COMMODARI ANTINORI GROUP / BMO NESBITT BURNS

INVESTMENT COMMENTARY: JULY 2017

"If you don't know who you are, the stock market is an expensive place to find out."

– George J. W. Goodman

Financial markets demonstrated remarkable calm during the first half of 2017 as the outlook for continued economic growth eased investor tensions and, in so doing, lifted equity markets higher. Valuations, which were already high after the post U.S. election advance, for the most part, have climbed higher still, as they appear to be discounting an extraordinarily rosy environment for corporate earnings' power going forward.

When all was said and done, for the six-month period ending June 30, 2017, the total returns in Canadian dollars for the Standard & Poor's 500 Index and the MSCI World Index were 5.68% and 7.30% respectively, while in Canada, the S&P/TSX Composite Index returned 0.74%.

According to market observers, we are now over eight years into what has been the second longest bull market in modern history. Absent yield producing alternatives, enthusiasm for equities remains extraordinarily high, market breadth has narrowed considerably, valuations are elevated, and bargains around the world are very hard to come by.

It should come as no surprise then that given this backdrop, we continue and maintain a defensive stance and, based on valuation, have been trimming equity positions as they reach their fair values. Understandably, our conservative posture has caused the rate at which we compound clients' capital to decelerate somewhat as of late. Nonetheless, aided by the unexpected takeover of one of our holdings - learn more about this in the *Company Developments* section - portfolios managed by the Commodari Antinori Group posted respectable results.

Keep in mind that performance does not happen on a schedule. Our task in the face of enthusiasm is to work as hard as we can to identify value and, absent that value, remain true to who we are. In the end, the market is going to do whatever the market is going to do. At times, it is best to simply ignore it while other times it is best to take advantage of it. But never should one forget that "while enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster."[1]

WE KNOW WHO WE ARE

Let us start with the obvious. We are value investors. This means we are only interested in buying businesses when they are trading at discounts to their intrinsic value. It should be noted however that we are not interested in just any old business. We are looking for buy high-quality companies, with durable competitive advantages, clean balance sheets and, ideally, long organic-growth runways ahead of them. Every great outperformer we have purchased over the years — from Visa to CN Rail to Precision Castparts to Sirona — had these characteristics in common.

The principles underlying our investment strategy were handed down to us from Benjamin Graham. These principles are tried and true, and have served us well for over 20 years, years that have seen a variety of market conditions – both good and bad.

If there can be but one thing you remember about our approach, it should be that we are not adventurers aiming to turn a thousand dollars into a million. Our primary goal is preventing your already **large** nest

egg from becoming a **small** one. In so doing, much of the value we add is in protecting capital during down markets not outperforming in bubbling ones.

BAKED-IN SHOCK ABSORBERS

We are all familiar with a teeter totter: a play thing consisting of a board balanced on a fulcrum where the board is ridden up and down by thrill seekers sitting at either end. Of course it is relatively easy to predict the direction the board is likely to travel based on the weight and position of each rider - the laws of physics are immutable in this respect.

What about stock markets? With the current bull market charging through its eighth year, a question naturally arises: what is next? – are stocks going higher, or are they highly overvalued? Up or down?

As many of you know, despite having a solid ability to identify individual securities that are mispriced, we have little insight into how long it may take for those mispricing's to be corrected and much less in predicting the short-term swing markets may take. When it comes to equity markets, the inconvenient truth is that predicting *when* the teeter totter will tilt over in the opposite direction is ***imprecise***. Turning points do not announce themselves. Moreover, rarely will one know what the catalyst is, sometimes even well after the fact.

Does this mean that we act like lemmings and simply wait for the market to teeter over? Of course not! Weaved into the fabric of our investment process are three natural shock absorbers that help dampen unpleasant surprises so as to help make navigating through occasionally rough markets more bearable. These ***buffers*** are applied through our margin of safety principle, periodic rebalancing and currency adjustments. Let's briefly consider each.

