



July 10, 2015

**Dear Starvine Capital Corporation Client:**

In Q2 2015, accounts open since the beginning of the quarter were down between 1.28%-1.66%. This was a level performance with the S&P TSX index (-1.63% including dividends) but compares unfavorably to the S&P 500 Index, which was up 0.23% including dividends over the same time period. The variance is attributable to the “small cap” holdings (<\$1 billion market cap) in the Starvine strategy; these holdings have been experiencing their own little bear market as of late. Though they may be creating a drag on performance in the near term, ongoing due diligence gives me conviction that these downdrafts are unwarranted; some of these companies are underfollowed by the market due to a host of reasons ranging from low liquidity resulting from closely held ownership, to an ongoing change of shareholder base because the company in question was recently spun off. During the quarter, I increased the weighting in four out of five of the aforementioned companies in client accounts, as the lower valuations made the same ideas more compelling from a risk-reward perspective. The capital used to increase the small cap weightings was raised mostly from exiting a large cap holding. On a separate note, exposure to real estate was reduced by exiting two Canadian positions, while maintaining two higher-conviction U.S. positions.

**Outlook**

As explained in the previous quarterly commentary, caution in this market environment is critical. Few had the courage to commit new money to stocks in March 2009, when almost everything in sight priced in pessimism. At the time, one qualified as a contrarian (and a loner) by virtue of investing in any stock. The lower the quality of the company, the more its share price was battered, and thus the better its performance would have been from the nadir – provided the company survived. It seems in hindsight that having guts and dry powder (in the form of cash) were equally important to one’s ability to perform competent valuation.

The picture now, after six years of rising prices, is certainly much different for new investors with excess capital to invest. Whereas mistakes in valuation at the bottom of the market stood a good chance of going unpunished by the ensuing bull market, sloppiness in valuation work at this juncture is dangerous and may lead to great pain. However, I am still seeing a steady torrent of ideas that I believe offer compelling risk-adjusted profiles. These opportunities tend to share the following in common: (1) sparsely covered by sell-side analysts, (2) consolidated profitability is muted in the short-term due to a troubled division, (3) lack of trading liquidity leading to the preclusion of big institutional funds becoming shareholders, (4) cash generation is much stronger than reported GAAP earnings would suggest, (5) operated by management with an excellent record of value creation, and (6) the underlying business meets a quality threshold.

There has been no shortage of world events as of late to rattle the nerves of investors. Front and foremost is the anticipation of Grexit (i.e. Greece leaving the European Union) and the prospect of follow-on contagion in the region. Meanwhile, the recent sell-off in Chinese markets is an incisive case study of what happens when newby investors pile in with margin debt. Gains were amplified on the upswing, while losses struck more violently on the downside as forced selling was triggered by margin calls.

Opportunities are beginning to surface from the market tumult, especially in small cap companies. In response, I have been nibbling away. Should markets enter into a more dramatic “risk-off” mode, thereby

resulting in a pronounced sell off of North American equities, lower prices will convert good opportunities into great opportunities. However, for a long-only portfolio that has limited cash reserves, tough decisions will need to be made in such a scenario. For example, selling a stock that was initially purchased with a large margin of safety can make perfect sense, provided an even better opportunity comes along. The capital has to come from somewhere. Although I am a value investor of the long-term variety (most of the time), I will not hold onto a stock for 20 years “just because”. There are very practical reasons for a buy-and-hold mentality: tax deferral of capital gains, lower trading/frictional costs, and the cumulative insight into a company that results from following management’s decisions over an extended period of time. On the contrary, bona fide opportunities surface from time to time that warrant a switch, provided adequate research was completed on the new idea.

### **The Significance of Capital Allocation**

Capital allocation is simply the act of deploying and reinvesting cash resources to grow the value of a corporation. For a public company, there are only five basic levers in the toolbox: investment in organic growth, acquisitions, debt reduction, issuing dividends, and share buybacks. A gross oversimplification would be to liken it to a piano with only five keys. The CEO must hit the correct notes, with the right amount of force, at the right time.

