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COMMODARI ANTINORI GROUP / BMO NESBITT BURNS

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"There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."

– John Kenneth Galbraith
A Short History of Financial Euphoria

The year just past was characterised by strong advances in asset values across a broad spectrum of classes. Clearly, despite several interest rate hikes, the general populace has yet to be enticed into the relative safety of bonds preferring instead to place their funds in any asset offering even a glimmer of higher returns – regardless the risk.

On November 15th, bidders gathered at renowned auction house, Christie's, experienced first-hand just what kind of effect an extended period of low interest rates can have on assets. It was on this day that a painting believed to have been created by Renaissance master, Leonardo da Vinci was auctioned. As expected, the painting, *Salvator Mundi*, attracted considerable interest. After nineteen minutes of bidding, the gavel fell and, surprisingly, the price tag stood at a whopping U$450,312,500 – yes, nearly half a **billion** dollars.

The painting, believed to have been commissioned in 1500 for King Louis XII of France, exchanged hands for centuries in European royal courts until somehow making its way to Louisiana in 1958 where it was purchased at auction for U$90. It resurfaced in 2005 when sold to an art consortium for U$10,000 at an estate sale.

Here is where it gets interesting. In 2011, it was authenticated as a newly rediscovered da Vinci by the National Gallery in London and promptly sold to a Swiss businessman for U$80 million. The Swiss owner then flipped the work for U$127.5 million to famed Russian billionaire, Dmitry Rybolovlev, who then consigned the painting to Christie's last year. Having grown in value more than 45,000 times in just twelve short years, with most of that appreciation coming in just the last five, it appears that art – or value in this case – truly is in the eye of the beholder.

Why this digression into the art world? Our goal is not to try to infuse our commentary with a touch of much needed culture, rather, it is to highlight that investors are throwing caution to the wind. Simply put, there is excess money swirling around the world today ***wildly*** pricing assets of all sorts: be it art, classic cars, real estate or stocks. The wildest of this euphoric pricing being showered on digital currencies like Bitcoin.

Returning to our normal purview, stocks, they too enjoyed hearty returns in 2017. Ordinarily, events that would roil equity markets came and went without so much as a nervous flutter: nuclear tensions with North Korea, Hurricane Irma's devastation, tense divorce negotiations between the British and European Union, a disturbed Middle East – to name a few.

When the final bell rang on December 31, 2017, the total returns in Canadian dollars for the Standard & Poor's 500 and the MSCI World Index were 13.83% and 14.99% respectively while in Canada, the S&P/TSX Composite Index finished the year with a gain of 9.10%.

THE PERFORMANCE DERBY

We are certainly pleased with the gains posted by stocks in 2017. That said, given the backdrop noted above where excess cash is fervently chasing returns, the stock market – as a whole – is currently shrouded in a veil of optimism. As such, unearthing value has become increasingly difficult and the potential for capital impairment has increased. Current valuations require a steady hand and warrant caution. This has been our mantra for nearly two years now – a consequence which has led to a slowdown in the pace of growth. Indeed, in relative terms, returns posted by the Commodari Antinori Group in 2017 were decidedly modest.

Rest assured, we are not reaching for a dose of portfolio *Viagra*! Certainly, a rise in results would be pleasing and we would then partake in the adulation and love flowing freely on both Bay and Wall Street. But, it would likely be short-lived and, in the end, unpleasant – think Michael Douglas and Glenn Close in *Fatal Attraction*.

As we have previously written, we are neither pleased nor disappointed with *short-term* results. At Commodari Antinori Group, we continue to focus on long-term results because we realize that performance is asymmetric and non-linear – it comes in spurts and cycles. Keep in mind, over short periods of time performance is totally random and is less a function of a manager's skills as it is with sentiment, luck and other arbitrary factors.

Long run success in the investment arena requires farsightedness and experience gained from observing and absorbing the expensive lessons of market history. Such a perspective is priceless and pays tremendous dividends down the line.

RETURN OF THE ANIMAL SPIRITS - THE DOT-BONG'S

As you have undoubtedly heard us mention on more than one occasion, when it comes to investing, although history does not repeat itself, it sure does rhyme! Granted, a philosophical opus this statement is not, but you get the idea.

To the point, we thought we would revive a heading from our July 2014 edition. At the time, the heading was quite fitting as it was used to highlight wearable sports camera maker GoPro and the seemingly ridiculous valuation it garnered subsequent its stock market debut.

We wrote *"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…What else but exuberant expectations about accelerated levels of growth and profitability."*

Today, we thought it fitting to use the same heading when cautioning readers about the "***high***" valuations given to cannabis companies like Aurora, Canopy Growth and the like. Let us be clear, we are not arguing that the industry is without future merit. That said, like all new industries that came before it – from the radio to the TV to the internet – it takes time for industries to mature and figure out what the economic reality will be. Based on current valuations for these companies, we believe that investors have lost sight of those realities.

