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**COMMODARI ANTINORI GROUP** / BMO NESBITT BURNS

# INVESTMENT COMMENTARY: WINTER 2019

*"You can achieve anything you want in life if you have the courage to dream it, the intelligence to make a realistic plan, and the will to see that plan through to the end."*

*– Sidney A. Friedman*

Adieu is most likely the shared sentiment felt by many investors when looking back at the 2018 investment year. Although the year started out in a thunderous fashion with the S&P 500 posting its best January return since 1997 and second-best since 1987, when all was said and done however, the solid start to the year was not enough to offset the precipitous fourth quarter pullback from September market highs.

Clearly, the early enthusiasm over U.S. tax cuts was short-lived as trade tensions, interest rate hikes, ongoing Brexit worries, and slowing economic growth around the world proved too much for our longtime foil, Mr. Market. After an extended period of unwavering enthusiasm, he succumbed to a sudden, rapid and dramatic reversal in confidence, and markets were left to pick up the pieces. The total return numbers below tell the tale:

| BENCHMARK | As at Sept. 31 | Q4 |
|---|---|---|
| **S&P/TSX** | 1.36% | -10.11% |
| **S&P 500 (U$)** | 10.56% | -13.52% |
| **MSCI Worl (U$)** | 5.89% | -13.31% |

Source: Bloomberg

Although not spared from Mr. Market's sharp change in sentiment collectively, our companies held up – as expected – much better than many of the overpriced constituents of any index. Sadly, index investors who participate in all of Mr. Market's highs suffered the brunt of the pullback as they must - by definition - also partake in all of his lows. We are not on that bandwagon and so, we outperformed all major indices in the fourth quarter, significantly narrowing the performance gap that existed in September. Should Mr. Market continue down the same gloomy path in the months ahead, we would expect our conservative approach to continue to make up ground lost to the euphoric markets of yesteryear.

For the full year, total returns in Canadian dollars for the Standard & Poor's 500 and the MSCI World Index were 3.98% and -0.18% respectively while our commodity-laden home market, the S&P/TSX Composite Index, finished the year down 8.89%. Stripping currency out of the equation, the S&P 500 and MSCI World Index declined -4.38% and -8.20% respectively.

As we have stated in the past, while we cannot eliminate the possibility that your portfolio will decline in value at times, our conservative approach should soften the impact that major market declines would otherwise have on your investments. This was the case in the fourth quarter. That said, our value-driven approach will only truly shine when a return to market sensibility takes hold for a more prolonged period. Those who have been with us for a long time know that we tend to look our best in tougher markets and our worst in stronger ones. Given the recent pullback, the good news is that we remain true to form!

## THE *SECRET* SAUCE

Diligent and thoughtful readers of our semi-annual commentaries no doubt discerned a common thread in recent issues. In a word, it has been "caution". The repetition of this theme tizme and time again may have left some of you justifiably wondering, then: *why have we yet to liquidate all our holdings and run for the hills?*

That is a valid question given that Wall Street is rife with people claiming to have the secret sauce: the ability to predict market turning points with precision. While they promise infinite riches, in the end, one should always read the fine print. Make no mistake,

these forecasts and predictions may tell you a great deal about the forecaster, but they tell you nothing about the future and turn out to be a costly distraction.

Truth is there is no secret sauce! Market tipping points cannot be accurately pinpointed with consistency and, contrary to popular belief, no early warning siren wails ahead of a pullback. We remind readers that we make no attempt to predict how markets will behave as, successfully forecasting short term stock price movements is something we think neither we nor anyone else can do.

It is possible however to gain an edge over time by developing a rational investment framework built on company-specific valuation, observation and experience, intuition and professional judgement along with a deep awareness of market history.

On that note, our framework - inspired by Benjamin Graham's 1949 book: *The Intelligent Investor* – has been applied with success for over twenty years now. At its core, lies the notion that a stock is a *business* and not simply some piece of paper to be traded. Given this distinction, our attention shifts away from daily stock quotations to wanting to know what we are getting for our money; how good the management team is; how the competitive position of the business stacks up, and other such quantitative and qualitative criteria.

Over the years, experience has taught us that all the headlines in the world will not change the fundamental value of a business. This does not mean that we may not get the opportunity to go out tomorrow and buy that said business for a cheaper price – we just might. What it means however is that it would be folly to forego buying shares in an outstanding business today whose long-term future is predictable, because of short-term worries about a possible economic or market pullback. At Commodari Antinori Group, the important question is not whether or not we will get the opportunity to buy it cheaper tomorrow, but rather, are we getting our money's worth today?

