



April 9, 2015

Dear Starvine Capital Corporation Client:

Starvine Capital launched intra quarter, with the first account opening in the second week of February. In the stub quarter, accounts open at least one month were down between 1.13%-1.95% This compares unfavorably to the S&P 500 and S&P TSX indices, which were up 0.28%-1.36% (translated into Canadian dollars) and down 0.86%-0.94% respectively. The ranges reflect the fact the four accounts were established intra quarter, and on different days. Going forward, I will continue to quote the aforementioned indices as they provide a proxy of the returns you can achieve in a low cost, passive product. Although I believe the S&P 500 and S&P TSX to be the most relevant indices for you to benchmark performance, the truth is that I do not take any index into consideration when searching for ideas or thinking about portfolio construction. As I practice a mainly contrarian approach - or at least shy away from sectors with lofty valuations – I expect to outperform the indices during bear markets when expensive stocks correct drastically, and to underperform on a relative basis during periods when valuations race upwards.

All accounts are invested in the same securities and more or less in the same percentages. As such, the variation in performance should be minimal between any two accounts, provided they are both fully invested into the strategy from the beginning to the end of a given period. However, with Starvine’s practice of prorating the hurdle rate for amounts invested for less than one year (ending December 31), accounts in their first year will have differing performance (net of the performance fee) depending on the start date and whether the hurdle is exceeded.

Outlook

My view of the general market level is that it is priced in the upper range of intrinsic value. Valuations are on the high end of reasonable, though not outright unrealistic. However, if I were limited to investing in only index instruments, I would be concerned about where the next lift could come from. It would be difficult to construct a rational explanation of how the levers that have benefitted markets since the bottom in 2009 have sustainability from this vantage point. Years of multiple expansion, decreasing interest rates, and peak profit margins are prompting many to brace for the next downturn. Indeed, a rising tide *should* lift all boats. But reality doesn’t quite work like that for the bottom-up investor. At quarter end, the S&P 500 Index closed 2.4% off its 52 week high, while the S&P TSX Index closed 0.5% off its recent 52 week high. In contrast, the median stock in the Starvine strategy closed ~20% off to its 52-week high.

I do not get the impression that the pendulum of market psychology has swung to a degree such that we should run for cover and just wait for the next crash. Howard Marks, chairman of Oaktree Capital, has masterfully illustrated in his various writings and speeches about the importance of taking the temperature of the market. In short, it is an assessment of market psychology taken by synthesizing messages in the media and the sentiments of market participants.

Memories of the GFC are not too far forgotten at this point: a lot of retail money stampeded out at the bottom of equity markets and has remained sitting in cash or low interest instruments for several years. Inflation may have been subdued, but loss of purchasing power is never a good thing, especially when the effect is compounded over years. In time, memories fade and lessons from the last bust will be forgotten by many. Envy will contribute to the memory lapse – envy from seeing others profit quickly from fads in the market. Combined with the opportunity cost absorbed from sitting out since the market bottom, a sense of urgency by retail and professional investors alike could be forming. It is this sort of scenario that could spur a

sudden spike in herd psychology, and hence valuations. Should I be cognizant enough to recognize the change when-and-if it occurs, I will raise the cash level in the investment strategy.

If there is a possible blind spot in the consensus view, it is the “new normal” in low interest rates that has formed. It is already known that the Fed will soon begin to lift rates as employment recovers; however, I believe the market may be underestimating the impact that sustained increases in interest rates can have on valuation multiples and growth for capital intensive companies. In other words, years of low interest rates have lulled most investors asleep to possible outcomes on both a macro and micro level. Thus it is more important than ever in this environment to tread carefully and be ever discriminating in selecting companies with an adequate level of financial flexibility.

Notwithstanding the above comments, macro forecasting is not a priority for me. In fact, I spend no time trying to forecast the stock market. Instead, my primary focus will always remain the identification of investments with a compelling absolute risk-reward trade off. But market levels do directly impact one’s ability to find undervalued securities, and it is from this anecdotal take on the ease or difficulty of finding ideas that I draw key inferences about market levels.

