



Overview

- ❖ Insider Buying Picks Up in Starvine's Laggards
- ❖ The Great Depression: Avoid Being at the Mercy of Economic Winds

July 14, 2017

Dear Starvine Capital Client:

In Q2 2017, accounts open and fully invested in the Starvine Flagship Strategy since the beginning of the quarter increased 3.4% to 3.5%, while the Mid-Large Cap Strategy increased 3.3%. During the quarter, the S&P TSX Total Return Index returned -1.6%, while the S&P 500 Total Return Index increased 0.3% in Canadian dollars (+3.1% in USD). The US dollar again weakened versus the Canadian dollar, though it was a more impactful detractor on performance last quarter given the 2.7% decrease. Aside from one new holding in both strategies initiated in April, turnover in the portfolio was relatively low during the past three months.

Outlook

As a contrarian thinker, I always want my money invested in companies that are worth far more than the stock market is currently willing to price in. This can lead to a situation where I feel entirely comfortable with the valuation of my portfolios, while being uncomfortable with the markets in general. At quarter end, the average price to free cash flow ("P/CF") multiple of Flagship stood at 10.5x (vs. 11.1x last quarter), which in an absolute sense is inexpensive. It is counterintuitive to suggest that the multiple can move down while the portfolio value increases intra-quarter. However, it must be kept in mind that I am occasionally rebalancing the strategies by selling some or all of positions that increase materially and recycling the proceeds into holdings whose return profiles are more attractive on a relative basis. Also, the P/CF statistic is based on my estimates of each company's 2017 free cash flows. I believe my estimates are neither aggressive nor inordinately conservative, but rather what I judge to be grounded views on each company's cash flow generation this year.

Oil and gas stocks, having been pummeled since the start of the year, currently shine as the out of favor sector to investigate. The Starvine strategies have a modest but underweighted commitment in the energy sector. Specifically, by underweighted I mean that as a percentage of the strategies, the energy-related holdings currently account for less than 8% of the Starvine portfolios, versus nearly 20% for the TSX index. Hence in a scenario where the energy sector experienced a strong rebound, the Starvine strategies would suffer on a relative basis compared to the TSX index (assuming I do not increase the weighting of energy stocks in the interim). My stance on energy stocks remains unchanged: they have practical value as holdings given their (hypothetical) use as a natural hedge against U.S. dollar denominated holdings. As previously stated, this relationship is crude at best; the USD weakened 2.7% in Q2 in conjunction with a 17% average drop in Starvine's energy holdings, a result that was opposite of expectations. I am considering adding more to the existing energy holdings or adding a new high quality name in the sector.

The last serious bout of market volatility occurred in January and February of 2016. Since then, the S&P has experienced a relatively smooth run upward. As an investor, it is easy to be fooled by randomness and feel

elated about one's net worth increasing on paper. Whether that giddiness is deserved ultimately depends on whether the stocks in question were truly underpriced (thus warranting an upward correction – otherwise called multiple expansion) or the sustainable earnings power per share of the companies have increased. While I believe the Flagship and Mid-Large Cap strategies are positioned to deliver absolute results, I have been devoting more time to thinking about where we are in the market cycle, and therefore how defensive I should be in the application of portfolio construction. But make no mistake: we are nine years into a bull market. One must move with extreme caution in this environment.

Insider Buying

It has been encouraging to see significant buying by insiders in the Starvine strategies over the past year. In Flagship, seven out of thirteen companies recorded insider buying. Notably, two significant laggards in Flagship (worth 20% of the strategy on a combined basis) recorded \$50 million and \$37 million respectively of buying by the CEO or chairman since the beginning of June 2017. Sure, insiders can be dead wrong in their decisions, just like the rest of us. And depending on the situation, the amounts may indeed represent insignificant portions of the buyer's net worth. However, when these individuals have outstanding long-term track records in value creation and also buy stock very infrequently on the open market, it makes sense to pay attention. After all, as the name implies, insiders operate *inside* the company. It's probably safe to assume their confidence is based on a deeper understanding of their companies than most of us passive investors can ever fathom obtaining.

The Great Depression: The Value of Cold Cash

"The greatest chance in a lifetime to build a fortune has gone and will probably not come again soon. Very few people had any surplus to invest—it was a matter of earning enough to buy the necessities of life." Benjamin Roth, May 1937

I recently read *The Great Depression: A Diary*, which was a daily account of the 1930s economic crisis penned by a lawyer named Benjamin Roth. Because of the invaluable lessons emphasized in it repeatedly by Roth, I think the book should be part of every investor's self-education. Economic crises create some of the best opportunities to make a fortune because it is during these times that stock prices unhinge and can become completely detached from intrinsic value (i.e. value as supported by a company's earnings). Yet it is always the case that points of weakness in the economy correspond to unemployment – or fear of unemployment – and thus a lack of liquidity to take advantage of bargains. Even the majority of those with excess cash are hesitant to take the plunge and invest with conviction when times look bleak.

