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COMMODARI ANTINORI GROUP / BMO NESBITT BURNS

INVESTMENT COMMENTARY: FALL 2019

"The trees that are slow to grow bear the best fruit."

– Moliere

The first half of 2019 was a fantastic period for financial markets, with equity investors enjoying six-month gains that would ordinarily be considered fabulous for a *full year*. As at June 30, the total return in C$ for the S&P 500 Index and the MSCI World Index were 13.72% and 12.60% respectively while our home market, the S&P/TSX Composite Index, gained 16.22%. This rally continued past mid-year and, through September 30, 2019, the above indices advanced even further.

This outcome was quite unexpected following the severe pullback that stock markets experienced in late 2018. Back then, trepidation, if not outright fear, was palpable amongst investors as central bank actions, trade & tariffs, decelerating economic growth and Brexit chatter dominated the news cycle.

Amidst this fragile backdrop, reliable sources observed our trusty foil, Mr. Market, stockpiling canned goods and, grainy video footage went viral on social media showing him retreating into an underground shelter near Wall Street. Alas, Mr. Market's stay was short-lived as he quickly re-immerged in an outright ebullient mood after U.S. Federal Reserve Chair, Jerome Powell, signaled a more dovish approach to near-term monetary policy and other central banks around the world followed suit.

Thus, as abruptly as the *correction* began, a sharp reversal in the opposite direction kicked off 2019. Indeed, for the S&P 500 Index, January was the best start to a calendar year since 1987. Despite minor flutters along the way, as noted above, equities have continued their way higher ever since.

Not to be overlooked, bonds also experienced a remarkable rally as prices of existing issues – especially longer-dated ones – rose to reflect central bankers more accommodating policy.

In this euphoric period for stocks and bonds, we made significant progress on an absolute basis albeit trailing benchmark indices somewhat on a relative one. This is no cause for concern as experience has taught us that relative performance in difficult periods is what really counts and, given this metric, an ounce of prudence today at the cost of a slight performance lag is more than made up for when a more difficult investment environment sets in.

ACCOMMODATION HAS ITS LIMITS

The accommodative, often coordinated, monetary policy of global central banks starting in early 2009 was the appropriate response to the global financial crisis. The idea was to stabilize the financial system and to stimulate the world economy by encouraging risk-taking, lending and consumption.

It worked: the world economy chugs along and most asset classes including stocks, bonds, art, real estate, land, classic cars, and fine jewellery have all

appreciated considerably since 2009.

Initially, the financial medicine injected into the global economy via rate cuts was but a *temporary* measure to spur growth. Unfortunately, more than a decade later the world appears to be addicted to the *highs* that low rates help support and, as at June 30th 2019, a staggering $13 **trillion** worth of global debt now post negative yields.

Remarkably, this means buyers of these said bonds are – in effect – paying the issuer for the luxury of owning the security. This idiosyncrasy exists because today, the interest earned on these bonds does not make up for the capital one must lay out to acquire them. Buyers are, in effect, guaranteed to *lose money*! The table below offers a glimpse into this bizarre phenomenon.

