



## Overview

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## Dear Starvine Capital Corporation Client:

In Q3 2015, accounts open since the beginning of the quarter were down between 8.64%-9.08% Performance trailed the S&P TSX index (down 7.86% in Q3 including dividends) and the S&P 500 Index, which was down 6.44% (+0.36% in Canadian dollars) including dividends over the same time period. The variance is attributable to the last three trading days of the quarter, which saw a significant fall in the share prices of companies that use acquisitions as a key growth driver. These “growth by acquisition” companies experienced a price drop far in excess of the general market, and thus Starvine’s relative advantage for the quarter vanished. However, the rebound in the first few trading days of Q4 2015 has been strong, restoring much of the paper losses most recently incurred. During the quarter, I increased the weighting in four companies and established four new positions. The capital was sourced from a mixture of exiting three positions and a partial sale of another. One of the exited positions was the result of a thesis violation upon completing more due diligence, while the other two were sold to raise capital. In a strategy with only sixteen stocks, this is indeed a lot of turnover for one quarter. Price declines positioned certain ideas on my watch list as better risk-return propositions, while a few existing holdings also became better investment ideas (at least in my view) when downticks were not accompanied by news that warranted a decreased estimate of intrinsic value. I certainly don’t expect this level of trading activity in a typical quarter, albeit everything is theoretically for sale should the correct conditions be present. As Starvine’s strategy does not generate a high level of dividends, a sale decision must generally be made to add a new position.

### Outlook

Investor anticipation and reaction to the Fed’s interest rate decisions have had an outsized impact on stock price volatility as of late. Interest rates have only one way to go, and the public is generally nervous about the implications of rising rates in a tepid economy. Historically, rising interest rates have been demonstrably unfavorable to equity valuations. It wouldn’t surprise me if the next ten to twenty years witnessed a grinding trend of multiple compression (i.e. P/E multiples decreasing).

What does all this mean for the investor trying to find good ideas to put hard earned savings to work? Personally, it will not change my day-to-day activities, which revolve around finding the best risk-return opportunities possible. Macro trends matter only insofar as they affect the micro. My belief is that quality companies managed by exceptional capital allocators should produce a satisfactory investment return over the intermediate to long term, provided a reasonable price was paid. This of course is trickier with cyclical companies (e.g. energy, industrials), where bad timing will lead to an extended period of frustration.

### Always Return to Basics: What is the Mission?

I previously stated that my objective is to form a respectable forty to fifty year track record; it is akin to saying that I want to improve as an investor for as long as is physically (and mentally) possible. This informal mission statement has impacted how I view both the big picture and present day challenges. Investing is like swimming in the ocean: we are subject to the ebbs and flows of waves as we swim to our destination.

However, the crucial difference with investing is that we cannot actually see the size and momentum of upcoming waves. We can only piece together imperfect information and position ourselves so as to be able to take advantage of opportunities when they become available. It goes without saying that one would be willing to endure these vicissitudes with the expectation of achieving a commensurate rate of compounding over the long term.

Value investing's focus on the absolute and its long term nature position it ideally, in my opinion, as a sound approach for compounding one's wealth. Viewing the world in a bottom-up manner and demanding a margin of safety allows a value investor to focus less on where macro trends are headed. Instead, resources are channeled to studying the unique properties of companies that enable them to endure against competition and adversity.

Sometimes this logic works against me in the short term. But provided a company is of good quality while priced at a compelling enough valuation, it's difficult to justify holding off on building a position because of where the market might go next. If a stock that trades at 70% of a conservative fair value estimate is identified, should one hold off on buying it to adhere to the "go away in May and come back in September" syndrome? Maybe, but that's certainly not my style. I have never known anyone to be consistently right about calling market crashes and market bottoms.

As naïve as it may sound, bottom-up investing is analogous to placing objects on a scale. You must satisfy yourself that the reading on the scale is close enough to the truth. What does something weigh in the here-and-now? What will it weigh in five years? Just an important, what are the key drivers that influence what it weighs in the future? Let us say you are considering the purchase of a company that manufactures and sells distinctive food brands (e.g. cereal and egg products) only in North America. Will the Greek crisis, slowing growth in China, or Fed announcements affect the company's earnings power in five years? Definitely not in my world.

