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COMMODARI ANTINORI GROUP

SAFEGUARDING YOUR WEALTH

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"During the past year, it was possible to become fiscally flabby through a steady diet of speculative bon-bons. We continue to eat oatmeal but if indigestion should set in, generally, it is unrealistic to expect that we won't have some discomfort."

– Warren Buffett

January 24, 1968, Buffett Partnership

Although the start of last year was met with elation by doomsayers as the tenor of the stock market suggested a difficult – if not an outright bad – year was in the offing, 2016 turned out to be a good year for stocks. Indeed, the cauldron of worry that was furiously boiling over for much of the year under the weight of numerous macro and political events suddenly appeared to simmer down and, in the end, as usual, doomsday prognostications proved to be inaccurate.

Of course, among the drama of 2016, the chef-d'œuvre was Donald Trump's victory over Hillary Clinton in the U. S. presidential election. How events will unfold is anyone's guess. We can infer from stock markets robust post-election rally however, that expectations are high – very high.

For the year ended December 31, 2016, total returns in Canadian dollars for the Standard & Poor's 500 Index and the MSCI World Index were 8.62% and 4.93% respectively. Here at home, the S&P/TSX Composite Index bounced back from 2015's poor showing by gaining 21.08%.

Elsewhere, it should be noted that the outsized returns experienced by long-bond holders over the last decade may soon be coming to an end as the potential for post-election fiscal stimuli and likely continued rate hikes by the Federal Reserve loom large. Over the final weeks of 2016, these and other factors aligned, triggering a precipitous drop in bond prices and, consequently, sending bond indices in the U.S. and Canada nearly 4% lower for the quarter.

Portfolios managed by Commodari Antinori Group posted healthy returns in 2016 and, more importantly, continue to post excellent multi-year results. This continues to be our focus: delivering superb long-term performance. We do this by hanging on to cash during ebullient markets when no bargains are to be had; protecting capital in difficult markets; and, deploying our cash when prices are marked down. We expect this approach will continue to deliver pleasing results in the years ahead.

BUYER BEWARE

As many of you know, it has become exceedingly difficult for disciplined value investors like us to find stocks that are trading at significant discounts from prudent estimates of intrinsic value. Generally speaking, we find equity prices to be relatively high at the moment as low interest rates and lofty expectations push stock prices ever so higher. But is that all there is to the story? Or, are there other forces at play?

Interest rates aside, the dominant market theme over the last several years has been index investing. Indeed, passive index investing has come a long way since John Bogle's Vanguard Group first pioneered the idea back in 1976.

At the time, his firm raised a little over $11 million for investment in the aptly named First Index Investment Trust. Although slow to catch on, today there are thousands of index related products and, since 2008, assets in passive investments have doubled, ballooning to nearly $4 trillion. According to Morningstar, over the last three years alone, nearly $1.3 trillion has flowed into passive index oriented vehicles including Exchange Traded Funds or ETFs – a far cry from the quarter century it took to accumulate the first $400 million.

No longer easily ignored, it is eerily clear to us that as more and more money has poured into global equity markets via passive index products, indiscriminant buying has helped drive broad equity indices higher. This has caused equity valuations, in turn, to skyrocket, creating self-reinforcing momentum for capitalization-weighted index funds. Alarmingly, an October 2016 study by the University of Amsterdam's business school reports that if the holdings of the "Big Three" index asset managers, Black Rock, Vanguard and State Street, were to be treated as a single entity, they would be the largest shareholder in just over 40 percent of all listed American firms, which, when adjusting for market capitalization, account for nearly 88% of S&P 500[1].

If one's goal is to produce a return no better and no worse than the index - **no matter what the result** – then passive index investing is a low-cost way of achieving that said goal. Assuming markets continue their meteoric rise unabated, this approach will do well. Unfortunately, with nearly half of the companies in the S&P 500 Index currently priced at more than 20x after-tax earnings, many of the underlying equity constituents of index funds are now trading at dangerously high valuations. If the past is prologue, when the tipping point comes – as we believe it will – and valuations drop, indexers who have never been through a downturn will lose their nerve and there is likely to be a rapid unwinding of their positions in turn putting more downward pressure on markets.

At Commodari Antinori Group, we remain bottom-up stock pickers – like we have been for over 20 years. Our goal has never been to beat an index but, rather to ascertain value and buy one good company at a time when we deem prices to be in our favor. Short of the latter, we simply allow cash reserves to rise as we wait for opportunities to present themselves. Rest assured we will never buy a stock just for the sake of chasing markets higher.

OUR "TRUMP" CARD

Given the Trump election and Brexit, we have seen to some degree a rejection of the status quo and that creates uncertainty. Based on the calls we received post-election, we wish to remind readers that uncertainty is nothing new and will forever be present. Looking back over the last 75 years, there was the Cold War, the Cuban Missile Crisis, race riots, the impeachment of a president, double-digit inflation, double-digit interest rates, double-digit unemployment, the S&L crisis, the collapse of the Soviet Union, the Internet boom and bust, and most recently, the residential real estate bust and Great Recession along with the bear market of 2008-09.

The point to bear in mind is that none of these significant political and economic events made the slightest dent in the principles of sound value investing. In other words, they did not render unsound the purchase of common shares in fine businesses at sensible prices.

As we look out over the current landscape, we know that there is uncertainty and that a new list of shocks will surely be added to those outlined above. Our trump card is that we will not try to predict them. Instead, our efforts will remain squarely focused on trying to identify businesses similar to those we have purchased in the past. If successful, external surprises will have little effect on our long-term results.

PRICING VS TIMING

We have shared our views with many of you in the past regarding the futility of market timing. Be forewarned, if forced to make market calls, chances are we will be wrong at least fifty-percent of the time – the post-election stock market rally in November would only have added to our poor record.

