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COMMODARI ANTINORI GROUP / BMO NESBITT BURNS

INVESTMENT COMMENTARY: JULY 2018

"Investing isn't about beating others at their game. It's about controlling yourself at your own game"

– Benjamin Graham

Year-to-date and in contrast to 2017, it has been an up and down year for most global equity markets. In local currencies, as a group, they have for the most part treaded water, held back somewhat by high valuations, rising interest rates, escalating trade tensions, political upheaval in Europe and a host of other macroeconomic worries.

As we write, markets have largely clawed their way back from the losses experienced in the turbulence of late January and early February when a sudden surge in volatility upset an otherwise robust market. Not surprisingly, the high-water mark for stocks was set at the beginning of the year.

As at June 30, the total return in Canadian dollars for the Standard & Poor's 500 Index and the MSCI World Index were 7.75% and 5.76% respectively while in Canada, the S&P/TSX Composite Index gained 1.95%. Notably, when the strength of the greenback is stripped away from foreign returns, the S&P 500 and MSCI World Index come in at a more modest 2.65% and 0.76% respectively.

Portfolios managed by Commodari Antinori Group performed well in the first half of 2018 – both in absolute and relative terms. We are pleased with this outcome but, as always, our real goal is to protect your capital and grow it at a healthy rate over a long period of time. To that end, client portfolios are well positioned for the future and should navigate, better than most, what we expect to be a more difficult market environment going forward.

SEEING IS BELIEVING SO LOOK AGAIN

With each instalment of our *Investment Commentary*, we strive to highlight some of the observations we make with respect to financial markets, valuation metrics and human behavior. More importantly, we try and explain how recent observations, informed by our professional judgement, shape our investment decision-making process and, in turn, your investment portfolio.

The goal is never to deflect away accountability when we make a mistake – remember our ill-fated investment in Valeant – or when our approach appears to be temporarily out of step with markets. Alternatively, our commentary is not a forum to pontificate about our past, present or future successes. Rather, it is a place to take stock of the facts, weigh the evidence and draw some conclusions in a plain, clear and unbiased manner. After all, we realize that when we are having a good run, we are probably not as smart as we think we are and when we are down, we typically are not as dumb as we look.

Shrewd readers will note that caution has been the one recurring theme delivered over our last several issues. Indeed, based on the evidence we see, our conclusion has been that most stocks – buoyed by historically low interest rates, inflated consumer confidence and excess risk taking – are richly priced and thus portfolio positioning should be defensive.

And yet, the stock market keeps trotting higher. Could it be that we are unwittingly falling into the trap of looking for what **fits** the picture we want to see? After-all, this tendency is a very common trick of the human mind.

We want to assure you of two things. First, we are not stubbornly holding onto our stance simply to save face and second, our wits remain focused exclusively on protecting and growing your capital.

It's timely therefore to step back and, with fresh eyes, reassess the investment landscape and draw some conclusions.

JUST THE FACTS MA'AM

– MULTIPLE EXPANSION –

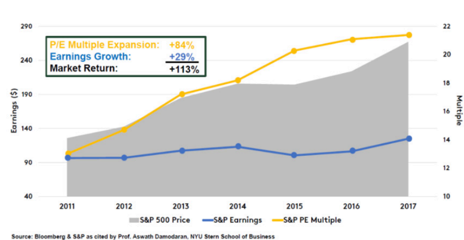
Regardless of whether you invest in individual securities or an index, the same three factors drive your return: earnings growth, dividend yield and valuation. At any given point, adding these three components together should give us a rough idea of what to expect as a market return going forward.

While the yield on an index like the S&P 500 is a known quantity and its rate of earnings growth over the last fifty years a relatively predictable number as it is tied to the pace at which the overall economy expands, the wild card in the mix is valuation.

It is true that we have written on many occasions that, over time, a company's earnings are what inevitably move stock prices. Notwithstanding, in the short-run, prices can sometimes appreciate or depreciate at a much faster pace when price/earnings ratios either rise (*expand*) or decline (*contract*).

At roughly 18x the earnings consensus expected for 2018, the S&P 500 Index is now trading at the high end of its historical range and is nearly double the P/E ratio that prevailed at the beginning of the bull market back in 2009. Granted, with interest rates near fifty-year lows, stocks probably warrant somewhat higher valuations – more on that in just a bit.

That said, as evidenced by the chart below, over the last seven years market returns have been very strong and were overwhelmingly driven by a change in the P/E ratio rather than the earnings growth in the underlying companies.



Whether multiples can climb higher is anyone's guess. In our view however, one thing is clear, they can't rise forever and so, caution is warranted. From this point forward, it is more likely that market returns will be much more heavily driven by corporate earnings than they have been in the past.

With the median dividend yield of all stocks under review by Value Line Investment Survey now at 2% and, adjusted for inflation, S&P 500 earnings growth registering roughly 5% over time, we must assume that market returns going forward will likely be more modest – say 7%. All of this - of course - assuming multiples remain unchanged. We will abstain from making a prediction but, if history has taught us anything, it is that caution ***is*** warranted!