"Magazines and newspapers are full of articles telling people to buy stocks, real estate etc. at present bargain prices. They say that times are sure to get better and that many big fortunes have been built this way. The trouble is that nobody has any money." Benjamin Roth, July 1931

My belief is that unless an individual is lucky to gain a windfall just prior to a market downturn – an inheritance, sale of business or home, or being awarded a large annual bonus at work, amongst other things – a deliberate buildup or maintenance of surplus liquidity is required to be able to take advantage of low prices offered by times of crisis. In this regard, the enemy of most investors is the notion of cash drag, defined here as the drag on a portfolio's return caused by averaging in the zero return earned on the cash portion with positive returns from rising stock prices.

"I see now how very important it is for the professional man to build up a surplus in normal times. A surplus capital of \$2500 wisely invested during the depression might have meant financial security for the rest of his life. Without it he is at the mercy of the economic winds." Benjamin Roth, August 1931

To put it another way, one must go against the grain and look years into the future in order to be positioned to take advantage of bad times. Without doing so, all the forces of nature will line up against an investor so as to preclude him from being able to capitalize on market dislocations. On this point I unfortunately speak from my experience in the 2008-9 financial crisis. Back then, I was a relatively fresh MBA grad with considerable student debt, and to top it off I was fully invested in equities, which were dragged downward for a few years. Even though I was gainfully employed during that period, I wasn't personally able to take advantage of the fire-sale when the market troughed in March 2009.

To be clear, I do not believe we will see another 1930s-type bear market again, at least not in my lifetime. The S&P dropped 85% from its peak prior to the Great Crash of 1929 to the summer of 1932. Had an investor set aside 50% of his trading account as a cash reserve prior to the Great Crash, that cash position would have naturally elevated to ~84% of the account at the market trough in 1932, assuming his equities dropped 85% in line with the index. This is cash drag in reverse; cash acts as a partial cushion when stocks drop via averaging in its zero return with negative returns from the equities. From a pain perspective, an investor holding 50% cash pre-crash would have still suffered a 40% paper (i.e. unrealized) loss at the bottom in 1932; however, had he then invested the cash at the very bottom and reinvested the dividends back into the S&P at the end of each year, his portfolio would have grown by a factor of 13.2x from the peak in 1929 to 1954 when the index finally recovered to same nominal level 25 years later. Annualized, this would have translated into a 10.9% return. While the return may not seem overly impressive, consider the result had there been a zero cash reserve before the bear market began: the account would have increased by a factor of only 4.3x over the same time period, or 6% annualized. Thus having the prescience to reserve cash in the scenario outlined above could have sown the seed for decades of outperformance versus the index.

Should a cash reserve be kept in every investor's portfolio even in times when bargains are plentiful? Increasingly, I am of the opinion that some level of cash should always be maintained, as a reserve has two key benefits: (1) bottom-up opportunities can appear at any time regardless of whether markets are at a peak or trough, and (2) it is the most practical source of liquidity to draw from when market corrections occur. As discussed above, the hesitancy towards holding cash typically originates from the fear of missing out on returns. This kind of thinking can be combatted by the constant self-reminder that one should always remain pragmatic; our overriding goal should be long-term compounding, not timing each investment to obtain every cent of potential profit. It is difficult from a psychological standpoint to sell part or all of a holding that is undervalued and well-researched – thus an objective gauge should be used to determine just *how* undervalued each holding is and rank accordingly, and at what threshold the optionality of holding cash is more valuable.

Sector Breakdown

A new holding in 'E-commerce' was initiated intra-quarter; the funds for this purchased were rotated from the Specialty Chemicals category in Flagship, while in Mid-Large Cap the funds were sourced from available cash.

Flagship		Mid-Large Cap	
<u>Sector</u>	<u>Weight</u>	<u>Sector</u>	<u>Weight</u>
Packaged Food	13.1%	Packaged Food	15.8%
Healthcare	11.4%	Healthcare	10.2%
U.S. Real Estate	9.7%	Financials	9.4%
Specialty Chemicals	9.2%	E-commerce	7.8%
Media/Broadband	9.1%	Energy	7.5%
Technology	9.0%	Technology	5.1%
Industrials	8.4%	Industrials	5.0%
Energy	7.8%	Business Services	4.7%
E-commerce	6.6%	U.S. Real Estate	4.7%
Business Services	5.4%	Specialty Chemicals	4.6%
Cash	10.3%	Media/Broadband	4.3%
		Other	10.5%
		Cash	10.4%

To label oneself as cautiously optimistic, at least in my interpretation, is akin to saying, "I'm optimistic, but I don't want to get burned if my bullish calls don't work out." As anyone who read the chosen topic for this letter can guess, I have been reflecting more on downside scenarios recently. Stock prices can go anywhere in the short term; they can float far above where they deserve to be based on a company's growth and earnings power, and conversely they can get temporarily flushed far, far below fair value. While there is no easy solution to protect a long only strategy from price fluctuations, preparations can be made to position the portfolio to be able to capitalize on volatility – rather than be at the mercy of it.