William Thorndike’s seminal book, *The Outsiders*, garnered intense interest from the investment community around the importance of capital allocation. Eight CEOs from different industries were selected and chronicled for their unconventional methods in steering the progress of their respective companies. The key similarity between these leaders was their discipline in pursuing growth in per-share terms, and shaping their capital allocation practices around that discipline. Accordingly, investors enjoyed outsized returns over long periods under each of the CEOs.

One critical takeaway from the book is that the ability to assess a management team’s capital allocation skills is of paramount importance in evaluating any investment opportunity (assuming the investor is a long-term, passive holder). It may not be enough to correctly identify a business’s competitive advantages (i.e. moats) and pay the right price for the stock. If the captain steering the ship sub-optimally reinvests earnings into unsuccessful projects, overpays for acquisitions, or fails to consider that repurchasing the company’s own stock is a compelling option when the shares are significantly undervalued, the path of one’s fortune in the investment will invariably suffer.

### **Capital Allocation History – A Predictive Attribute?**

Having stated all of the above, there is one observation I would like to expand on: a CEO’s record of capital allocation can be a predictive attribute. This presupposes that a study of history can provide insights that help forecast the future, or alternatively that past achievers are likely to continue achieving. One example of a tried and true capital allocator is John Malone of Liberty Media. An investment in Liberty Media in 2006 would have grown eight-fold or at a compound annual return of approximately 30 percent<sup>1</sup>. Without further knowledge, one may be under the impression that such results can only be attributable to luck. In actual fact, Malone’s track record and decision-making as a public company CEO could have been observed over his 26 year reign at Tele-Communications Inc. (TCI). From his inception at TCI in 1973, one dollar invested grew more than 900-fold by 1999 (which happens to also work out to a 30 percent compound annual return).

Do I expect such returns going forward through investment in Malone-controlled companies, of which there are several? Definitely not. This is just a prime example of how consistent success in creating shareholder value is linkable to a verifiable history of following a distinct process of capital allocation. It involves a playbook of tax-efficient maneuvers to build per-share value and return capital to shareholders, including share repurchases, spin-offs, and making horizontal acquisitions with strict valuation criteria. Still sprightly at the age of 74, Malone is aggressively following the same playbook. I hope to benefit from his work for at least several more years.

---

<sup>1</sup> Liberty Media Investor Presentation, April 2015 (pg. 8)

Despite Malone's success and appearances on the front page of newspapers, he is still a relative unknown as far as mainstream business celebrities are concerned. When I bring up the name, I'm amazed how many investment professionals have no idea who he is. The truth is I did not even know who Malone was until five years ago.

The identification of "Outsider" type CEOs is a core part of my job. I believe that eight out of sixteen companies in the Starvine strategy are operated by such individuals, while another four qualify as having good capital allocation policies but are "not quite there". The management teams I select may not be as good as John Malone on average (except for the Malone companies in the portfolio), but their track records in generating shareholder returns are indisputable. With the knowledge that the intrinsic value per-share of my investments is growing, I sleep well, even when the market doesn't immediately agree with my decisions. There remain several companies I dream of owning on my watch-list that are run by stellar capital allocators, but the issue is buying in at favorable prices.

In investing parlance, the practice of "jockeying" can be defined as identifying a manager (CEO, chairman and/or other key decision maker) and then becoming a beneficiary of her talents by way of investing in the common shares of the company that she operates. The obvious problem with having your investment thesis reside in one individual's ability is key man risk. Similar to a heart surgeon with a great twenty year performance record, is the valuable track record invalidated once a new physician takes the helm? And so it is important, in my opinion, to have other pillars supporting the thesis – most notably valuation and business quality.

### Update on Energy

As I predicted, the two Canadian energy positions established in Q1 have thus far served as crude (at best) hedges against fluctuations in the U.S. dollar. Nonetheless, I am pleased with the progress these companies are reporting in growing key aspects of their businesses despite the downturn in the sector. During the quarter, I initiated a modest position in a distributor of oil & gas parts on the U.S. side of the portfolio. This was done for bottom-up reasons rather than for any thought as to its contribution as a natural hedge. In other words, I expect the company to excel over the next several years regardless of the macro picture. Energy related names now represent c.11.5 percent of the investment strategy.

Yours truly,

Steven Ko  
Portfolio Manager

Attached is a discussion of the changes in holdings during Q2 2015 for existing investors.