The Tinnerman Wealth Brief

Spring 2017

In our last letter, we wrote in some detail about how the outcome of the U.S. election stunned the experts who had universally predicted a Clinton victory. And we also wrote about how the predictions of doom for equity markets in the "unlikely event of a Trump win" were also incorrect as the S&P 500 soared to return 3.82% in U.S. dollar terms during the fourth quarter of 2016. The trend continued with the experts again confounded as the Trump Rally (as it is now known) picked up speed through the first quarter of 2017.

For the three months ending on March 31st, the S&P 500 Index posted an impressive total return of 6.07% in U.S. dollar terms or 5.05% in Canadian dollar terms. Canadian equity markets tagged along with their U.S. brethren, and the S&P TSX Composite Index finished up 2.41% for the same period. Against this positive market backdrop, the investment portfolios of our client families outperformed these indices on an overall basis - and far outperformed our benchmark, which consists of equal weightings of these indices in Canadian dollars terms*.

We are always pleased when our clients do well with their investments, but the fact is that we do not put any more stock in our outperformance this past quarter than we did in our underperformance at the end of 2016. Having managed investment portfolios for some 30 years, there are two reasons why we are indifferent about such outperformance. The first reason is that quarterly and even annual investment performance numbers are simply too short-term to be meaningful. And the second reason is that index returns are a reflection of the collective sentiment of market participants more than anything else.

On the latter point, we would note that the rally that we have seen since November has been powered by investors who are optimistic that Trump and his policies will be good for the United States and its economy, even as polls suggest that Trump and his policies are widely disliked. The obvious oxymoron aside, investor optimism has powered the markets to record levels, as can be seen in the Cyclically Adjusted Price to Earnings (i.e. CAPE) Ratio. Developed by Nobel Laureate Robert Shiller, it reflects the ten year average inflation-adjusted earnings for the S&P 500 Index. Today, the CAPE ratio stands at almost 30. The markets have only been more expensive twice in the past century – prior to the crash of 1929, and prior to the bursting of the dot-com bubble in 2000.

*Please note that summary performance results are not provided in our quarterly letters because the Tinnerman Wealth Group does not employ a "one size fits all" approach in the management of our client families' portfolios, as is practiced by mutual funds and pooled funds. Investment portfolios are tailored to meet the unique goals and objectives of each of our client families, and in this regard we ask that you please review your account statements or call us directly for your individual portfolio information.

Let's connect

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We don't know whether the markets will go higher from current price levels, or whether they will correct, and we frankly do not much care. What is most important to us as investors is knowing the intrinsic valuation of a business rather than its share price, which as was noted earlier reflects market sentiment. The distinction between price and valuation is critical because as we have previously quoted Benjamin Graham, "in the short term the stock market behaves like a voting machine, but in the long term it acts like a weighing machine". In our view, the fundamental premise of the Graham quote is that investment success depends on the ability of an investor to determine the intrinsic value, or "weight", of a business, and to use this knowledge to take advantage of irrational market pricing, or "voting".

We have written many times about how the Tinnerman Wealth Group is focused on finding better businesses which we are attractively priced. To recap, our definition of better businesses means companies which have: (i) simple and easy to understand business models, (ii) strong balance sheets, (iii) revenues and dividends which are predictable and sustainable, and, (iv) a proven ability to generate above average returns over the long term. Such better businesses are "what" we seek to own in our client portfolios.

What we have not previously done is discuss the "how" behind our making investments in these better businesses. To this point we would note that we gather the knowledge and information needed to identify better businesses through a variety of research methods. These include regulatory filings (e.g. quarterly and annual reports), corporate presentations, investor calls, industry research papers, analyst reports, quantitative analysis and business modelling.

Although the foregoing are important and useful inputs to the process of making thoughtful investment decisions, they tend to be rearward looking in their emphasis. Given that our goal is to own better businesses for the long term, we need sources of information which give us insight into what the future should look like for a company. The people that make up the company are the only such sources of information, as they know - or should know - better than anyone else where it is that their business is headed and how it is going get there.

When it comes to managing our clients' wealth, one of the most important things we do at the Tinnerman Wealth Group is maintain close contact with key constituencies at the companies in which we invest. As mentioned above, this affords us the opportunity to receive firsthand information about the company and its future prospects from board members, officers, senior management and other employees. This contact allows us to assess the capabilities of the people that are directing and operating the businesses that our clients own, and to evaluate their character, including – importantly – how well their values and personal interests are aligned with those of the company.

Anyone who has studied financial accounting can attest that there is a large field of research known as agency theory, which examines the issues around the alignment of the values and interests of different stakeholders. The classical question in agency theory is whether the interests of the board of directors, officers and management that are operating a company are aligned with those of the company owners (a.k.a. its shareholders). In our view, this is a very important investment consideration which can only be evaluated through persistent contact with a company and its people. Therefore, one of the things that we in the Tinnerman Wealth Group do is stay in constant contact with the companies that our clients own – it is difficult and time-consuming, but it is well worth the effort.

In the interests of brevity we will limit our discussion of agency theory to stating our belief that a company must provide a "seamless web of deserved trust" in order for us to become investors. By this we mean that we must believe that the board, management and, by extension, the entire company will put the best interests of its owners (i.e. shareholders such as ourselves) first. This is something which is not a function of compensation or regulation, but rather a function of personal values and it is such personal values that make great companies.

Now one might intuitively expect all companies to act in the best interest of shareholders, but the unfortunate reality is that there are always plenty of bad actors which are less than ethical in their dealings, current examples of which would include Valeant and Theranos. Our perspective is that it is unimaginable that we would invest our clients' wealth in a company without having done our homework, and being secure in the knowledge that its directors and management are excellent business operators who are deserving of our trust. However, as of late it would appear that the numbers of money managers who share our views on the importance of knowledge and due diligence are shrinking.

In this regard, we would note that there are many investment managers today who research companies through their regulatory filings and other information sources, but do not meet with them because they do not value the insights of management.

And there is a large category of investment managers who ignore company management entirely in favour of making decisions based on quantitative information derived from algorithms analyzing historical data. Finally, and these days most importantly, there is a huge industry (we hesitate to call it investment management) which ignores not only management, but also all historical and other company data, in favour of making investments based solely on market prices – i.e. index funds.

We will offer only one of our views on these approaches to investment management, which is that we can think of no other examples where anyone would accept, and much less promote, the idea that people are not the primary determinant of the long term success of a business. Having excellent people who are members of a "seamless web of deserved trust" is important to us, not just as investors in businesses but also as the managers of our own business, and as the clients of many great businesses.

Whether we are acting in our capacity as investors, managers or clients, one of the most important factors for us is knowing that we have a relationship of mutual trust and confidence. In making this last point, we would refer you back to our last letter which discussed the importance of personal insurance and which introduced Allison Bryce and the Magnes Group. Be assured that we would not have made such an introduction if we were not in every way certain that Allison and her group are excellent at what they do, have a durable business, and are deserving of the trust which our clients place in the Tinnerman Wealth Group.

We hope that you enjoyed our letter, and you better understand what the Tinnerman Wealth Group looks for in the investments that we make in the course of managing your family's wealth. As always, we ask that you please call us if you have any questions or concerns about your family's wealth management plan.

Sincerely,

Mark Tinnerman

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Portfolio Manager

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