



## Spring 2018

Equity markets have experienced volatility yet despite recovering from large declines there is a sense of uncertainty. Market pundits suggest that this heightened volatility is a result of higher interest rates, the first onset of inflationary pressures and concerns over the prospects for continued monetary tightening in the U.S. and Europe, as well as increasing trade tensions between the U.S. and its major trading partners.

Most recently, the election of a nationalist and anti-Euro government in Italy has raised concerns about the stability of the European Union once again. This new government has focused investors' attention on Italy's economy. The Italian economy is Europe's third largest and is in a precarious financial position. The consequences of a Greek style crisis in Italy would be far more serious and could spark turmoil in financial markets.

Despite these risks, equity market valuations remain at historical highs. As we have written in the past, current valuations portend the potential for very large capital losses and the near certainty of very low future returns.

Market optimists argue that synchronized global growth will allow corporate profits to grow into their very high equity market valuations. This view has been reinforced by the passing of a new tax reform package late last year in the U.S., which significantly lowered corporate tax rates and in turn increased prospective after-tax income. This argument masks the actual amount of time it would take for the growth in corporate profits to bring market valuations back to historical averages.

Table 1 shows the number of year's equity markets would have to remain at current levels at different rates of profit growth for the Schiller P/E Ratio to get back from its current level of 32.1x to its historical average of 16.9x.

**Table 1**

<b>Earning's Growth</b>	<b>Year's to Historical Valuation</b>
3%	21.5 years
5%	13.5 years
7%	9.5 years
10%	6.5 years

To clarify, if corporate profits grew at three per cent annually, the S&P would have to stay at existing levels for approximately twenty two years before the S&P 500 returned to its historical Schiller P/E of 16.9x; in other words fair value. This means twenty two years without capital gains! The total annual return would approximate the S&P 500's current dividend yield of approximately two per cent.

Long term profit growth is tied to GDP. On aggregate, corporate profit growth will equal growth in the overall economy. GDP has grown at a long term average of three per cent. As a result, the long term profit growth of the S&P 500 will also be 3%. This is the most likely scenario.

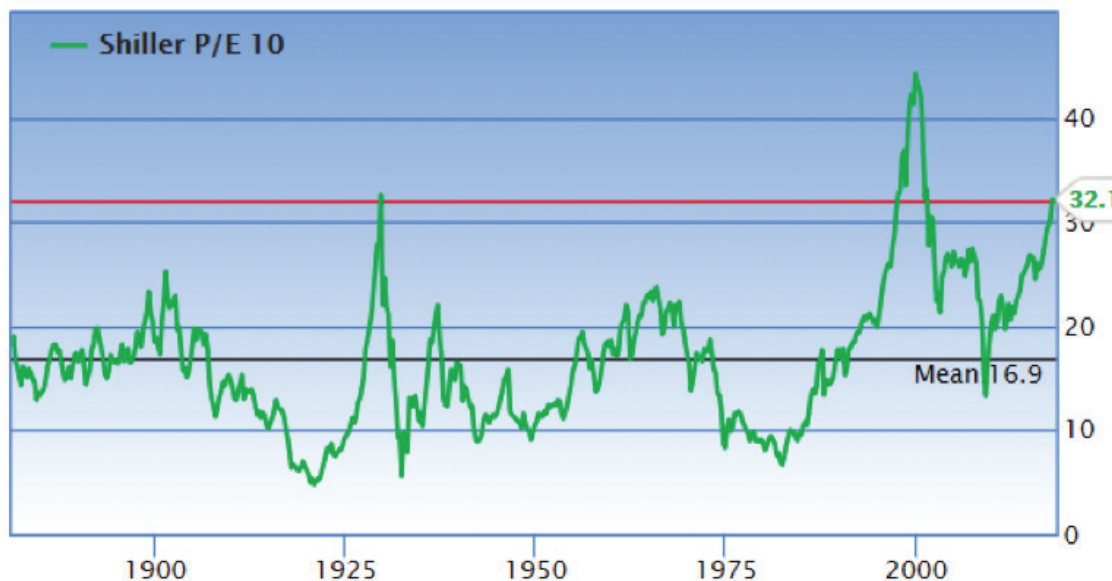
If we suspend economic reality and assume that long term profits grow at an impossible rate of ten per cent, investors would still experience no capital gains for just over six years before valuations returned to fair value!

Investors cannot be faulted for not appreciating the above analysis. After all, valuations were at similar levels in March of 2000 and the eighteen year return on the S&P 500 was 5.23%. However, it is important to note that the return calculation is end date sensitive. The total return for the eighteen year period ended March 31st, 2018 includes the current extreme valuations. If we value the S&P 500 as of March 31st, 2018 using the average Schiller P/E of 16.9x the eighteen year total return would have been two per cent. The very same return that we expect over the next twenty two years!

