Winter 2017

Donald Trump was inaugurated as president of the United States just over a month ago. Despite the angst and the concern the world has not ended. The sun still rises in the east and sets in the west.

In strong contrast to the political chatter, investors have responded quite positively to President Trump's victory. Equity markets have reached record highs since November 8th. Market participants including some notable investors have gone "all in." The basis of this optimism has largely been the widespread belief that the new President's economic policies will result in higher growth for the U.S. economy and increased profitability for U.S. companies. Mr. Trump proposes two economic policies that have resonated particularly well with corporate leaders and investors; increased infrastructure spending and lower taxes. These plans along with less regulation have boosted both business and investor confidence.

Ever the contrarians, our enthusiasm is quite a bit more tempered. While a pro-business president and investor friendly legislation are undoubtedly positive for growth, we must look at the implications of these proposals in the context of today's environment. In addition, the implicit assumption is that these policies will be implemented without delay and without offsetting compromises. This belief is truly optimistic given the level of discord in U.S. politics and the vehement opposition to Mr. Trump in some quarters.

Mr. Trump wants to increase infrastructure spending by one trillion dollars. Such large expenditures will add to an already high level of public debt. In addition, such a significant amount of stimulus in an economy operating near capacity and close to full employment will add to inflationary pressures. Higher government debt and higher inflation will lead to higher interest rates. Given that today's valuation levels have been supported and justified by record low interest rates it should follow that rising interest rates will result in lower valuation metrics.

Mr. Trump's other major proposal is to significantly reduce corporate taxes. If implemented there will be a short term bump in profitability. However, we believe that the benefits of lower tax rates will be offset by the natural impact of competitive pressures as businesses fight to gain market share. Margins across all businesses ultimately revert to their long term averages. Adam Smith's "invisible hand" guarantees that outcome.

When we consider lofty valuation levels alongside the very real possibility that Trump's policies will lead to higher interest rates, our concerns are magnified. If our assumption that corporate profitability will revert to its long term average holds true, then we have a truly risky scenario. Falling valuations resulting from higher interest rates without significant support from earnings growth will ultimately lead to capital losses.

Ultimately, our biggest concern is that equity prices have increased in the context of what virtually **all empirical long term valuation measures** suggest are very lofty valuations. Irrespective of which measure one chooses; the Market Cap/GDP Ratio, the Shiller P/E Ratio or the S&P 500 Dividend Yield; the evidence is clear, equity valuations are at their highest levels with the exception of the technology bubble of 2000.

Pick your poison!

Market Cap/GDP Ratio

Shiller P/E Ratio

S&P 500 Dividend Yield

As we have often stated, our unshakable belief is that true long term returns (as opposed to speculative returns) are determined by the prices paid for the asset. The higher the valuation the lower the long term return. This principle has held true in one form or another since the advent of modern commerce. It is impossible for any politician/policies to defy this immutable principle.

Discussions such as the one above are certainly interesting and timely but aggregate market valuations and politics play no part in our investment process. We construct our portfolios based solely on the individual merits of any potential investment. While we have discussed this process in detail in previous newsletters and in other forums (https://www.youtube.com/watch?v=kJUAF-69dYI&feature=youtu.be) it bears some clarification.

Our approach can be summarized as purchasing attractive businesses at a substantial discount to their intrinsic value. There can be some confusion in the above statement. The second part of the statement, substantial discount, is very easy to determine. We define a substantial discount as forty to fifty per cent below a security's true worth. For example, if we value a business at ten dollars per share we would want to purchase those same shares at five to six dollars.

It's the first part of the statement that often leads to misunderstanding. The most common definition of an attractive business is taken from Warren Buffett's comments and annual letters to shareholders. Mr. Buffett essentially describes an attractive business as one having an unassailable competitive advantage that allows for pricing power, earning high returns on capital and generating substantial free cash flow supported by a very strong balance sheet. There is no doubt that this definition captures all of the characteristics that one would desire in every investment. In a perfect scenario we would be able to construct an entire portfolio of such businesses at a forty to fifty per cent discount to intrinsic value.

