



# Winter

## Gold medal performance

Equity markets put in a gold medal performance last year!

The S&P 500 increased by 32.39% and the Canadian market rose by 12.99%. Global indices also showed significant gains in 2013. As we discussed in 2012's year-end newsletter ([www.patientcapital.com/news](http://www.patientcapital.com/news)) investors were encouraged to shift from bonds to equities because they were viewed as offering better returns. The "Great Rotation" did occur despite the very high levels of valuation that existed then, proving once again that sentiment and momentum often trump fundamentals in the short and medium terms.

The two most frequent questions that we have been asked recently are what do we think markets will do in 2014 and where do we think the Canadian dollar is headed? Our views are that:

- Valuations are substantially above long term averages;
- Equity markets do not provide an attractive risk adjusted long term return;
- Historically, returns generated from these valuation levels have been very modest at best;
- The Canadian dollar is worth \$0.80 to \$0.85 on a "purchasing power" parity basis relative to the U.S. dollar.

Please note that the above statements make no prediction about the future direction of equity markets or of the Canadian dollar. We believe that it is very difficult for most and impossible for us to make such predictions with any degree of confidence and consistent accuracy. More money and reputations have been lost than ever gained attempting to reliably predict and manage for short term market movements.

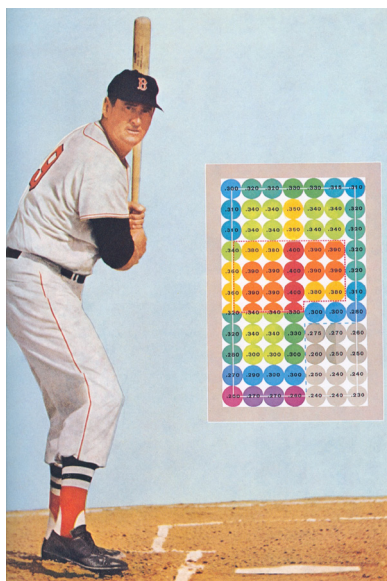
## The “sweet spot”

What we can control and manage is the assessment of risk so that the outcome is largely skewed in our favour and that the probability of capital loss is very low. Some use the art of hitting a baseball to illustrate this point. The best baseball batters attempt to increase their batting average by only swinging at pitches in the “sweet spot.” Ted Williams, one of professional baseball’s greatest hitters, studied pitches thrown at him and determined which ones he was best able to hit. As shown in the photograph, Ted Williams only tried to swing at the bright colored balls; the pitches that he had the highest odds of hitting.

We try to do the same thing; invest in opportunities that are a sure thing over the long term. Whereas a baseball player is a superstar if he hits a ball safely only thirty-three per cent of the time, we try to achieve a near perfect record. We try to accomplish this objective by eliminating risk. In effect we try to dramatically increase the odds in our favour of a positive outcome by trying to minimize the things that could go wrong. We have found that by focusing on risk we are better able to generate long term returns.

We have tried to increase our odds by changing the rules of the game. Our mandate allows us to invest in T-Bills if we can’t find investments that meet our criteria for value and quality. Unlike investors that must be fully invested we don’t have to swing for that very low probability pitch on the outside corner. We won’t swing if we don’t want to; we can patiently wait for that perfect pitch in the “sweet spot.” We are grateful that you are not yelling: “Swing you bum!” from the bleachers.

We also are very careful of the price we pay. We only make investments that we are able to purchase at a forty to fifty per cent discount to what we believe they are worth. This discount allows for a very large margin



Ted Williams and his batting average.

of safety. We have found that if our investment thesis changes or if we were incorrect in some aspect of our analysis that we can typically sell the investment without suffering a capital loss. The very high discount to intrinsic value increases our probability of earning a substantial long term rate of return and reduces the risk that we suffer a permanent loss of capital.

To improve our probabilities even more we only purchase companies with very strong fundamentals. The businesses that we choose have long and attractive operating histories, strong balance sheets, and generate substantial cash flow. The odds of businesses with these characteristics suffering serious erosion in intrinsic value are very low. Once again we minimize risk and improve our chances of success through the disciplined purchase of high quality businesses.

The ability to patiently wait for the perfect pitch and the purchase of high quality business at a substantial discount to their true economic worth greatly increases our batting average. We are in effect swinging at a very large beach ball with a very large bat; we want to make the easy hit.

We won’t hit many out of the park but we won’t strike out either.

Slow and steady wins the race. Currently we are not seeing many beach balls being offered up to us. The high quality companies that we prefer are outside of our strike zone by a wide margin. For example, Canadian National Railway (CNR) is considered the most efficient and best managed railway company in North America. CNR has an asset base that is almost impossible to replicate, a strong balance sheet and the benefit of large quantities of commodities that have few transportation and distribution alternatives. However, at current prices the valuation is extreme as the charts below illustrate; rendering CNR’s shares are a very risky investment. Assuming a return to long term average valuations, the probability of



a substantial rate of return from CNR's shares is quite low while the possibility of a loss of capital is high. The vast majority of situations that we look at today are priced with the same risk reward metrics. Under such circumstances we step out of the batter's box and patiently wait for that beach ball come at us so that we can hit it with our oversized bat.

### CNR Long Term Price/Book Ratio<sup>1</sup>



### CNR Long Term Price/Earnings Ratio<sup>2</sup>



<sup>1</sup>Source: Capital I.Q.

<sup>2</sup>Source: Capital I.Q.

## **PCM is continuing to grow**

We are now approaching seven hundred million dollars in assets under management. We are quite pleased with our growth because it gives us the opportunity to help and serve more people.

As we grow it is critical to all of us at PCM that we keep our level of service up to the standards that you expect and that we remain accessible to you. If you have any questions or suggestions for improvement as we continue to add clients and assets please do not hesitate to contact us directly.

We thank you for your support and wish all of you continued good health and happiness.

Vito Maida  
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**Patient Capital Management Inc.**

**111 Peter Street, Suite 602 Toronto, Ontario M5V 2H1**