In order to earn the past eighteen years' compound annual return of 5.23% over the next twenty years, equity markets would have to maintain today's valuation on March 31, 2038. While it is possible, we don't like these odds.

As the chart below indicates, today's extreme valuations have occurred only three times over the past one hundred and forty three years.

**Chart 1**  
**Shiller P/E Ratio**



The above analysis suggests that those investing in passive indexes will experience disappointing returns over the next several years. Paradoxically, equity investors have been rushing into equity index funds at an accelerating pace. In turn, they have been abandoning long term value based strategies; the exact opposite of what a rational fiduciary should be doing. Value investing has become so unfashionable that many well-known value investors have “adapted” their investment disciplines to accommodate the current market conditions.

The Wall Street Journal wrote recently: “Hunting for cheap stocks has been out of favor for so long that some self-proclaimed “value” investors are embracing a broader mandate...Many such buyers have drifted away from the hallmark of value investing championed by the likes of Benjamin Graham and Warren Buffett : actively picking stocks the market has overlooked. [sic] and valuing businesses using traditional measures of cash flow, earnings and book value”

The author goes on to state: “Some critics say the measures used to identify value have aged poorly in a market dominated by passive investing strategies and asset-light technology companies. Those trends have pushed more investors into the shares of fast-growing companies such as Apple and Netflix that have powered the market higher in recent years.”<sup>1</sup>

Passive investors and those preaching the new era of investing are breaking all of the fundamental principles that legendary investors, such as Benjamin Graham, John Neff and Warren Buffet, have followed to amass vast wealth over time. These common sense rules, listed below, are being totally ignored in today’s environment.

### **Fundamental Rules for Investing**

- Public equity investors purchase a fractional interest in a business; not a piece of paper to trade
- When buying a business, know the business
- The price paid determines the ultimate return
- Beware of overpaying for growth
- Prices will always return to the fundamentals and value of the business

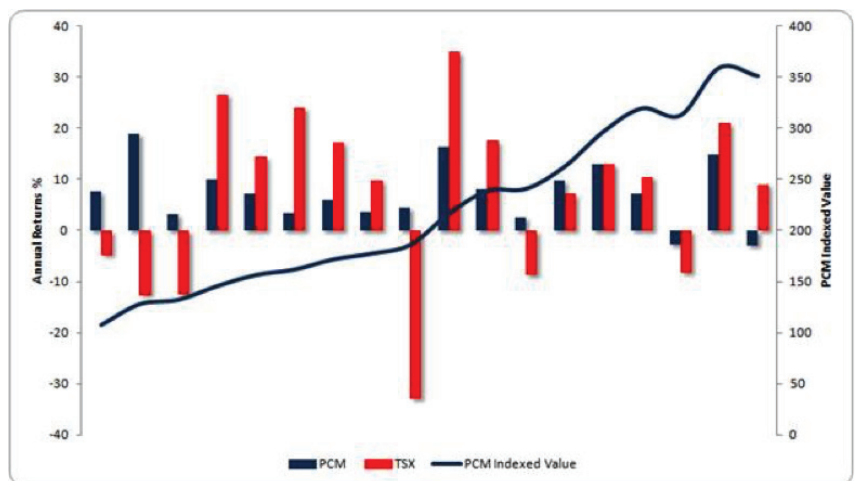
<sup>1</sup>Value Investors Face Existential Crisis After Long Market Rally  
The Wall Street Journal, June 4th, 2018

You can rest assured that we will never stray from our founding principle and core promise; that we would never compromise our investment philosophy based on absolute value and quality. This uncompromising discipline is based on hundreds of years of economic evidence, market history and the common sense principles listed above. The only way to earn a sustainable rate of return is to purchase good businesses at reasonable valuations.

The “proof is in the pudding”. We started Patient Capital in March of 2000. At the time the valuations were very similar to today’s overheated environment; with valuations at all time historical highs. Despite that initial starting point, we have compounded your wealth with substantially less risk than the major market indices, by staying true to our promise.

Graph 1 is quite illustrative and provides hope despite the prospect for very poor broad market returns. The bar graphs show our annual performance relative to the TSX since our inception. The superimposed line graph represents the cumulative growth in value over the past eighteen years. To repeat, the prospect for acceptable long term returns is based on the irrefutable belief that buying sound businesses at a discount to their underlying worth will grow our capital irrespective of overall market conditions.

**Graph 1**  
**PCM Annual Returns and Compound Annual Growth in Capital**



What is notable is that while we have underperformed the index in several years the growth in capital is still substantial. This result is due to the fact that we have avoided substantial losses. While there are no guarantees we would expect to achieve similar performance in the future.

These market conditions can be frustrating and test our collective patience. We have often stated and cannot repeat enough how grateful we are for your support. We would not be able to do what we do with such conviction without your trust and confidence.

Thank you!

Vito Maida



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