interest rates unchanged.

When the closing bell rang on June 30, 2016, the six-month total return in Canadian dollars for the Standard & Poor's 500 Index and the MSCI World Index were -3.09% and -5.72% respectively while in Canada, the S&P/TSX Composite Index gained 9.84%.

Portfolios managed by the Commodari Antinori Group posted positive results for the same period. Comparatively speaking however, results were modest. 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 remain farsighted.

Case in point, although Canada-centric equity investors will be quite satisfied with their year-to-date results, regrettably, as evidenced by the table below, when we peel the onion on those said results and look further out, we see that a celebration is far from warranted.

INDEX	YTD	1 YR	2 YR
S&P/TSX Composite	9.84%	-0.20%	-0.68%
S&P 500 (C$)	-3.09%	7.55%	16.29%
MSCI World (C$)	-5.72%	1.15%	9.88%

Source: Bloomberg - as at June 30, 2016

As always, we continue to stress that it is a combination of outperforming in difficult years – dropping less than the market – along with slow and steady growth in the good that outperform in the long-term. We remind readers today, as we did back in July 2007, that investing is a marathon and not a sprint. While the financial sprinters dash to oblivion we will always remain focused on the long-term prize.

TAKING THE LONG VIEW

No one will argue that in the short-run, stock prices move more dramatically than business values do – sometimes quite dramatically. With each tick on the screen, this *incessant motion* moves stocks – and markets for that matter – through various stages of value. Minute-by-minute, hour-by-hour, day-by-day, prices constantly shift about, sometimes for no apparent reason. The good news is, over time, history has shown that stock market quotations eventually do converge with a business' true worth.

The question then is how patient should one be and how long does this convergence process take? We hate to disappoint those among you expecting an eight decimal place answer. Unfortunately, we have never had much success in forecasting this gestation period. Although we can identify companies that we believe are undervalued at purchase, we have no control as to when – or if – that value gets recognized in public markets. The one thing we can say for sure is that recognition takes time and often occurs with a great deal of randomness.

Equity portfolios built by Commodari Antinori Group consist of a group of 25-30 businesses. By design, not all will flourish at the same time and so, equity returns are sometimes lumpy by nature. Notwithstanding, our goal over time remains the same: to achieve superior long-term results.

We encourage clients to always remain focused on the long-term picture because, given the multitude of variables that move stock prices around, short run investment records contain elements of both luck and skill. We prefer to be judged on the latter.

Case in point, using monthly data, we looked at the rolling returns of our equity portfolios going back to 2001. As longer tenured clients can attest, returns have been excellent – that should not be shocking. What is shocking is just how random short-term results could be. Just under half of the one-year periods showed underperformance, as did nearly one-third of the two, three and four year periods. Thereafter, luck begins to be less of a factor and underperformance declines significantly until it disappeared altogether in year eight.

All this to say, when your approach is sound, time tested and value based like ours is, time tends to eradicate randomness. What is needed in the interim is the ability to insulate oneself from external noise and self-doubt allowing the process to take care of the rest. While past is not prologue, we see little reason why future client experience should be any different than that of the past.

LA VIDA LOCA

With investors now turning to stocks for income and long bonds the source of impressive capital gains, the financial markets have been turned upside down in recent years in a move worthy of a *Cirque du Soleil* contortionist.

Just how topsy-turvy have things become you ask? Well, as at June 30th of this year, the 10-year United States Treasury note registered roughly twice the return of that of the S&P 500 and the 30-year note returned more than four times as much – its third-best start of the year on record[2]. All the while, the median dividend yield as measured by The Value Line Investment Survey stands at 2.30% compared to the anemic 1.49% and 2.3% paid to investors for holding a 10 and 30 year U.S. Treasury note[3]. Incidentally, similar stories are playing out in markets around the world, albeit at different magnitudes.

To be sure, the respective moves in bond and equity markets aren't unrelated. Both are manifestations of central banks' near-zero percent interest rate policies. Understandably, the relentless decline in interest rates has pushed long bond prices higher and kept the stock market aloft as capital – otherwise intended for bonds – continues to pour in, driving prices higher still and making future gains harder to come by. It should come as no surprise then, that some of the valuations we deem to be the most stretched are now found in what are traditionally lower multiple, higher dividend paying sectors such as utilities, telecoms, and consumer staples.

In our view, many of the things we are seeing today strike us as being a tad irrational. Be it committing one's capital to a 30-year bond at less than 2.5% or buying a richly priced telecom stock offering little to no hope of future capital growth, the story seems eerily familiar. Perhaps the motivation of such folly can best be described by Citigroup's now disgraced former chief executive officer, Chuck Prince, who in July 2007 commented that "*as long as the music is playing, you've got to get up and dance*."

Today, the music is definitely playing and the party is well underway. This time around, the disk jockeys are global central bankers' and their tune of choice is "lower for longer." Believe us, we would love to report the same outsized gains experienced by long bond holders. Unfortunately, that would require us to lace up our dance shoes and join a party that we know will end badly when interest rates eventually rise. After all, in our view, bonds should serve as the ballast within balanced portfolios and not as a speculative play.

Instead, we choose to continue to buy short duration bonds (nothing more than five years in length) and suffer the temporary underperformance that comes with that decision. As always, we are willing to leave a dollar or two on the table today in order to safeguard the long-term value of client portfolios – both in capital and purchasing power.

A VALIANT EFFORT MISSES THE MARK

Fallibility is a fact of life in all endeavors including, unfortunately, investment management. Life is truly stunted for people who always must be "right". They would be better off to accept that mistakes do happen and that, for the wise, they have a utility: the potential to learn and thus, hopefully, improve oneself. Mistakes *should* make us better!

