VALUE CONTRARIAN
ASSET MANAGEMENT

# 2017 Second Quarter
# Value Contrarian Equity Fund

Dear Partners,

I absolutely am not saying stocks are too high, the FAANGs (Facebook, Apple, Amazon, Netflix, Google) will falter, credit investing is risky, digital currencies are sure to end up worthless, or private equity commitments wont pay off.
All I am saying is that for all the things listed above to simultaneously be gaining in popularity and attracting so much capital, credulousness has to be high and risk aversion has to be low….. their returns may not justify their risk.

Howard Marks
Oaktree Capital Management
July 26, 2017

My suspicion is that the rise and fall of active (as opposed to passive index) managers is a cyclical phenomenon. Much of their underperformance (this year) is probably due to inadequate exposure to the FAANGS-Facebook, Amazon, Apple, Netflix and Google. In considering the bloated valuations of these seemingly impregnable tech giants, it is salutary to recall that in December 1999 the largest (stock) market capitalisation in the world belonged to AOL.

John Plender
Financial Times London
August 7, 2017

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As an avid student of stock market and financial history, the recent daily records being set on the Dow and S&P 500 Index's have given us some pause for reflection.

Below are two indicators which we feel require us to be more cautious in our investing outlook/approach.

**Question #1**

Since 1950, what has been the longest number of consecutive years without the S&P 500 having incurred a single calendar year of negative returns?

**Answer:** 9 consecutive calendar years (1991-1999)*.
Today, we are once again on track to tie the old 9 yr. record.

Fyi: The 1991-1999 streak was broken in 2000, with the bursting of the tech/telecom bubble (S&P down -9.1%)

**Question # 2**

Since 1950, what has been the longest winning streak in which the S&P 500 has suffered neither a calendar year or intra-year(s) Bear market (20+) decline.

**Answer:** 9 years and 5 months.
Between October 1990, until the March 2000 tech bubble peak, the S&P 500 Index never suffered a decline of 20% or greater. (Intra-year 1998 the S&P Index did drop 19.3%. Close but no bear cigars.)

Folks, today we are fast closing in on the October 1990 – March 2000 record of 9 years and 5 months with nary a U.S. bear decline! (Note: the recent bull run started (March 2009 to…?) Yes, new records can always be set, but… In contrast, the TSX suffered a recent bear decline (-25%) from September 2014, until its bottom in January 2016, thanks to the collapse in oil and commodity prices.

*1991:+30.4% 1992:+7.6% 1993:+10.0% 1994:+1.3% 1995:+37.5% 1996:+22.9% 1997:+33.3% 1998:+28.5% 1999:+21.0%

Simply stated, bear market corrections are a necessary and healthy phenomenon for the proper functioning of the financial markets. The occasional "forest fire" (bear market) is a necessary pain to cleanse the excesses, whether they be "financial" or "underbrush" in nature.
As to the timing of the next market correction, your guess is as good as ours!

## Second Quarter Performance

**At a healthy business, cash is sometimes thought of as something to be minimized-as an unproductive asset that acts as a drag. … Cash, though, is to a business as oxygen is to an individual: never thought about when it is present, but the only thing in mind when it is absent.**

**Warren Buffett**
**Berkshire Hathaway**
**2014 Letter to Shareholders**

**The U.S. has been an incredibly strong market for a number of years, so passive (ie: ETF index investing) is classic returns chasing behavior.**
**…The light at the end of tunnel is that the more people buy on the basis of market cap (passive Index funds), the greater the opportunities for active managers (when Index funds are eventually pummeled by a bear market).**

**James Montier**
**Grantham Mayo-Investment Management**
**August 2017**

Your Fund ended the second quarter with a net asset value of <u>$3,598.14 per unit</u>, an increase of <u>$4.70</u> from the December 31, 2016 net asset value of <u>$3,593.44 per unit</u>. Year-to-date six-month performance: 0.13%.

To put it bluntly, this has not been a great first half for your Fund. It has also been a "stinker" for the S&P/TSX Composite index, with first half returns of 0.74 per cent. Amongst the worlds major stock markets, Canada's has been the only one in the red as of early August.

Over the past six months, the TSX has been dragged down by the index's three largest sectors, financials, energy and materials. A further severe <u>headwind</u> on our results has been the sharp rise in the Canadian dollar. From December 31, 2016, the loonie has risen from 0.74 cents to 0.80 by July 31 (0.77 June 30). Approximately fifty percent of our assets are in U.S. dollars. On the other side of the coin, in 2015, foreign currency gains provided us with a huge <u>tailwind</u>.

During a severe bear market decline, when the world rushes to the U.S. dollar for safety, we would not be surprised to see a 70 cent or lower Canadian dollar. I base these comments purely on <u>historical patterns</u>.

Your Fund's first six months, was characterized by our steady selling of some long-term (10 yr plus) positions – Lassonde Industries, being one such name. From $35 dollars, to over $235 dollars, we have profited greatly from the growth and acquisitions behind the Oasis brand of fruit juices. "<u>Buy and hold</u>" investing is especially lucrative when sustained earnings growth pushes up a stocks P/E multiple. One dollar of earnings on a 10 P/E stock is $10, but on a 20 P/E, $20.