Sincerely,

Steven Ko
Portfolio Manager

DISCLAIMER

Readers are advised that the material herein should be used solely for informational purposes. Starvine Capital Corporation ("SCC") does not purport to tell or suggest which investment securities members or readers should buy or sell for themselves. Readers should always conduct their own research and due diligence and obtain professional advice before making any investment decision. SCC will not be liable for any loss or damage caused by a reader's reliance on information obtained in any of our newsletters, presentations, special reports, email correspondence, or on our website. Readers are solely responsible for their own investment decisions. The information contained herein does not constitute a representation by the publisher or a solicitation for the purchase or sale of securities. Our opinions and analyses are based on sources believed to be reliable and are written in good faith, but no representation or warranty, expressed or implied, is made as to their accuracy or completeness. All information contained in our newsletters, presentations or on our website should be independently verified with the companies mentioned. The editor and publisher are not responsible for errors or omissions. Past performance does not guarantee future results. Investment returns will fluctuate and there is no assurance that a client's account can maintain a specific net liquidation value. The S&P 500 Total Return Index and the S&P/TSX Composite Total Return Index ("the indexes") are similar to Starvine's investment strategy in that all include publicly traded equities of various market capitalizations across several industries, and reflect both movements in the stock prices as well as reinvestment of dividend income. However, there are several differences between Starvine's investment strategy and the indexes, as Starvine can take concentrated positions in single equities, and may invest in companies that have smaller market capitalizations than those that are included in the indexes. In addition, the indexes do not include any fees or expenses whereas the return data presented is net of all fees and expenses. SCC receives no compensation of any kind from any companies that are mentioned in our newsletters or on our website. Any opinions expressed are subject to change without notice. The Starvine investment strategy and other related parties may hold positions in the securities that are discussed in the newsletters, presentations or on the company website.

Appendix: Portfolio Changes During the Quarter

Please note that this appendix is intended to provide an overview of the decisions made in the Starvine investment strategy during the most recent quarter. As such, it is based on an aggregation of all accounts under Starvine's management. Although insignificant, minor differences will remain between the information as presented in your quarterly statements and the figures presented below. End of quarter position weights and position changes during Q2 2017 are as follows:

Company	Ticker	Weight	Share count (% chg)	Comment
Nomad Foods	NOMD	13.1%	0.0%	N/A - no change
Valeant Pharmaceuticals	VRX	11.4%	34.3%	Averaged down upon price decrease
Howard Hughes Corporation	HHC	9.7%	0.0%	N/A - no change
Platform Specialty Products	PAH	9.2%	-36.8%	Funds used to initiate JD.com position
LiLac Group	LILAK	9.1%	0.0%	N/A - no change
Brookfield Business Partners	BBU	7.5%	0.0%	N/A - no change
CGI Group	GIB.A	7.1%	0.0%	N/A - no change
JD.com	JD	6.6%	New	New position
Veritiv	VRTV	5.4%	0.0%	N/A - no change
Raging River Resources	RRX	4.1%	0.0%	N/A - no change
Canadian Energy Services	CEU	3.7%	0.0%	N/A - no change
Photon Control	PHO	1.9%	-38.5%	Partial sale: profit taking
Colfax	CFX	0.9%	-69.7%	Partial sale: rotating funds into VRX

REMOVALS

N/A – No companies were removed the portfolio in Q2 2017.

ADDITIONS

JD.com (NASDAQ: JD): During the quarter, a new position in JD.com was initiated at a 6% weight. JD is commonly referred to as “the Amazon.com of China”. Despite its large size at over US \$60 billion market cap, revenues are still growing organically at >40% year-over-year. I believe this company not only has strong moats that protect it from competition, but is positioned to keep gaining market share from rivals and benefit from the fast-growing e-commerce trend in China. Upon completion of the spin-off of its finance division (JD Finance), investors will be able to more easily see JD's immense cash generation. The company carries zero net debt on its balance sheet. Ultimately, growth must slow due to the Law of Large Numbers; however, I believe double-digit organic growth will be obtainable for a minimum of 10 years. In time, this holding has the potential to grow several multiples in value.