Thus, with positive intent and in the spirit of self-improvement, we hereby proclaim that our purchase of Valeant Pharmaceuticals on November 5, 2015 at $99.99 earns us our first ever *Dunce Award*. Incidentally, it is the first only because it has just recently been created – we suspect that it may not be our last. While the impact on client portfolios may have been negligible – less than 40 basis points – where did we go wrong?

Valeant was familiar to us as, over many years, we observed its ascendancy to market darling reaching a peak share price of nearly $350. When the company became engulfed in a storm last fall, we were ready with an assessment of Valeant's intrinsic value – both from a discounted cash flow and sum-of-the parts basis. At under $100, we deemed the shares sufficiently undervalued and believed all the downside was priced in. That said, residual doubt about the culture and character of management led us to cap our position: rather than a full weighting in client accounts, Valeant would stand at ¼ typical position size.

In retrospect, the root of our mistake was giving management a passing grade. The watershed moment occurred on Valeant's March 15, 2016 investor conference call. The chief executive officer's disingenuous reply to a question about scrip trends led us to conclude that, at a minimum, Valeant had engaged in channel stuffing. We will refrain from more colorful and possibly scatological prose to describe the moment we realized the subterfuge that invalidated our valuation model. With no reasonable basis for determining Valeant's true value, we acted and sold the shares the morning after the conference call.

Suffice it to say, the takeaway from our Valeant experience is simple: if, for whatever reason, you are not comfortable taking a full position, do not take any.

PORTFOLIO DEVELOPMENTS

Picking up on a trend that started late last year, portfolio activity has been uncharacteristically high lately. We note this because investor enthusiasm in recent years has kept volatility low, and thus provided us with less opportunity to initiate positions at prices we deem to be attractive. All that began to change late last year.

Of course, there are plenty of reasons stocks of all sizes get cheap – our job as portfolio managers is to determine which of those reasons are of lasting import and which are more temporary. We did just that early in the year as we continued to add energy-related businesses like Suncor, Canadian Natural Resources, Computer Modelling Group and Finning to client portfolios. More recently, we used the uncertainty of the Brexit referendum to add two wonderful global reaching businesses to client portfolio's – they just so happen to be British-based.

Diageo PLC – In the run-up to the United Kingdom's historical vote to leave the European Union, we took advantage of what we deemed *temporary market weakness* to top-up our ownership at under $100 per share of this long-standing holding. Incidentally, this is the first time we have done so since 2010 and, until just recently, had been trimming the position well above our most recent purchase price. Of course, this was a new entry into the portfolios of clients who joined us after 2010.

Originally incorporated as Arthur Guinness Son & Co. Ltd in October 1886, the company changed its name to Diageo in 1997 following its merger with Grand Metropolitan so as to more accurately reflect its diverse portfolio of products. Today, they are one of the world's largest alcoholic beverage producers and distributors. Popular brands include Johnnie Walker, Jose Cuervo, Baileys, Tanqueray, Captain Morgan, Smirnoff, and Guinness to name but a few.

Because of the worldwide appeal of Diageo's robust product portfolio, its strong balance sheet and the fact that the majority of its revenues come from outside the United Kingdom, we believe this London-based distiller will fare just fine over the years and reward those willing to see beyond current European uncertainty. Until then, *stay thirsty my friends!*

Rolls Royce Holdings PLC – Rolls Royce is one of the only two makers of jet engines for both Boeing and Airbus wide-bodied airframes. They are the sole supplier on the A350 and, along with GE, the only other supplier on the 787 Dreamliner. With sales of these new wide-bodied airplanes doing well, air carrier traffic rising and, existing wide-bodied fleets nearing the end of their useful life, we like the market demographics of this duopolistic business and believe that Rolls Royce is in great shape to continue to increase their market share.

As it stands, Rolls Royce has a very robust sales backlog that, in-time, will drive the future value of the company higher. In the short-term however, all these sales create an issue for Rolls because the business dynamics at play operate much like that of a razor blade business. i.e. as you sell the razor – in this case the engine – you receive little to no profit in exchange for 20-30 years' worth of razor blades sales – in this case maintenance contracts – at very nice margins. Because Rolls Royce is building toward a 50% plus share of the installed market base, the sales ramp up of the razor – the low margin part – has temporarily put pressure on the business.

We believe that Rolls Royce's share price has suffered simply because the company's business dynamics remain misunderstood by Wall Street. Benefitting from a long-term perspective, we are perfectly comfortable to sit back, relax and wait for the future cash flows tied to each engine sale to start rolling in.

CONCLUDING THOUGHTS

At Commodari Antinori Group we are the first to acknowledge that clairvoyance is not our strong suit. How will the European Union shake out in light of the Brexit? Are the halcyon days of strong growth in China over? Will the Middle East settle down? When will central bankers reverse course and begin to lift interest rates? We can not answer these questions nor can we know what these worries mean longer-term for markets – only time will tell.

As investors, we should not lose sight of the fact that businesses are a mix of human, physical, and intellectual capital, and have a remarkable ability to adapt to changes in the economic and regulatory environment. It is our conviction that for the disciplined value investor, a focussed approach consisting of buying great businesses at marked down prices will always yield superior results over times. Our task today then is to stay the course; we are safely heading in the right direction – let's keep walking.

We thank you for your continuing support and wish you an enjoyable summer – see you on the trails and beach side.

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[1] CNN Money, Wild January Stock Market ends on a high note, January 31, 2016
[2] Barron's, Markets Confound in Year's First Half, July 2, 2016
[3] U.S. Department of the Treasury, Daily Treasury Yield Curve Rates