VALUE CONTRARIAN
ASSET MANAGEMENT

2018 Second Quarter
Value Contrarian Equity Fund

Dear Partners,

"The best way to win (in the market) is by not losing."

Rupal Bhansali
Chief Investment Officer
Ariel Investments

History suggests that the leadership of the stock market does not rotate into laggards (value stocks) late in the cycle – bull markets don't broaden. Instead, investors chase the leaders (FAANG stocks) even harder, narrowing bull markets further.

Robert Buckland
Chief Global Equity Strategist
Citi Bank

"The economy is strong, so stocks will keep rising."
Evidence suggests, however, that the linkage between the two is somewhere between haphazard and non-existent. The market is all about the future, not the past.

Tom Bradley
President Steadyhand Funds

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It's been quite a ride since March 9, 2009. US equities have returned more than 300% since the financial crisis nadir in March 2009. Specifically, it has been tech (FAANG) stocks that have powered the U.S. index rally in recent years (Facebook Apple Amazon Netflix Google). Unfortunately, the party has not been as bright for the TSX. The blue chips TSX 60 Index has increased 110% since the March 2009 lows.
(Note: The above S&P 500 and TSX 60 returns exclude dividends).

To put things in perspective for 2018, as of early August, the TSX has advanced approximately 3%, while the technology heavy Nasdaq has moved an impressive 14%.

The Nasdaq outperformance is further evidence of the narrowing leadership [poor "breadth"] within the US market. These are classic signs of a late bull market cycle.

From your manager's thirty years of investing experience, chasing momentum trades in an aging bull market, is a dangerous strategy. It is usually these "super hot" sectors that lead the way down in any subsequent bear market.

A major difference this time, from the 2000 – 2002 Tech/Telecom/Dotcom bear debacle, is that most of the FAANG stocks are highly profitable businesses with strong competitive advantages, and loads of free cash flow. FAANG is not going into oblivion, as AOL or NORTEL experienced in the previous bust. Nonetheless, the FAANGs are not immune to an old fashioned slump either. But, here is the caveat!

Like the super popular, and expensive "Nifty Fifty", one decision stocks of the early 1970's period (ie: Philip Morris, Coca-Cola, Disney, Johnson & Johnson, P&G, etc…), the FAANG hyper growth rates will start to slow, and as a result their P/E (price-earnings) multiples will contract. Contracting P/E multiples ultimately translate into lower share prices. Thus, despite huge continuing profitability, FAANG stock prices could easily stagnate under the weight of slowing earnings growth rates and higher interest rates. This latter scenario, in our opinion, will be an important element signaling the waning days of this super U.S. bull market.

This would be similar to what Microsoft experienced in the decade after 1999. Microsoft's share price and its elevated P/E ratio had simply raced too far ahead of its slowing earnings growth rate. As a result, Microsoft's stock price peaked and then stagnated for over a decade, despite producing higher earnings per share in most years. Coca Cola suffered the same fate in the late 90's when its stock peaked at 50x earnings.

Paying attention to stock market history is an important element in any equity manager's toolbox. In fact, many speculative excesses repeat themselves, and thus can be contained by simply paying attention to past irrational market behaviours.

Prudence and caution doesn't sell well on Bay or Wall Street. But then again, your Fund manager is the second largest individual shareholder in the Value Contrarian Fund. Although no guarantee, having major "skin in the game" is what keeps us focused and level headed each and every day.

Second Quarter Performance

Bull markets don't die of old age, they die of excess.

LPL Research
August 2018

Since December 2015, the Fed has raised U.S. interest rates seven times, and another two increases are pencilled in for 2018.
Rising rates can inflict serious damage to bull markets. Only in hindsight, will investors realize which rate increase caused the music to abruptly stop.

Ben Horwood
Value Contrarian Asset Management
August 2018

Your Fund ended the second quarter with a net asset value of $3,527.00 per unit, an increase of $55.52 from the December 31, 2017 net asset value of $3,471.48 per unit. Year-to-date six-month performance: 1.6%. (TSX: 1.95%).

Aisle 5 – reality check please - the TSX vs. The World. The reality is most major stock markets have fallen short of the S&P 500 since it bottomed on March 9, 2009, during the depths of the financial crisis.

Besides the Toronto Index, indexes in Japan, China and Europe have lagged far behind the U.S. markets. (Shanghai: +27%, MSCI Emerging Market Index: +150%, European Stoxx 600: +64%, Hong Kong: +150%, TSX 60: +110%, S&P 500: 320%)

The gulf is partly a testimony to U.S. economic dynamism, the rise of tech giants such as Facebook, Apple, Amazon, etc… and the recent corporate tax cuts (35% down to 21%).