Provided an investor manages a modest sum of capital, there are over 8,000 exchange listed companies to choose from between the U.S. and Canada alone. With that kind of variety, we are never required to buy “the market”. In this environment – and perhaps at all times – our goal should be to keep a resolute focus on those special opportunities that offer asymmetric return possibilities. Alas, I would be disappointed if I could not come up with at least 12 ideas (Starvine’s mandated minimum) at any given time in the market cycle that collectively sported high odds of providing a satisfactory total return over the next five years. That is not to say I think alpha will be easy to generate. In fact, quite the opposite. Barring a significant market correction, I believe that strong absolute performance going forward for the long-only investor will require sniper-like patience and skill. At present, I am not finding many dirt cheap bargains, and certainly no excellent companies at obvious low valuations. But I am finding a fair number of “high quality at a moderate discount” and “decent quality at a significant discount” type opportunities.

Instead of worrying top-down too much, I find it to be more productive to worry by asking the following questions on a periodic basis:

- Is the basic thesis on each portfolio holding intact?
- How asymmetric is the range of outcomes for each portfolio holding? How lopsided is the estimable outcome in favor of a positive result with limited downside?
- How conservatively is the company priced in terms of valuation? What mix of outcomes is the valuation imputing versus valuable ‘free options’ that, though difficult to quantify, we are receiving for free in the current share price?
- Why is the holding undervalued? Is there an identifiable reason that explains why the valuation is at a discount to fair value? Is the reason verifiable and detached from fundamentals?

If your investment ideas each stand on their own two feet (based on fundamental strength, management track record and growth potential) and are significantly undervalued as verified in your due diligence, should you sell because you are spooked about the overall state of “the market” and believe it may be possible to buy back in lower at some point? The Starvine strategy is currently comprised of 16 holdings, all of which I believe are positioned with a margin of safety. Thus my time is more effectively used in deepening my fundamental knowledge on current portfolio investments, or alternatively “turning over more stones” to constantly seek better risk-return opportunities.

The “Unscreenables”

I am not averse to plain vanilla type situations (cheap and high quality) that are considered mainstream. In the current environment where the consensus is that markets are fully valued, I think it is important to have a clear understanding as to why a particular company appears undervalued. Is stock XYZ underpriced because of over-pessimism toward a particular industry? Is the market under-appraising a company’s earnings power or hard asset value due to the nuances of GAAP accounting? Or are there non-fundamental reasons

explaining the situation? For example, motivated selling caused by a change in shareholder base when a stock is removed from an index?

The majority of holdings in the Starvine portfolio do not screen well in commercial databases. That is, if you ran a query to search for companies trading at a low valuation multiple while displaying a strong track record of ROE (return on equity), most of the holdings will not rank well – or in the case of a recent spin-off, its financial history often times will not populate the data fields until months after the issue begins trading.

While I do not reject ideas sitting in plain sight, my experience is that competition is materially lowered when you calibrate your antennae to pursue opportunities that you know for a fact are off the radar screens of institutional investors. When a company with good economics must be sold by a majority of the shareholders (think spin-offs and index removal) regardless of its fundamental reality, the probability of outsized returns tilts largely in your favor versus trying to analyze household names.

Taking this line of logic a step further, I always want to angle my search process to seek opportunities that do not screen well, regardless of where we may be in the market cycle. This is simply because such opportunities should attract less competition at any given time.

