Overview

- ❖ Outlook: Value persists in specific pockets
- ❖ Sector breakdown: healthcare emerges due to low valuations
- ❖ Stay focused on the process
- ❖ Management's track record; droning on again about its importance

April 11, 2016

Dear Starvine Capital Corporation Client:

In Q1 2016, accounts open and fully invested since the beginning of the quarter were down between 7.31%-7.99% Performance trailed the S&P TSX Total Return Index (up 4.61% in Q1) and also trailed the S&P 500 Total Return Index, which was up 1.35% (-5% in Canadian dollars) over the same time period.

I can point to the following as contributors to relative and absolute underperformance last quarter:

- Approximately two-thirds of the strategy is invested in U.S. small- to mid-cap companies, which have underperformed as a group. Over Q1, the Russell 2000 Total Return Index (more representative of Starvine's strategy in terms of its constituents' market capitalizations) declined 1.52%, which translates into -7.69% in Canadian dollar terms.
- Imperfect timing on adding to positions whose prices dropped in the January/February sell-off. In other words, I caught a few falling knives.
- Using energy related holdings as a natural hedge against the U.S. dollar was ineffective, given the rebound in the US dollar that was not offset on aggregate by increased share prices of Starvine's energy category. This was due to one of the companies reducing its dividend, thereby leading to a significant decrease in share price. I added more to this position on the decline as I believe its issues are temporary, and the price decline in my opinion was attributable more to a change in shareholder base (from investors prioritizing dividends to those who do not) rather than market participants giving serious thought to underlying value.
- The outright avoidance of mining stocks, which generally do not fit the criteria of the Starvine investment strategy. In Canada, gold companies recorded their strongest quarterly gain since 1986!
- Guilt by association: companies attached to themes such as emerging markets and consolidators (i.e. rollups) remain broadly out-of-favor, as reflected in stock prices.
- Starvine owns several holdings with a large hedge fund following. Hedge funds have generally been experiencing redemptions, and I believe this has led to temporary pressure from forced selling in certain holdings.

Notwithstanding the poor surface results, positives arose from the quarter. The broad market sell-off in January and February (which I shall label "The Storm") created distinct pockets of absolute value. Although the Starvine strategy was not prepared for the sell-off in terms of reserving an adequate level of cash to capitalize on opportunities, best efforts were made to take advantage of the situation. This entailed making select switches from companies whose stock prices held up relatively well, rotating the proceeds into names on Starvine's watch list that were hammered into valuation brackets that I had not seen for several years.

Outlook

The Storm appears to have been just that – a market storm that happened to occur in the coldest months of the year (in Canada). Whether the sell-off was a temporary blip or the start of a bigger movement is beyond me. However, I still see clear dislocations in select pockets of the market despite the rebound that has since ensued. Chief among these pockets are the areas noted above (emerging markets and certain rollups) as well as the healthcare sector. As value is a key criterion of the Starvine strategy, it means welcoming themes or companies that are deeply out of favor and having the patience to wait, provided a quality threshold is met. At quarter end, the S&P 500 Index closed 3.5% off its 52 week high, while the S&P TSX Index closed 13% off its

52 week high. In contrast, the median stock in the Starvine strategy closed 27% off its 52-week high, and 37% off after adjusting for position size.

Sector Breakdown: Healthcare Emerges

Starting with this letter, I will provide a sector breakdown. Note that healthcare has become the second largest sector in the portfolio from having no representation only two quarters ago; this was the result of certain candidates on Starvine's watch list becoming more compelling after valuations plummeted since the Valeant crisis.

Sector	Weight
Media/broadband	16.6%
Healthcare	16.3%
Industrials	15.2%
Specialty chemicals	12.8%
Energy	11.8%
U.S. real estate	10.5%
Technology	10.2%
Food	5.6%

The allocation between sectors is driven more by bottom-up stock picking than top-down design, while obeying a maximum 30% representation for each.

The Process: Stay Focused on It

One recurring comment I receive from clients and non-clients alike is that few of the companies in my strategy are recognizable to them. It has also been suggested that I mix in more mainstream names into the strategy (think the big banks in Canada or top S&P 500 constituents in the U.S.) so as to help potential clients feel more comfortable with my approach. The intention obviously is to deliver clear value over the longer term. In this quest to compound capital, many investors who follow a fundamental approach would list their criteria in stock selection as a variation of the following:

- Find a sound business with sustainable barriers to entry,
- Operated by excellent management, and
- Available at a cheap enough price so as to provide a margin of safety

In other words, the Buffett approach. However, unlike Buffett, whose assets under management have grown (and continue to grow) to a point where "mega caps" like Exxon and IBM become natural places that can absorb the funds, the small-time investor is not burdened with the constraint of applying the above criteria only to large, mainstream companies. Provided one is comfortable and indeed skilled enough to analyze companies, would it not make sense to expand the range of consideration to all shapes and colors of entities? Familiarity does not equate to safety, just as relative obscurity does not equate to more risk.

For the majority of core holdings in the Starvine strategy, the true common denominator is not obscurity but rather a stellar track record of growing value per share. That is, management has demonstrated this in the current company or a former company they operated. The key assumption here is that the longer the time period under examination (e.g. 7-10 years or even longer), the less likely it is that value delivered was attributable to luck.

More specifically, I like to see a strong record of growing free cash flow per share (CFPS) over time. As explained in the previous letter from Q4 2015, this is a matter of piecing together data that is made public in order to see a simple picture of management's accomplishments. Also, from this initial research step, it is most often determinable from the financial timeline *how* the growth per share was generated. For example,

did margins expand as a result of successful cost control while revenues grew organically? Did management make an accretive acquisition that moved the needle? Did management repurchase and then cancel shares at low prices? All the above would drive up CFPS. Ultimately, the point of all this is to gain confidence that the management team has a knack for making smart decisions over time. I would say this is critical to any long term investment in a stock, unless you are an activist who has the power to change management. Besides the prospect of buying earnings on the cheap and hoping for a re-rating, otherwise known as multiple expansion, holding a stock for a long period means one is implicitly banking on management to reinvest cash flow at a satisfactory return.

As easy as it is to lay out a company's financial track record, its importance cannot be overstated. It shows whether shareholder value was unquestionably created. Granted, it does not work cleanly for all situations, namely Net Asset Value ("sum of the parts") type opportunities wherein the above template just may not be able to capture the company's progress.

The companies in the Starvine strategy may seem to be off the beaten path to the casual observer, but that is more a by-product of the research process than by design. It just so happens that small to mid-size companies do not attract as much attention from the investment community, which often leads to lower valuations.

In Closing

The first quarter of 2016 served as a reminder that stock prices really can go anywhere in the short term. I was comfortable with accumulating a few positions to the maximum allowed weighting (10% at cost) during the market tumult, based purely on bottom-up reasoning. With enough time (e.g. five years), I believe these decisions will prove to be quite satisfactory given the very low valuations secured, which starkly juxtapose against the high quality of the underlying businesses.

Sincerely,

Steven Ko
Portfolio Manager

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