Country	6-Mo	1 YR	2 YR	3 YR	4 YR	5 YR	6 YR	7 YR	8 YR	9 YR	10 YR	15 YR	30 YR
Switzerland	-0.75	-0.64	-0.89	-0.91	-0.89	-0.87	-0.79	-0.76	-0.69	-0.63	-0.52	-0.29	-0.01
Germany	-0.58	-0.68	-0.74	-0.76	-0.74	-0.68	-0.64	-0.58	-0.46	-0.40	-0.31	-0.10	0.27
Netherlands	-0.59	-	-0.72	-0.70	-0.64	-0.61	-0.50	-0.42	-0.32	-0.25	-0.15	-0.01	0.30
Japan	-0.13	-0.17	-0.20	-0.22	-0.23	-0.22	-0.22	-0.22	-0.21	-0.16	-0.12	0.07	0.36
Denmark	-0.66		-0.70	-0.70	-	-0.68	-	-	-0.45	-	-0.28	-	-
Austria	-	-0.54	-0.65	-0.63	-0.57	-0.47	-0.39	-0.28	-0.22	-0.14	-0.03	0.31	0.70
Finland	-	-	-0.66	-0.63	-0.61	-0.54	-0.45	-	-0.19	-	-0.01	-	0.56
Sweden	-0.40	-	-0.62	-	-	-0.55	-	-0.26	-	-	-0.01	0.18	-
France	-0.59	-0.60	-0.68	-0.66	-0.62	-0.53	-0.41	-0.31	-0.21	-0.10	0.02	0.38	1.15
Belgium	-0.57	-0.58	-0.60	-0.66	-0.60	-0.54	-0.42	-0.25	-0.14	-0.06	0.09	0.40	-
Slovakia	-	-0.33	-	-	-	-0.24	-0.50		0.00	0.18	0.26	-	-
Ireland	-0.41	-0.55	-0.45		-0.46	-0.39	-0.24	-0.14	0.45	-	0.22	0.58	1.16
Slovenia	-	-0.48	-0.30	-	-	-0.31	-	-0.14	-	-	0.25	-	-
Spain	-0.41	-0.39	-0.40	-0.34	-0.27	-0.21	-0.06	0.08	0.20	0.29	0.43	0.80	1.47
Portugal	-0.38	-0.34	-0.37	-0.25	-0.17	-0.14	0.05	0.16	0.28	0.44	0.56	0.95	1.50
Malta	-0.23	-0.20	-	-0.10	-	0.02	-	-	-	-	0.74	-	-
Bulgaria		-0.13	-	-0.01		0.05	-	0.37	-	-	0.58	-	-
Italy	-0.16	-0.02	0.22	0.71	1.03	1.31	1.53	1.61	1.77	1.82	2.12	2.45	3.17
United States	2.19	2.03	1.81	1.75	-	1.78	-	1.89	-	-	2.03	-	2.52

Source: @CharlieBiello, July 3, 2019

So, who is buying these money losing investments you ask? Although there are many market participants, the main buyers are: first, central banks executing a policy decision - think quantitative easing - where profit or loss is not a consideration; and second, mandate-constrained buyers who have ***no choice*** such as bond index funds and insurance companies.

That said, in countries currently facing negative yields, some rational investors ***with choice*** are also electing to buy these bonds which, contrary to their self-interest, are destined to lose them money. The rational being a small quantifiable loss in highly liquid bonds is better than the potential for a large unquantifiable loss in stocks.

The takeaway in all of this is that there is now a large disconnect that exists between the bond market and the stock market: one is pessimistic seeing easy monetary policy as indicative of a weak global economy and the other, enthusiastically marches ever higher in the belief that accommodative monetary policy will arrest any potential slowdown in economic growth and corporate profits. Clearly, both scenarios cannot be correct…only time will tell which is right.

THE CHEESE OR, THE MOUSETRAP

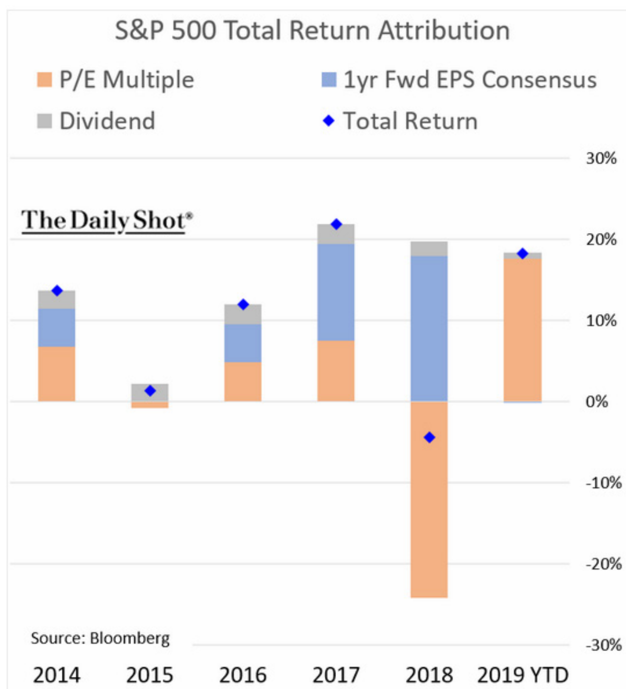
Like mice in a cheese factory where the supply of milk is limitless, equity investors have been gluttonously gorging themselves on the fruits that low interest rates bring. Although it would be tempting to indulge in such gluttony by simply tweaking some of the inputs of our valuation methodology and in so doing indiscriminately buy names regardless of price, we refuse to discard centuries of economic history and stalwart valuation metrics.

