



Spring 2017

“This too shall pass.”

Valuation seems to have been forgotten in the investment process. This has been evident over the past several years but we are now in the territory of “reckless abandon” as “animal spirits” take over. There are several reasons for the current state of affairs. Among them:

- Persistent record low interest rates fuelled by Central Bankers fearful of a decline in asset prices;
- Enormous corporate share repurchases funded by ever increasing levels of debt;
- The large amount of fund flows into passive investment strategies that are fully invested and by definition must continuously purchase equities in an ever rising market begetting higher and higher prices.

These factors coupled with investor optimism have pushed current equity valuations to record highs. In our view risk is now exceptionally high; particularly relative to potential future returns. While we can't predict how long these markets will persist, history tells us market sentiment often changes quickly and for unforeseen reasons. Below we list some of the risks that are being ignored:

- Political risk, with President Trump being embroiled in several investigations that threaten his administration's pro-business policies;
- Geopolitical risks, especially in the Middle East and the Korean Peninsula;
- Higher interest rates being telegraphed by the U.S. Federal Reserve;
- Valuations that sit near all-time highs.

The current environment is eerily similar to previous peaks in 1987, 2000 and 2007. In each of those circumstances valuations were ignored. Investment pundits of all stripes provided eloquent justifications for continued optimism

and ever rising prices. Investors got enamoured with the popular investment of the day and impatient with any asset that didn't show an immediate return. Any rational argument rooted in financial and historical norms was dismissed in favour of the new paradigm of the day.

As we have come to expect, our performance tends to lag in these markets; often quite significantly. We are not invested in the "hot stocks" and own out of favour businesses. Our portfolios are concentrated and very different from our peers and the benchmark resulting in very different short term performance from industry averages. Consequently, our long term value approach is questioned and doubted; sometimes in a very aggressive and personal way by those who argue that "this time is different".

But it has never been different. In every case investors suffered large and permanent losses of capital. Confidence was shaken and financial plans and goals were disrupted or permanently damaged.

After a very strong performance last year, 2017's year to date results have been weak. The energy and financial businesses that performed so well in 2016 have given way to negative sentiment so far this year. These factors combined with large cash balances in a rising market have come together to produce a wide short term underperformance relative to the index.

We at PCM are invested right along with you; "we eat our own cooking". We are nonplussed by the share price performance of our investee companies. The underlying basis of our confidence lies in the strong operating fundamentals of the businesses we own, the capable people managing them and the substantial intrinsic value inherent in each enterprise.

Our energy companies all have the following characteristics:

- Excellent resource bases and assets;
- Low operating costs;
- Strong balance sheets;
- Experienced and well regarded management teams.

In addition, despite the short term volatility in the price of oil, virtually every long term study suggests that there will be a supply shortage sometime in the next twelve to twenty four months. This supply shortage will ultimately result in higher oil and gas prices. It is only a matter of time, in our view, before share prices reach their intrinsic value. In the meantime we are earning dividend income while we wait.

Our investments in Canadian banks have been affected by the recent controversy surrounding Home Capital. Home Capital, until recently, was a very successful alternative mortgage lender. It largely catered to individuals who found it difficult to borrow money from traditional lenders because they were self-employed, lacked a credit history or were new to the country. Over a very long history, Home Capital's mortgage portfolio performed in line with those of more traditional lenders, despite its higher risk profile.

Recently it was revealed that the company did not disclose some regulatory issues in a timely manner. The resulting maelstrom led to a crisis of confidence and a "run on deposits". The company required and obtained very expensive emergency funding to avert a total collapse. It is important to note that Home Capital's problems are not the result of bad assets but poor operational and management decisions.

The problems at Home Capital have been projected onto Canadian banks largely by foreign investors who assume that our banking system is similar to that of the United States and that our financial institutions have a widespread problem with asset quality due to an inflated real estate market in Canada.

While we strongly believe that a "housing bubble" exists in Canada we do not see systemic risk in the Canadian banking system. Canadian banks have several characteristics that protect investors and provide long term sustainable earning power:

- Strong capital positions that exceed minimum regulatory requirements by large amounts;
- Conservative loan growth;
- Retail deposit-based financing;
- Diversified income stream income.

The Canadian banks' earning power is exceptionally strong. Our "stress test" analysis indicates that even under a situation where house prices decline dramatically and default rates rise substantially above historical norms, capital levels and dividends would be maintained.

The Canadian banks are also protected against some mortgage losses by the Canadian Mortgage Housing Corporation. This government-backed entity insures the bank's high loan to value mortgages. An American style financial crisis is highly unlikely in Canada.

Despite share price fluctuations the risk of permanent loss of capital is very low. At our purchase price, our bank investments provide substantial yields. Given our relatively low weighting in bank shares we hope that this misperception continues to drag down share prices so that we can make additional purchases at prices that provide an excellent income stream and the potential for substantial capital appreciation.

May 4th, 2017 marked my thirtieth anniversary in the investment industry. During this thirty year time span we have experienced several periods of stock price volatility and divergent performance. We will continue to do so over the next thirty years. But we have been fortunate that our long term value based investment focus has stood the test of time and allows us to say with confidence that "this too shall pass."

As always, we thank you for your continued trust.

Vito Maida



Patient Capital Management Inc.

100 Simcoe Street, Suite 100 Toronto, Ontario M5H 3G2