Knowing that we are getting our money's worth when we purchase our holdings is why we are comfortable holding onto many of them through complete market cycles. As evidenced by our track record, we have benefited tremendously over time by owning outstanding companies across complete market cycles – recessions included – provided their quotations do not deviate substantially from economic reality.

Rest assured, we are keenly aware that as the price of a stock rises to levels that bear no reasonable proportion to even the most optimistic assessment of future profits, even the greatest of businesses become something other than a great investment. In such cases - think Fastenal, Corning, Tim Horton's and others - we move on.

## WEALTH CREATION

Sudden and sharp reversals such as those of late 2018 often provoke rash and costly investment decisions. Given that there is no secret sauce and, to highlight the importance of keeping emotions in check, we feel it is important to re-examine how long-term wealth is truly created.

From a strictly theoretical standpoint, one can argue that wealth is created by making sure you remain on the winning side of the future value of money formula defined as FV = PV x (1+r) n. For the laymen, this equation states that the future value of money (FV) is equal to the present value of money (PV) times one plus a rate of return (r) to the power of time (n).

This is an important formula and so, a closer look is in order. The goal here is to give you a deeper understanding of how various inputs can affect future value. Since it is self-evident that the larger the starting or present value, the larger the future value, we will skip over PV and concentrate our efforts on *Time*, *Return* and *Taxes*.

## IT'S ABOUT *TIME*

Without a doubt, the most important element in the equation is time. To put things in perspective, imagine for a moment you had $1 million that could be invested today at 10%. In 20 years that $1 million would be worth $6.7 million. If you delayed your investment by one year – giving your money only 19 years to work – your total would be $6.1 million. A two year delay would yield $5.5 million. Remarkably, if you delay just a little longer, say five years, your $1 million would come in almost 40% lower as it would be worth only $4.1 million. Clearly, given the non-linear drop-off in value, time is of critical importance. Since we cannot buy time, the best time to invest has always been now.

## RETURN

First things first, we don't mean to suggest that investors should expect a 10% return from equities over the next 20 years. Clearly, based on current valuations, we would expect the pace to slow - at least in the near term. That said, even if the S&P 500 performance turns out to be below average for the period, the future value of money equation almost

always guarantees a favorable result.

Unmistakably, the laws of mathematics on this matter are clear. The larger the multiplier (1+r), the larger the future value. Provided, one does not take on risks outside their comfort zone, we should all endeavor to maximize (r) over time.

On this metric, we give ourselves high marks as our ten, nine, eight and seven year rolling return record handsomely beat our comparative benchmark in all 42 data points recorded over the last ten years. Despite this long-term record, naturally, over a shorter period, as skill is replaced by luck, performance becomes more random and, on a year-over-year basis, there is a 2-in-5 chance that we will underperform.

| *Rolling Returns Beginning 01-Jan-2001* | | |
|---|---|---|
| *Rolling Years* | *Data Points* | *Underperformed* |
| *1* | *18* | *39%* |
| *2* | *17* | *29%* |
| *3* | *16* | *25%* |
| *4* | *15* | *27%* |
| *5* | *14* | *14%* |
| *6* | *13* | *8%* |
| *7* | *12* | *0%* |
| *8* | *11* | *0%* |
| *9* | *10* | *0%* |
| *10* | *9* | *0%* |

*Source: Standard & Poors and BMO Retail Information System*

## TAXES

Although not technically part of the future value of money formula, the greatest frictional cost to wealth creation is taxation. Assume for a moment you held two identical investments over a ten year period. The only difference being one was bought and held, while the other was sold at the end of each year and then quickly bought back. You would agree that from a performance standpoint each scenario generates the same rate of return.

Unfortunately, we live in a world with taxes and so, although the performance is identical, the wealth accumulated at the end of ten years under each scenario is vastly different. Suffice it to say, postponing the tax to the end of the period by simply buying and holding delivers a superior result to triggering tax along the way by being more active. Assuming you are at the top marginal tax bracket, the difference is significant!

So, from a tax perspective, to get the most out of our formula, your objective should not be to minimize the taxes you pay but rather, to maximize your long-term after-tax return.