So, although the names may be different this time, what we wrote back in 2014 most certainly applies here today. On that note, with market capitalizations of $6.1 and $7.2 billion respectively, as at this writing, both Aurora and Canopy Growth are currently valued so richly that – on paper – they are worth more than, say, Jean Coutu, a likely distributor of their products – and this despite never posting a dime of profit. Oh, and for the record, as at this writing, GoPro's value has declined by more than 85%.

DON'T FLY TOO CLOSE TO THE SUN

Given what we just discussed above, we are reminded of Daedalus, a character from Greek Mythology who was imprisoned by King Minos of Crete within the walls of his own invention, the Labyrinth. To escape, Daedalus constructed wings made by adhering feathers to wooden frames with wax. He gave one pair to his son, Icarus, and both leapt from atop the cliff where the labyrinth stood.

Before leaping however, Daedalus left important instructions with his son. He cautioned him not to fly too near the sun as doing so would cause the wax to melt and he would surely fall to his death. As the tale goes, Icarus became ecstatic with the ability to fly and forgot his father's warning. The feathers came loose when the wax melted, and poor Icarus fell from the sky.

Bull markets have a tremendous pull on investors. Much like the euphoria Icarus must have felt when initially taking flight, the reinforcement provided by rising prices is addictive and feeds on itself. Watching others *fly* when our feet are still firmly planted on the ground creates an overwhelming feeling of remorse and seduces one into action – even when reward is sometimes grossly outweighed by the risk. Sadly, most investors become consumed by the fear of missing out and the "*need to get some of that*" slowly becomes their driving force.

We remind you that this sentiment leads to the wrong decision at the wrong time. Like Icarus, as the market rises, investors become overly optimistic and over-confident. They relax their standards, forget history and choose to leap from the cliff straight towards the sun.

Icarus likely recalled his father's warning but, he just could not help himself. Similarly, every investor knows the mantra, "buy low; sell high" yet history is rife with examples of people buying high and selling low. That is what long bull markets do: they lull and seduce investors into biting off more risk than they otherwise would.

That is not how we operate. Our driving force has, and will always be, valuation – this is our key advantage. The ability to calculate the real value of a business allows us to weigh the merits of an investment not on euphoria, but rather, the discounted value of its future cash flows. Without this ability, it would be impossible to take positions with conviction or, conversely decide to pass on a given opportunity. In short, we would be at the mercy of the market as it goes through its cycles of euphoria and panic.

Valuation remains a powerful tool for those who know how to apply it. Granted it is not perfect, nor is it able to pinpoint the moment a stock reaches its absolute bottom or top. More often than not however, it does steer us in the right direction, protecting us from colossal losses and, conversely allows us to partake in pleasing gains.

PORTFOLIO DEVELOPMENTS

The second half of the year brought with it noticeable changes to client portfolios. Some, like Amazon's takeover of Whole Foods Market or, Potash's merger with Agrium to form aptly named nutrient powerhouse, Nutrien, were outside our control.

Others, like the decision to exit our position in industrial and construction supplier, Fastenal – completely divested as at this writing – or trimming our position in core holdings Diageo, Finning, and American Express were strictly responses to their richer valuations.

To offset large gains realised in the course of the year, we sold our stake in beleaguered casual fast food restaurant chain, Chipotle Mexican Grill, late in the year. This decision was strictly a tax planning one as it allowed us to purposely realize a loss, hence reducing the tax burden for many clients. We have since bought back our shares and continue to believe that Chipotle will turn things around. On that note, their recent announcement that they have begun searching for a new CEO to replace Steve Ells means that the company is serious about righting the ship.

Proceeds generated through the selling activities above were used to increase our holdings in Jacobs Engineering, Ritchie Brothers, Wells Fargo and Omnicom Group. All suffered market weakness over the last six months that we were happy to capitalize on. In the case of Jacobs, skepticism around a recent acquisition pressured the share price. Ritchie Brothers and Omnicom disappointed on earnings and Wells Fargo suffered a black eye to its reputation over ongoing fraudulent employee activity. Long term, these concerns will be but blips on a radar screen.

We also initiated three new positions in client portfolios. We will reserve discussion on these until after all our purchases are completed. Stay tuned to our next edition where we will elaborate on the decision making behind these new investments.

CONCLUSION

Our objective at Commodari Antinori Group is to diligently steward clients' hard earned wealth. This entails protecting capital and growing it at a satisfactory rate over a long period of time. Given the uninterrupted advance of the stock market since the end of 2012, the notion of what was once *satisfactory* can sometimes be lost and may even come into question.

When mistakes are no longer characterized as the permanent loss of capital, but rather as the degree by which they lag a high flying stock or sector and even winners get redefined as mistakes, it is time to step back and pause.

We do not write these words flippantly. We write them because we know the power that euphoria and panic wield. These emotions tug at our rational senses until they become so dominant that we act on them. This is dangerous because, if history has taught us anything, it is that at market extremes the most logical - but often the most difficult - decision is to do the exact opposite of the majority of investors.

In the case of today's markets, it is to remain disciplined and stick with an investment approach we know to have worked in the past, as opposed to throwing that discipline out the window in search of higher returns.

Thank you for the confidence you have placed in us.

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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."

Let's connect

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