Unless Oasis becomes a takeover target, (likely since we sold half our position) or makes another significant acquisition – it's an expensive, slow growth stock (20x plus earnings). Furthermore, changing consumer tastes/behaviour, are not working in our favour. Fruit juice, while not Coke, is still a sugary, high calorie drink. (Ok…natural sugar). <u>Time to take some money off the table</u>.

Hate to admit this, but we also sold 5,000 shares in Berkshire Hathaway -B class. The Berkshire position after the sale, still represents 10.2% of your Funds assets. Our sale at $ 177 U.S., was not far off from the $179.99 52 week high. I felt if the market (S&P 500), which now trades at over 21X forward earning, reverts to its historical mean of a 14-15X P/E multiple -Berkshire "B" shares would also fall. These shares could easily be repurchased at a more opportune moment down the road. Time will tell.

In July, we continued to prune names from the Value Contrarian portfolio. Our cash position is now approaching 20 percent. For us, cash represents a "comfort blanket" and soothes our nerves during global selloffs. More importantly, cash represents our opportunity "Tool Box".

While the stock markets can remain expensive for long periods of time- ignore this fact at your peril, because valuations do matter. Undervalued (2009), fairly valued (2011), fully valued (2017).

Simply stated, your future equity returns are highly correlated to your entry point into the market. And since most investors don't have the stomach to invest in early 2009 or January-February 2016 (when the TSX was down -25%) its best to slowly roll into stocks over a period of time.

We made one significant purchase during the latest quarter. Interestingly it is the only company in Canada to provide this specific type of service. Its not a pure monopoly business, but no other company in our lifetime, will likely receive approval for a similar multi-billion dollar project or service. More on this investment opportunity next quarter.

## OUTLOOK

> **"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, <u>you've got to get up and dance</u>. We're still dancing." (Pre-global financial crisis comments from former Citigroup CEO Chuck Prince).**
>
> **…. Today I think most investors know the good times will end someday, as Prince did (in 2007), but for now they feel they, too, have no choice <u>but to dance</u>.**

**Howard Marks**
**Oaktree Capital Management**
**July 26, 2017**

Very often, the lessons of history can provide a better education than any MBA program. The above comments from Marks, are a prime example.

Thirty years of investing experience has taught us that the best time to prepare a portfolio for the next downturn, is when markets are <u>calm</u> and returns positive. Conversely, the time to increase risk is when others are fleeing from it. Certainly, not a situation we see today.

Today, investors are at the <u>mercy of low interest rates</u> to justify the elevated valuations. As Warren Buffett wisely pointed out in his latest shareholder's letter, "…the risk always is that <u>interest rates go up a lot</u>, and bring stocks down."
This recent period of <u>extremely low volatility</u> in the stock markets (it has been more than a year since there has been 5% or greater pullback in the S&P 500, according to the publication Barrons) is merely an indicator of <u>investor sentiment today</u>, as opposed to a predictive forecast of <u>future volatility</u>.

Simply stated, don't extrapolate <u>todays ultra low volatility</u> and assume it will last. The present "goldielocks" environment of <u>low inflation</u>, increasing corporate profits, and the snails pace rise in interest rates, continues to juice the U.S. markets upwards.

What are some of the usual catalysts for a bear market decline?

1) Extended period of aggressive interest rate increases. (todays snails pace increases – not yet a threat)
2) A looming business/profit recession. (no signs)
3) A Geo-Political/Financial crisis. (stay tuned…for surprises)
4) Euphoric retail investor participation. (no evidence of a retail bubble yet)

A fully valued, or an expensive stock market, has historically not been a defining catalyst to topple a bull market run. Elevated stock market valuations can persist for an extended period.

The real medium to longer-term risks investors have to guard against, concerns the massive amount of disruptive (secular) changes to businesses (stocks). These are changes caused by the forces of technology, the internet, and the new tastes/habits of the millennial generation. Get it wrong, and your portfolio will be sunk by the next AOL, Kodak, Blackberry or Sears. Investors must understand that the dreaded "bear market" decline is only a temporary event, not a permanent one.

On the brighter side, volatility, fear and panic are the friend of the value investor holding cash. C.A.S.H. should not be viewed as a four-letter word in the investing world, but rather as a psychological "life saver" when bargains become scarce, or the headlines become downright terrifying.

Respectfully yours, **

Benjamin D. Horwood
Portfolio Manager
August 15, 2017

P.S. Do visit us at our **NEW** web site: **www.valuecontrarian.com**

**We're often asked: "When is the best time to invest in the Value Contrarian Fund?" Although there is no best time, since it is impossible to time the market, a preferable entry point is when the Fund has produced a month of negative returns or a year of underperformance. Unfortunately, human nature prefers the exact opposite.

Overall, long-term shareholders in the V/C Fund benefit from a sinking stock market, the same as a regular grocery shopper benefits from declining food prices. So when stock markets plummet – as they will from time to time – "neither panic nor mourn". It's good buying news for your Fund.