Rest assured that technology has not yet rendered the business cycle obsolete and so, our focus remains not on the cheese but rather, the mousetrap. In our view, shy of real economic growth, the supply of additional *milk* by monetary authorities may not be sufficient – on its own – to keep stock multiples at current levels forever or be able to move markets higher indefinitely.

Our intent here is not to put a damper on the party but rather to remind readers that milk alone does not produce award winning cheese. When it comes to returns there are three key ingredients that move markets higher: dividends, earnings and, price/earnings (P/E) multiple. This last component is inversely related to interest rates and tied to investor psychology – herein lies the danger.

The graphic to the right attributes the return of the S&P 500 into the components outlined above going

back to 2014. As you can see, recently, P/E multiples have had the biggest impact on returns as their sharp contraction eroded over 20% of the S&P 500's return in 2018 and, so far this year, account for nearly all of the gain. Absent any significant increase in earnings, with multiples at historically high levels, the current situation may be akin to a mouse staring down a freshly caulked mousetrap.



PORTFOLIO DEVELOPMENTS

While our investment principles have remained constant over time, our methods have evolved principally through the addition of new, and we believe valid, measurements of value criteria. In the end though, our objective remains the same: to get more for our portfolio than we gave to assemble it.

As you know, the strategy we employ in pursuit of that said goal is to purchase - while paying very close attention to price - a collection of highly advantaged businesses with solid prospects and then, hold them for long periods of time as business owners.

If we are responsible on price and are right about the nature of our businesses and what they are capable of over the long term, then we need not be right about much else. To that end, we initiated several new positions early in the year that we believe will add value to portfolios – Facebook, Mohawk & Google. We also increased our holding in several other names, the largest of which we thought we should bring you up to speed on since we have yet to talk about its virtues since initiating the position late last year.

Booking Holdings Inc. – Booking Holdings (formerly The Priceline Group) is an online travel company that offers reservations for hotel rooms, flights, car rentals, vacation packages, cruises, and restaurants. With brands such as *Booking.com, priceline.com, KAYAK, agoda.com* and others, an average of more than 1.5 million hotel room nights are reserved on their sites each day.

While Booking's reported room-night growth has decelerated somewhat recently, management continues to deliver on an already impressive execution record as both revenue and EBITDA growth expanded several hundred basis points in the last quarter coming in at 16% and 35% respectively.

We understand many Booking Holdings investors are nervous about decelerating room-nights, however, we think they are missing the more important consistent improvement in overall cash flow returns, which is a by-product of management's excellent balance between growth and profitability. Sadly, top-line growth at the expense of profits has often been the case for growth-oriented stocks such as Booking. We took interest in Booking because they have shown that they have the ability to prudently balance both.

CONCLUDING THOUGHTS

Looking ahead, the near term is rife with uncertainty – it always is. Fortunately the longer one's investment perspective the easier it becomes to make at least some meaningful predictions. For instance, although we do not know the exact timing, we are very confident that interest rates will eventually rise; recessions

will come and go and, fueled by new technological discoveries, business productivity will rise and so too will valuations. Unfortunately, what we don't know is the timing of all these events.

That said, in a framework of investing that – for many of you – spans years and decades, we would argue that the more critical task to get right is understanding the businesses one owns and their ability to weather the inevitable cycles and create value for shareholders through a wide variety of conditions.

Ultimately, whatever happens in the near term and whatever styles, industries or market capitalizations move in or out of favor, we remain committed to our investment discipline of buying durable businesses at value prices and holding them for the long term. We have seen this bottom- up, research-driven approach prove highly effective through a wide variety of market conditions and believe that keen attention to stock selection combined with a sensible framework for building portfolios is a time-tested and reliable way to compound capital over full market cycles.

Thank you for your support. We look forward to continuing our investment journey together.

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