- INTEREST RATES -

To say we have come a long-way since the fed funds rate reached a high of 20% in 1979-80 would be an understatement. Despite rising nearly eight-fold to 1.91% since hitting an all-time low of 0.25% on December 17, 2008, it is still well below its 48-year 5.72% average.

Suffice it to say, given a large enough sample size, the tendency of all units of measure over time is to return to the mean. That being the case, the only question that remains is how long it will take to get there?

Unfortunately, nobody has that answer and that is good reason enough to be cautious going forward.

We say this because interest rates are inversely related to the P/E ratio discussed in the previous section and so affect how much people are willing to pay for assets. As Warren Buffet once eloquently put it, interest rates act on valuations the way gravity acts on matter: the higher the rate, the greater the downward pull.

- BAD BREADTH -

Like any prosperous society, a healthy and sustainable market is one in which gains are equally shared by a large cross section of its participants. Although imbalances sometimes do occur, they rarely go on indefinitely as, at some point, laggards either catch up or outliers start to fizzle.

Looking at the price-only returns below of the S&P 500 over the last few years can help us make a prognosis of the relative breadth/health of the market. The unshaded rows indicate that a broad number of stocks in the index accounted for that year's return, while grey shaded rows indicate that only a small number of stocks (in this case 10, 25 & 50) accounted for the return that year and thus did most of the heavy lifting.

PERIOD	Top 10 Avg. % Change	Top 25 Avg. % Change	Top 50 Avg. % Change	S&P 500 % Change
2017	32.11%	31.20%	24.81%	19.42%
2016	15.00%	11.61%	9.73%	9.54%
2015	16.52%	10.53%	8.40%	-0.73%
2014	11.37%	10.66%	12.23%	11.39%
2013	28.63%	24.67%	34.75%	29.60%
2012	8.90%	17.34%	18.95%	13.41%
2011	11.05%	7.63%	5.33%	0.00%
2010	11.21%	10.39%	15.34%	12.78%
1999	58.69%	53.61%	105.12%	19.53%
1998	68.15%	55.62%	46.97%	26.67%

Source: S&P Dow Jones Indices. Returns are price-only

As you can see, over the last three consecutive years the top 10, 25 and 50 companies by market capitalization significantly outpaced the index. Although not yet at the top-heavy performance extreme recorded in 1998-99, it would be wise for investors to take notice.

So far this year, despite not registering as large of an investment chasm as in the preceding three years, an alarming 99% of the index return is still attributable to only six companies – Amazon, Netflix, Microsoft, Apple, Google & Facebook.[1]

Unfortunately, the tendency for many is to try and keep pace with the market no matter what. As was the case during the tech-bubble in the late 90's and the "Nifty Fifty" in the 70's, most investors just could not look away and this, despite pervasive evidence of irrational exuberance – both extremes ended badly. On that note, given that from these levels, the downside likely outweighs the upside for many of these high-flyers, we again conclude that caution is warranted.

- EXCHANGE TRADED RISK –

We first wrote about passive investments and the explosive growth of exchange traded funds (ETFs) in the January 2017 edition of our *Investment Commentary*. The heading used then was Buyer Beware and the crux of our concern was the indiscriminate buying of these

financially engineered products by otherwise risk averse investors. With ETF's now accounting for over 5 trillion dollars, assets held within these products have grown by a staggering 25% or $1 trillion dollars in just a short period of time.

Our view today, as it was then, is that what started as a good idea when John Bogle pioneered index funds in 1976 has been carried to an extreme that has lost sight of the original purpose: low-cost, plain-vanilla, long-term exposure to the stock market. Mr. Bogle himself in recent writings and interviews laments what Wall Street has done to his creation.

The proliferation of ETFs is simply the latest manifestation of Wall Street's well-worn tendency to encourage trading and excessive risk taking. A case in point was the Frankensteinean creation of a new class of ETF known as *Short Volatility* funds. Using complex financial instruments, the intent was to profit from the low and stable volatility of markets.

Unfortunately, owners of these products experienced staggering losses in early February and, in the after-math, the sponsors of these ETFs announced their liquidation - all at values less than 90% of the previous day's price!

Unfazed, spokespeople for these products noted that the offering documents filed with industry regulators indicated that the expected value over time of these ETFs was zero – they were simply feeding an appetite for product.

While there are many worthy ETFs offered that adhere to the guiding principles set by John Bogle, careful selection is nonetheless required. Indiscriminate buying of a large basket of newly manufactured product by an otherwise risk averse group in such staggering quantities is nothing to be ignored. The risks are high and, once again caution is our watch word.