Selecting the Glove that Fits

As Starvine is currently managing a modest sum of capital, the investment strategy is quite unconstrained with regard to the market capitalization and trading liquidity of the underlying securities. The following table provides an overview of Starvine’s holdings by market capitalization:

<u>Market Cap (USD)</u>	<u>#</u> <u>Stocks</u>	<u>%</u> <u>Portfolio</u>
> 20 bn	1	7%
10 - 20 bn	1	5%
5 - 10 bn	5	31%
1 - 5 bn	2	9%
500 mm - 1 bn	4	27%
250 - 500 mm	3	20%

The distributions outlined above are the result of finding opportunity with a bottom-up approach rather than a conscious effort to allocate by market cap. Smaller companies are not inherently better risk-adjusted investments. However, it is true that competition from other market participants is often less intense in “small cap” companies, thereby increasing the odds of being able to find undervalued names. Institutional investors deploying large sums typically require a threshold of liquidity in each idea before devoting the resources to perform in-depth fundamental research.

As an illustration, if funds under management were \$500 million and I identified a potential investment with a \$250 million market cap, a 5% position for Starvine’s clients would require a \$25 million position. This would equate to a 10% ownership in the underlying company, which would likely mean not being able to exit the position in quick fashion (should the need arise) without driving the share price down significantly. It is an absolute reality that flexibility and assets under management have an inverse relationship.

If an activist approach were to be considered, perhaps managing larger sums of money would be advantageous as large ownership positions could be established with the intention of Starvine affecting changes to unlock shareholder value. For now (and perhaps indefinitely), the plan is to be a purely passive investor and maintain a boutique operation that will allow clients to benefit from the advantage of being nimble.

Energy Companies as a Partial (and Imperfect) Currency Hedge

Thus far, I have initiated a few oil and gas related positions in the investment strategy that totaled 7% at cost. There are another few Canadian positions in the portfolio totaling over 18% at cost that, while only indirectly related to energy, have lost significant market value over the past year as a result of their exposure to western provinces.

These positions serve as both (1) natural hedges against the U.S. positions, and (2) bottom-up selections operated by excellent management teams. Please keep in mind though that this hedge is far from perfect, especially if assessing its effectiveness in smoothing day-to-day price volatility. Should we experience a capitulation in oil prices over the next several months, the U.S. dollar should strengthen against the Canadian dollar. In such a scenario, it is likely that I will harvest a modest amount from the U.S. holdings and reallocate the capital to the energy related names. I have intentionally left room to invest more in energy should the opportunity present itself.

Structure

At the risk of sounding cliché, Starvine subscribes to a Buffett-like approach: allocate capital to the best investment opportunities based on price and quality. However, there are two key things to keep in mind with the Starvine strategy: (1) risk controls are in place to constrain the limits of concentration and restrict the strategy from using certain tactics, and (2) Starvine has a ceiling of 50 clients.

No security may represent more than 10% of net liquidation value at cost, as I do not wish the compounding to be seriously set back by any one mistake. With 40-50 years to go, and the knowledge that I am not (and never will be) as brilliant as Buffett, I need this rule as a hard constraint to guard against potential overconfidence. Also, the use of margin loans, derivatives, and short selling are prohibited. Starvine is “plain vanilla” in that sense and as a result should attract investors that feel comfortable with a long only, all equity strategy. The second major constraint is stated as a maximum number of clients. The intention there is two-fold: (1) ensure that every client has direct access to me, and (2) limit the assets under management (AUM). I believe my ability to be nimble and find asymmetric opportunities will be lessened if I were to manage more than C\$500 million in today’s dollars, though it is a ceiling that needs to be marched forward as inflation naturally ensues.

Acknowledgements

As it currently stands, Starvine Capital is an investment management firm consisting of... just me! Despite the self-reliance that the current setup instills, Starvine would not have been possible without the unconditional help of other people. For example, were it not for the support of a top Canadian entrepreneur, family, and friends as seed investors, I probably wouldn’t have had the gumption to branch off on my own. Certain individuals provided invaluable counsel regarding compliance and start-up matters. Most importantly, I am fortunate to have Kimberly - my wife - as a partner. Her support, encouragement, and advice through every step has been critical to the launch.

Yours truly,

Steven Ko
Portfolio Manager

Attached is a discussion of the strategy’s positions for existing investors.