I – MARGIN OF SAFETY

Having written about this all important concept in the past, we have no desire to subject readers to a long dissertation on the matter. Simply put, a margin of safety is the buffer we require between what we pay for a stock and what we believe its actual value is. Think of it like the safety net installed beneath a trapeze – the larger the net, the safer the performer. As the margin of safety shrinks the net becomes smaller and the risk to the performer increases. When the net is too small or non-existent we simply pass on the opportunity – if we already own the security, we trim or sell the position. Generally speaking, the harder the trick, the larger the margin or net we require.

Let us look at a practical example – in this case Whole Foods Market. When we first bought Whole Foods in late 2015, we calculated their intrinsic value to be about $55 – keep in mind this is not an exact science. Based on the predictability of the business, the balance sheet and our understanding of the industry, we sought a 40% margin of safety (MS). This meant that we were buyers of Whole Foods at under $33 per share, trimmers of the name if the price crosses $44 (80% intrinsic) and finally, should the safety net be reduced further in size, sellers at over $55.

Name:	Intrinsic	MS	BUY	SELL
Whole Foods Market	$55.10	40%	$33.06	$44.08

II – PERIODIC REBALANCING

Even more important than our role as your investment managers is our priority at the start of our relationship to identify, understand and resolutely commit to long-term investment objectives that are realistic both in the context of market history and your unique circumstances.

Investor, know thyself: what is your time horizon? What are your return requirements? Do you need current income from your portfolio? What about liquidity? What is your tolerance for fluctuations? Are there any constraints that must be considered? What will keep you up at night?

Together, we answered these questions and used those findings to determine the right mix for you between stocks and bonds – your asset allocation. So why did we go through all the trouble? We did so because one's asset allocation serves as a touchstone to remind us of our objective and help us maintain long-term focus when market highs or lows may otherwise cloud our judgement.

In the end, one's asset allocation is designed to act much like a release valve on a pressure cooker. In good markets, rebalancing to your asset allocation means we are forced to sell high-flying stocks in favour of soundly priced bonds. In poor markets, it means selling safe predictable bonds in favour of unwanted underpriced stocks. Performed with discipline, this buffer, in and of itself, provides great absorption as it takes money off the table in good times and stacks the chips in bad.

III – CURRENCY ADJUSTMENTS

Before diving into how we protect client portfolios against short-term currency swings, we wish to remind readers that when it comes to currency we are agnostic. In other words, we believe that in time, returns on foreign stocks cancel out currency movements and so, at the *right price*, we will never hesitate to invest in a company denominated in a foreign currency.

Granted, currency swings can play a big role in short-term results. One need look no further than the recent strength of our loonie to be reminded of that. This begs the question. How do we protect ourselves against short-term currency swings?

While we may resemble garden variety vegetables, the answer my dear Watson is elementary. It all comes down to price and position size. Assuming the price is right – more on that in a minute – the position size a foreign security holds in your portfolio is always calculated in local currency. This means that when the U.S. dollar is strong relative to our loonie, we do not need to hold as much of the foreign security to meet our Canadian equivalent sizing requirement. Should the U.S. dollar weaken – all else equal – the impact is lessened and we simply buy additional shares to hold our position constant. Conversely, when the Canadian dollar is strong, like it was in 2007 & 2011, we will buy more of a foreign security to equalize the position in Canadian terms.

Now that we covered position size, we turn our attention to price. Specifically, what is the *right price*? To answer this question, let us look to the Whole Foods example once more. This time however, as we do for all foreign denominated securities, we will add a simple but important step to the process – adjust the quoted price higher or lower so as to reflect the long-term fair value of our currency. To do this, we rely on the Organization for Economic Cooperation and Development (OECD) and their regularly published Purchasing power parities (PPP's).