Understandably, the bull market we have experienced since March 2009 has raised questions among many of you about the risks of remaining invested. While we agree that the S&P 500 is, at least, fully valued, we remind you that the chances of successfully timing the market requires three sequential events: one, picking the market top, two, having a significant decline (i.e. 25%), and three, picking the market bottom to reinvest.

In our experience, the chance of correctly predicting **any** of these three occurrences is quite low and so, of all the ways to build wealth in the stock market, we believe that market timing is not only the most risky, but the most likely to lead to lost returns as well.

Case in point, recently, wealth management firm Index Fund Advisors (IFA) surveyed the 20-year period from January 1, 1996 to December 31, 2015. Over this period, there were 5,036 trading days. The compound rate of return on common stocks was 8.19%. If by poor market timing you missed just the best 40 days of that market, and had been fully invested for the other 4,996, your return would have fallen from 8.19% to -1.96%. Those 40 days, 0.8% of the trading time, accounted for 124% of the returns[2]. Match-and-point!

Despite making no attempts to time the market we do try and price our purchases. Some people may confuse this with market timing, but be assured, they are entirely different things. Pricing is focused on individual businesses and stocks, while market timing is based on general sentiments about the market. Pricing a purchase requires the diligent analysis of a business and its management to uncover investments with a wide margin of safety for long-term capital compounding. Pricing a sale simply requires the discipline to recognize that that same margin of safety no longer exists.

While we are not advocates of making drastic moves based on sentiment, it should be noted that our disciplined value-driven approach acts very much like a shock absorber as it is more likely that we will be accumulating cash in pricier markets and deploying it in cheaper ones. But never will we liquidate the portfolio in its entirety.

It helps if you think of your equity portfolio as if it were a flower garden. That being the case, you would plant a few seeds every year, weed out a few mature plants here and there, but you would allow the garden to remain intact so as to always have something in bloom. Investing is no different, as you are periodically selling and reinvesting and re-invigorating the garden, but you are not uprooting the whole garden every year or two.

PORTFOLIO DEVELOPMENTS

We used the run-up in stock prices in the latter part of this year as a chance to trim many of our positions that had either grown larger than we liked or deemed fully valued. These included, Jacobs Engineering, Finning, Walt Disney, General Electric, 3M and Intel to name but a few.

On the addition front, we must admit, there are not a lot of bargains to be found. That said we did add a new name to client portfolios in late July – Chipotle – and took advantage of stock price weakness to selectively add to longstanding holdings: Wells Fargo and Great West Lifeco.

Chipotle – Chipotle Mexican Grill operates 2,129 fast-casual, fresh Mexican food restaurants throughout the United States as well as 27 international locations. In the latter half of 2015, a series of pathogen outbreaks at some of their locations caused a precipitous drop in traffic at their restaurants. The ensuing negative publicity caused Chipotle's stock to drop into the low $400 range from a high of $757 per share. Prior to the outbreaks, Chipotle was one of the most successful restaurant concepts of the past thirty years.

CEO Steve Ells, a classically trained chef, helped pioneer the concept of high-quality food made from fresh ingredients in a fast casual environment. Chipotle's high-quality product, simple menu, and efficient service combined to make its restaurants extraordinarily profitable, and this in turn has allowed Chipotle to expand its footprint at a rapid pace without resorting to franchising or borrowing money.

In the wake of the pathogen outbreaks, Chipotle management has established industry-leading food safety practices in all of its stores. While we expect Chipotle to suffer through a slow and bumpy recovery, we do not believe that the business has been permanently impaired and see tremendous value in the franchise given that Chipotle has an opportunity to more than double its U.S. store base going forward. Additionally, given that the history of similar outbreaks at public and private restaurant chains had little to no long-term impact on franchise value, we deem the chance of this investment leaving us with indigestion to be quite low.

Jacobs Engineering – We initially bought Jacobs back in August 2014 at $49.99. In a nutshell, Jacobs is an extremely well-run worldwide engineering and construction company. They are unusual in the engineering world in that they go after smaller contracts so as to avoid potential "blow-ups" and enjoy a roughly 95% retention with its customer base.

What originally got us interested in Jacobs was our perception that the U.S. would soon experience a renaissance in the chemical industry due in-part to its large natural gas discoveries. Unfortunately, despite getting more than its fair share of business, projects were not moving forward into the construction and detailed design phase quickly enough and so, the

stock underperformed even though their backlog was growing.

We never lost confidence in Jacobs and continued to aggressively accumulate the stock well into the $30's as the price retreated. Today, Jacobs is it is one of our largest holdings and was one of our best performers in 2016. Because of size, we decided to take advantage of the "Trump rally" late in the year to trim our position somewhat.

CONCLUDING THOUGHTS

In these uncertain times, our advice, as always, is to be patient and to maintain a long-term focus. Economies have always moved in cycles and that will continue to be true going forward. We make no attempt to hide this truism or the fact that these cycles include both periods of growth and recession.

Our job is to grow your wealth prudently over time. That said, as a long-term investor, chances are your portfolio will likely have to navigate through at least one full business cycle. What this means is that you should be prepared both financially and **psychologically** to live through, potentially, a series of both bull and bear markets.

As value investors, we do not run from these cycles, but rather we embrace them. We do so because we know they provide us with the opportunities we need to identify mispricing's and plant new seeds in extraordinary businesses during times of dislocation. In time, more often than not, those seeds blossom into very profitable investments.

Thank you for investing with us and for your continued confidence.

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[1] CORPNET, University of Amsterdam, "Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk", October 28, 2016
[2] Index Fund Advisors Inc., Missing the Best and worst Days, www.ifa.com/12steps/step4/missing_the_best_and_worst_days/2017