There are two practical problems with adhering strictly to this definition. The first problem is that very few such companies truly exist. We would estimate that there are no more than fifty of these wonderful businesses globally. Competitive advantages by their very nature are truly unique. The second problem is that these companies are well recognized by the market. There are very few oppor-

tunities over generations to buy them at a substantial discount to their intrinsic value. Purchasing them at fair value will earn steady but index-like returns.

Our objective is to earn a compound annual total return of twenty per cent over a five year period for each equity security that we invest in for our high net worth clients. Since our inception in March of 2000, we have exceeded this goal for the thirty five securities that we have bought and sold for our high net worth clients.[1] In order to achieve these results we have had to make tradeoffs on occasion.

The tradeoff has been to invest in companies that do not meet the ideal standard as defined by Mr. Buffett. We strongly believe that superior rates of return can be achieved by investing in less than perfect businesses as long as the analysis is thorough and the investment is purchased at our required forty to fifty per cent discount to intrinsic value. For example, we have invested in resource companies. Resource companies are by no means ideal businesses; they do not possess any franchise value and require substantial capital investments to maintain their asset base. Yet, we have often met our return objective by investing in this sector. The key has been to purchase these investments at approximately a fifty per cent discount to net asset value **AND** to carry out a thorough analysis. Our analysis concentrates on companies that have low operating costs, large and sustainable asset bases and very sound capital structures.

We have also invested in the second or third best companies in their respective industries with a considerable degree of success. The crucial task has been to ensure that our analysis and assessment of fair value explicitly recognizes their competitive position. Long term operating ratios, margins and returns are used to assess the business that are in line with their current and future prospects to determine true worth. If we are comfortable with the business and if we can purchase it at a forty

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[1] Before Fees
Based on Representative Portfolio
Past Returns are Not an Indication of Future Returns

to fifty per cent discount to its value, then we will not hesitate to do so. We have found that these companies are in many cases the subject of takeover offers as larger or better positioned industry participants seek to consolidate an industry.

While we are willing to make some tradeoffs there are some business characteristics that we will not compromise under any conditions. We will not make investments that we cannot analyze because we do not understand the business or the public operating history is too short. We will not participate in companies that have weak capital structures and that do not have a history of generating positive cash flow. Aggressive accounting practices and managements that have a history of questionable behaviour are also non-starters. We have found that companies that exhibit these "red flags" turn out to be very poor long term investments.

The above discussion may shock some investors who live and die by the words of Warren Buffett. The irony is that most of what have become common beliefs about Mr. Buffett's investment philosophy has been construed and inferred from a cottage industry that has evolved around Mr. Buffett's annual letter to shareholders, annual meetings and occasional public comments. To our knowledge, unlike Benjamin Graham, Mr. Buffett has never provided a detailed discussion of his investment process. Indeed, Mr. Buffett has often made some of the tradeoffs that we have discussed; he has purchased resource companies, he has acquired capital intensive businesses and he has invested in businesses with less than ideal characteristics. Conoco-Phillips, Burlington National Railway and Solomon Brothers are a few that come to mind. More recently, Berkshire Hathaway has invested in several airline companies; an industry he once described as a sure way to lose money.

We would venture to suggest that the "Cult of Buffett" has in some ways been a disservice to a generation of investors. Many investors now focus exclusively on these very rare ideal businesses without a rigorous regard to the price paid. As a result, investments are made in these businesses offering lower long term returns without even considering perfectly sound and acceptable businesses that offer substantially more attractive

gains. Perhaps even worse, is that Mr. Buffett's ideals have been blindly followed and the discipline of thorough and intellectually rigorous analysis has fallen by the way side. To be clear, the above discussion is in no way a criticism of one of the world's greatest investors. It is merely an observation that investors should not follow blindly notions attributed to Mr. Buffett about an investment process that he himself has never discussed in much detail.

The investment industry is losing one of its good ones. Our very good friend, Keith Graham, has decided to retire. Keith has had an outstanding career in the investment business. More importantly, Keith has distinguished himself as an individual of the highest integrity, loyalty and passion. We wish Keith and Karn much happiness in the next phase of their journey.

In the past few months we have been fortunate to have several clients join us. To our new clients; welcome! Thank you for placing your trust and confidence in us.

To all of our clients, thank you for giving all of us at PCM the privilege of serving you.

Vito Maida

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