Without getting overly technical, PPP tracks rates of currency conversion that eliminate the difference in price levels between goods in various countries over time. When we placed our last large Whole Foods purchase back in 2016, the published number for Canada stood at 1.2170. This meant that according to the OECD's long-term empirical evidence, a fair value for our loonie was about $0.82. At the time our dollar was trading in open markets at about 1.2785 or, stated differently, was worth only $0.78. According to PPP our currency was undervalued by roughly 5% (1.2785/1.2170). To compensate us for a potential 5% loss in currency and make sure that our purchase truly was the *right price*, we had to adjust the quoted market price higher. In this case, despite our purchase price being $29.99, the cost to us was actually $31.50 ($29.99 x 1.0505). Since the adjusted price still fell well below our buy point of $33, we made the purchase.

Name:	Intrinsic	MS	BUY	SELL	Price*	Adj Price
Whole Foods Market	$55.10	40%	$33.06	$44.08	$29.99	$31.50

** Market price as filled on August 18, 2016*

Keep in mind that the buffer applied above works equally well on the sell side of the equation. In other words, had we had a foreign security with a listed intrinsic value of, say, $50, our system would flag a sell notification when the price reached but $47.60.

COMPANY DEVELOPMENTS

The ability to concentrate squarely on the fundamentals of the businesses that we own allows us to look beyond many of the important but unknowable factors that are commonly featured in day-to-day news headlines and instead, focus on the important and knowable.

Despite the tepid pace of portfolio activity in the last six months, there have been many new developments within our companies that we deem important and would like to share with you. In time, if they have not already done so, these developments will add to our future results.

Whole Foods Market – For those among you that may have missed the news due to holidays, we are happy to report that Whole Foods has agreed to be purchased by online shopping giant Amazon.com for $42 a share in cash. The transaction, which is expected to close later this year, represents a favorable conclusion to our purchase of the natural food chain retailer back in 2015 and is well above our original purchase price. Given the unlikelihood that the transaction fails to go forward, the shares now trade a whisker shy of the takeover price and so, we now view this holding as a source of cash and have been selling it where needed.

Finning – Aggressive buying of Finning throughout 2015 and early 2016 make this industry leading Caterpillar equipment dealer one of the most widely held businesses in client portfolios. Aided by a recovery

in commodity markets and accelerated global economic activity, Finning recently reported higher orders toward the end of last year and into 2017. Moreover, plans by various governments to allocate additional capital toward infrastructure spending have led to greater equipment utilization. In time, as volumes continue to firm, Finning's relatively high-margin product support business should be the direct benefactor.

Rolls Royce – Not much has changed in our thinking about Rolls Royce since we first wrote about it at this time last year. With over 50% market share of the wide-bodied jet engine backlog, Rolls Royce remains a leader in its market and stands to benefit tremendously over time from the long-term service contracts tied to each engine sale. Interestingly enough, during this year's Berkshire Hathaway Annual Meeting, we had the opportunity to chat with Precision Castparts CEO, Mark Donegan. We will spare you the gory details! Suffice it to say that we were pleased to hear nothing but praise from Mr. Donegan when the subject of Rolls Royce came up. Being one of PCP's largest customers, he knows Rolls' business quite well and hearing him say that their prospects look excellent make us downright giddy – especially since Rolls has grown to become our largest holding.

CONCLUDING THOUGHTS

The overall stock market today is expensive and so, there are precious few cheap stocks. We remain value investors and will continue to invest with a long-term focus, trying to identify and buy – for responsible prices – businesses with the potential to grow for years. At a time when many smart people are looking at every good idea, we think our ability to invest with a long-term horizon is a competitive advantage, as the intrinsic value of long-duration growth can often be underappreciated by investors distracted by short-term momentum.

Once again, we thank you for investing with us and for your continued confidence.

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"The Commodari Antinori Group of BMO Nesbitt Burns offers a boutique private client wealth management experience. We work exclusively with high-net-worth individuals and their families and build for them unique portfolios - no pooled funds or other proprietary products."

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[1] Benjamin Graham, The Intelligent Investor