## PORTFOLIO DEVELOPMENTS

As it has been for many years, our investment philosophy is to make concentrated commitments of capital in a limited number of companies that have superior long-term economic prospects and that sell at what we believe are attractive prices. The table below shows the stock price performance of our largest holdings for 2018:

| *Source: BMO Retail Information Systems* ***Holdings*** | ***% of Equity 31-Dec-17*** | ***Price Change[1]*** | ***% of Equity 31-Dec-18*** |
|---|---|---|---|
| *Rolls Royce Holdings Plc* | *4.7%* | *0.4%* | *5.4%* |
| *Saputo* | *0.6%* | *-13.3%* | *4.8%* |
| *General Electric* | *3.7%* | *-52.8%* | *4.8%* |
| *Omnicom Group* | *4.3%* | *9.4%* | *4.6%* |
| *Berkshire Hathaway* | *4.1%* | *12.1%* | *4.3%* |
| *Nutrien* | *4.5%* | *-0.5%* | *4.2%* |
| *Toronto-Dominion Bank* | *3.8%* | *-7.9%* | *4.0%* |
| *Carmax* | *3.2%* | *6.4%* | *4.0%* |
| *Wells Fargo* | *3.8%* | *-17.4%* | *3.8%* |
| *Ritchie Bros Auctioneers* | *4.2%* | *18.6%* | *3.8%* |
| *Booking Holdings* | *0.0%* | *7.5%* | *3.7%* |
| *Great-West Lifeco* | *4.0%* | *-19.7%* | *3.6%* |
| *Jacobs Engineering Group* | *4.1%* | *-3.6%* | *3.6%* |
| *Diageo Plc* | *4.1%* | *5.6%* | *3.6%* |
| *Chipotle Mexican Grill* | *2.0%* | *62.5%* | *3.4%* |
| | *51.05%* | | *61.29%* |

In any given year, business results matter much more than stock prices, and on this front, the news was mostly good. Rolls-Royce made progress on important strategic and operational initiatives that should make them an even better business in the future. Jacobs announced a big divestiture that will focus the company on its two most profitable and least cyclical segments while wiping all the debt off its balance sheet. Carmax and Booking continue to gobble up market share in their respective industries. Diageo sold 19 underperforming brands, to Seagram's for $550 million, Chipotle's same store sales continue to show signs of improvement and Berkshire completed several sensible acquisitions and investments.

We initiated three new positions in the second half of 2018: Booking Holdings, Saputo and Canadian Natural Resources – the largest being Saputo.

Although we have long admired this leading producer, marketer, and distributor of dairy products, Saputo's stock price made it such that we dared only admire it from afar. That all changed in early November when the company announced disappointing earnings and the

price subsequently dropped to a level where we felt we had a nice margin of safety to initiate a position. Saputo's products, which include cheese, fluid milk and dairy ingredients to name a few, are sold in over 40 countries under brands such as Saputo, Armstrong, Baxter, Dairyland, Land O'Lakes, Stella, and others. The balance sheet is pristine and given the fact that the Saputo family own controlling interest, we know our long-term interests are aligned with those of management.

On the flip side of the page, our position in General Electric caused us some consternation as the company had a very difficult year. They were forced to take sizeable impairment charges, their Power unit was plagued with turbine issues and, weakness in oil and gas prices delayed customer spending within major pieces of the current GE puzzle.  There was a bright spot however as, late in the year John Flannery was replaced by Lawrence Culp as chairman and chief executive.  Mr. Culp presided over Danaher's successful turnaround and we expect him to bring a sense of urgency to GE's ongoing efforts.  For many of you, we sold our shares late in the year to mitigate large taxable gains and subsequently bought back our stake – and then some – at a very attractive price.

## CONCLUDING THOUGHTS

No one can determine with certainty how events will play out in the coming months.  As at this writing, Mr. Market has pushed aside last year's fourth quarter concerns and is once more in a jovial mood.  How long this will continue is anyone's guess.

Come what may, our mindset of long-term business ownership will forever be a defining characteristic of our approach and, on that note; we believe that we own a collection of businesses whose aggregate quality, growth prospects and valuation make them a much more appealing investment than the crowd of companies that comprise a generic index.

Almost without exception, our companies enjoy deep and durable competitive advantages that allow them to outgrow both their peers and the broader economy while producing remarkable excess cash flows that can fund strategic investments or distributions to shareholders.

These virtues should accrue to our benefit over the years to come.  As always, we thank you for your patience and continuing support.  You make possible our success.

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[1] Based on the closing market price the last business day of 2017 & 2018 and reported in Canadian dollars