During the first six months, your Fund benefited from a falling Canadian dollar (0.795 to 0.760). This foreign currency gain helped offset the Fund's 26% (low return) cash position.

We now have nine million dollars in United States government Treasury Bills. For the foreseeable future, we will be very prudent with our cash investments. This means we will avoid short-term Canadian bankers acceptance notes, and U.S. commercial paper. The slightly higher rates on these securities do not justify the risks. We want guaranteed federal government liquidity in the event of any fixed-income/credit crisis.

During a recession, we would be happy buyers of junk bonds if they traded at 900 basis points above risk free U.S. treasury notes. There is a time and place for all investments. Very often it's just a question of "price" and "timing".

During the second quarter, the Fund's portfolio was trimmed with the sale of our entire position in the emerging market Colombia ETF. With the recovery in global oil prices and a peace deal with the FARC rebel group, we felt it was an opportune time to take profits and move on.

The speculative hype of combining cannabis with coffee shops enabled your manager to exit our Second Cup stock at a small profit. This was a turnaround story that never panned out.

Finally, we did add one new small holding during the quarter. The day after General Electric was removed from the Dow Jones Industrial Average, we took a "look-see" position in the common stock.

In the upcoming year or two, GE will spinoff its healthcare unit and sell its Baker Hughes division. The remaining slimmed down company will have four clear operating segments (power turbines, aviation, renewable energy and a much smaller GE capital). Unless there is further consolidation amongst GE competitors in the depressed gas turbine power business – this stock will

potentially bottom only during the next bear market recession. Thereafter, GE could triple or quadruple off the bear bottom. This is a classic "contrarian" play, but patience is required.

We would not be surprised to see Warren Buffet take a large position in GE, especially in light of GE's depressed earnings and new capital allocation discipline.

OUTLOOK

> **Bull markets are like incandescent light bulbs. They tend to glow brightest just before they go out.**
>
> **Sam Stovall**
> **Chief Strategist**
> **CFRA Research**

> **The S&P 500 has roughly quadrupled, including income, from its low in 2009. It was certainly easier for the P/E ratio to go from the low teens in 2011-12 to 25 P/E today than it would be for it to double from here. …And if that's the case, isn't it appropriate to take less risk…**
>
> **Howard Marks**
> **Oaktree Capital**
> **January 2018**

Unlike the current U.S. bull market, which recently made history as the longest (in duration) on record, the current bull market in Canada is a mere 18 months old. (Canada suffered a commodity/oil bear market which ended in January 2016.)

As explained earlier, markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip or tech names. This "narrowness" of markets has in the past been a classic characteristic of the last stages of a bull market. Nonetheless, it's impossible to time the markets. (But certainly fun to take a stab at the "when & how" of its final demise.)

This nine-year U.S. bull market has certainly pushed client expectations higher, yet opportunities to generate outsized returns have been lowered with the increase in the P/E ratio over this period (A sign the merchandise is much more expensive).

On a more positive note, there is the real possibility of a final North American stock market "melt-up". Respected Fund managers Ray Dalio & Jeremy Grantham consider this a key element of "the classic top". On cue, the S&P 500, Nasdaq, Dow Transport and Russell 2000 indexes have all, in the past week, made record new highs.

Canada is due to play some catch-up compared to our high flying U.S. neighbour. The next 6-9 months could see the TSX recoup some of its recent underperformance. Barring a meltdown in the U.S. markets, or a surprise jump in interest rates, the lackluster six-month performance of the TSX Index seems to be finally reversing itself as a result of continued robust earnings growth, higher energy prices, and the settling of trade tensions with a potential NAFTA deal.

The reintroduction (this November) of sanctions on Iranian energy exports may well result in higher global oil prices and hence Canadian energy stocks.

In concluding, at this stage of the business cycle, [rising interest rates, loosening loan standards, high valuations, and abundant retail investor speculation] one must not fall into the "buy-buy-buy" trap whereby today's supposed "good value" buys become even "bigger value" buys down the road. Thus, investing today requires an even bigger "margin of safety".

As the business cycle ages, "value investing" becomes a much trickier endeavor. Proceeding with caution is just plain common sense in this environment. It is not inconceivable that there are still a few strong "puffs" left in this business cycle

cigar. Yes, rising oil/commodity prices would certainly help the TSX index get back on track for the remainder of the year.

Watch out for rising interest rates and thousand-point swings. Enjoy the party while it lasts.

Respectfully yours, **

Benjamin D. Horwood
Portfolio Manager
August 25, 2018

Value Contrarian Equity Fund
Next Fund purchase date: September 24, 2018
Call today: 514 – 398-0808

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.