DRIVING PORTFOLIO RETURNS

Throughout our history, we have always been on the lookout for situations where a company's managerial blunder(s) or economic hardships create challenges that temporarily obscure the economic value of a business. Think Coca Cola and *New Coke* in the 80's, Gillette's decade long development of the Sensor in the 90's, or Wal-Mart's public relations nightmare in the early 2000's – weren't they locking workers in at their stores overnight?

Learning to ignore public opinion and independently judge whether a company's ailments are permanent or temporary is a key strength of Commodari Antinori Group and allows us to look beyond the headlines and find hidden value. Of course, finding the value is only part of the equation, the bigger challenge is having the resolve to remain patient as we wait for our thesis to unfold and a company's fortunes to change. That is the most difficult part!

Fortunately, we are experts in this matter and have more than our fair share of experience – maybe too much. On that note, we are happy to report that we recently added everyone's favorite fast casual restaurant, Chipotle, to our curriculum vitae.

Clearly this business needs no introduction as it has been a flash point for many of you for the greater part of a year – thank you for your patience. As you know, the woes we had to endure came in rapid succession with respect to Chipotle and can only be characterized as a *Perfect Storm* of bad news. In addition to facing an e-coli scare – something we knew going in – we also faced a class-action lawsuit, rising wage and avocado costs and a norovirus outbreak at one of its restaurants in Virginia.

Thankfully, our patience looks to have paid off as Chipotle's revenue, same store sales and margins all show signs of improvement as management continues to execute what we believe is a well thought out game plan. These improvements did not go unnoticed as the share price has jumped more than 70% from its lows forcing us to declare 2018 the year of the Burrito!

PORTFOLIO DEVELOPMENTS

The last six months came with lots of activity as we completed our purchase of three new businesses, tendered both our Potash and Jean Coutu shares for positions in Nutrien and Metro and took advantage of trading opportunities to add and trim several of our holdings.

With respect to our three new holdings: General Electric, CarMax and Peyto Exploration, many of you may have noticed the names appear in your December statement and may be wondering why we are referring to them as new additions. Simple, in our last issue, although noting that we began to accumulate three *new* holdings, we did not mention them by name and promised to fill you in after our purchases were complete. The good news is that the purchases are now complete. The bad news is, in two of the three cases, tardiness would have gotten us a better price. No matter, we have come to accept that, as value investors, we will forever be surrounded by a sense of unease as markets rarely see what we see. Until then, we must practice patience and be comforted by the business merits of our investments.

General Electric – This Boston-based maker of jet engines and gas turbines was one of the original 12 companies listed on the newly formed Dow Jones Industrial Average in 1896 and, today is a global industrial powerhouse selling its products and services in over 180 countries through eight business divisions.

Recently, weak demand in two of its core business segments coupled with the restatement of earnings following a US Securities and Exchange Commission probe have caused GE's share price to fall to lows not seen since the early stages of this decade. New CEO, John Flannery, has embarked on a plan to streamline GE's operations down to a more manageable four operating segments and will likely shed non-core assets in the

process. We think the plan has merit and believe that, at these levels, GE offers little downside and an attractive upside should the turnaround take hold.

Carmax – The used car market is a 40-million-units-a-year industry. CarMax is the biggest used car dealer in the United States with 173 locations in 39 states selling over 650,000 cars per year. That said, the industry remains highly fragmented and will likely see much consolidation in the years ahead. With its already large footprint and ongoing expansion plans (15 new locations in fiscal 2018 alone), we believe that CarMax can be that consolidator.

Earlier this year, concerns about whether loan losses were on the rise at CarMax's finance arm gave us the opportunity to pick up shares of this first-class operation at a compelling price. Long-term, CarMax's ability to offer a wide selection of warrantied pre-owned vehicles should keep customers coming back and store base expansions will undoubtedly add new customers along the way.

Peyto Exploration - Peyto is a Canadian energy company involved in the development and production of natural gas. Because they boast an extremely high degree of vertical integration - using their own midstream infrastructure to transport and process essentially all their production - and their finding and development costs are well below industry averages, they are one of the lowest-cost natural gas producers in North America.

Sharp declines in natural gas pricing over the last several months has put severe downward pressure on the natural gas industry and this best–in-breed producer. Like all our past commodity related investments, we believe that, in time, the law of supply and demand will return pricing to more normal levels and reverse Peyto's fortunes. Until then, we are pleased to sit back, collect our dividend and wait for perceptions to change.

CONCLUSION

After having reassessed the current investment landscape, we are convinced that our conservative stance is the right course of action – especially if you are more concerned with protecting your capital as opposed to capturing the highest percentage of 'up' moves.

While we cannot eliminate the possibility that your portfolio will go down in value at times, our conservative approach should soften the impact that major market declines otherwise would have on your investments. If successful, long-term results will more than make up for not fully capturing all the upside in times of euphoria.

Dedication, self-control and, most importantly, the ability to recognize that successful investing is not about beating others at their game but rather, controlling yourself at your own game remain the key.

Thank you for choosing to work with us - you make possible our success. See you beach side.

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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] CNBC Money Talks, July 10th,2018