### **Broken Plates and Negative Associations**

Market participants tend to undervalue companies that carry a temporary imperfection, even if the issue is isolated to one particular part of the business. In other words, the negative association is cast across the whole company rather than objectively contained to the relevant segment when pricing the company. This has created compelling opportunities in the past, such as Brookfield Residential Properties in 2011. Current opportunities in this genre abound in a variety of industries.

Our tendency to misappraise situations that require the separate evaluation of more than one component is highlighted in the following example. A study done out of the University of Chicago by Christopher Hsee asked a group of students to price two sets of dinnerware. The first set contained identical pieces as the second *and* an additional sixteen pieces, seven of which were intact and nine broken. Logically, one should be willing to pay more for Set A given it clearly has more economic value.

	Set A	Set B
Number of intact pieces (value of concern):	31	24
Total number of pieces (reference):	40	24
Relation to reference:	Bad	Neutral

However, Hsee's study showed the opposite. Separate groups, each evaluating only one set, priced Set A at \$23.25 and Set B at \$32.69. Ultimately, the subjects were influenced by the presence of defective pieces, such that they priced the intact dishes much lower than had fewer intact pieces been offered in the first place (Set B).

The tendency to misprice "sum of the parts" situations, as illustrated above, applies directly to stock investing. Three out of sixteen positions in Starvine's strategy have this dynamic, all in unrelated industries

(packaging, real estate, and media). One may wonder, though, whether it is a good idea to own stock in companies that are painted all over erroneously with the same brush. After all, is it not possible that the company stays undervalued for an extended period of time? If human tendencies undervalue such situations, could we not be waiting for a decade for the valuation gap to close? The answer is yes to both, and that is why it is key to study management's track record in both their present and past companies, if applicable. Have they successfully spun off overlooked divisions in the past to highlight value? Have they capitalized on undervaluation by repurchasing shares at low prices? These are a few corporate action tools that management can use to surface value.

### **Brookfield Residential's Broken Plate**

Going back to Brookfield Residential Properties (BRP), this was very much a case of buying an intact plate along with a broken one. BRP was the result of a simultaneous spin-off of Brookfield Office Property's Canadian homebuilding and land sales business, and a merger with Brookfield Homes (BHS) which carried out similar activities but in the U.S. Brookfield Asset Management, the parent company, seemingly engineered this transaction to ensure that BHS (the U.S. division) was financially supported while it recovered from the U.S. housing recession. At the time, in mid-2011, BHS was generating slight losses given its concentration of property in suburban California, one of the worst hit regions in the U.S. housing crash. The merger was not expected to bring much in the way of cost synergies, so it was feasible to evaluate each half independently.

I estimated at the time that the Canadian side generated about C\$1 per share in earnings power. The stock started trading at C\$10, but the price was driven down during the Greek Crisis to a low point of C\$6.50, which implied a 6.5x P/E ratio on the Canadian business alone. Despite the near-dormant status of the U.S. side of the business, it didn't take a genius to realize that the ~50,000 residential lots had a lot of latent value. Even at C\$10, you were arguably paying only for the Canadian business and getting essentially half of the company as a free option on the U.S. housing recovery.

BRP was destined to be neglected by most professional investors. With the parent company owning more than 70% of the shares from inception, less than C\$300 million of float was freely trading, meaning it would have been suitable only for small cap funds. It came as no surprise that sell-side analysts did not begin covering the company until a few years after BRP began trading, given the grim prospects of generating trading commissions from such an illiquid stock. Add to that the strong stigma still attached to anything related to U.S. housing at the time, and furthermore the nasty headlines from the Greek crisis in 2011, and you were handed a perfect cocktail of pessimism that drove the valuation from cheap to dirt cheap.

Similar to the dinnerware example above, I believe the presence of a broken plate (U.S. housing business) resulted in a lower initial valuation for the Canadian business than if it had been listed as a pure-play Canadian housing business. If Mr. Market's view of U.S. housing lightened up just a bit, I knew this situation stood to generate significant profits. The key insight was the realization that the broken plate would repair itself eventually. In less than four years of trading, BRP was taken private by the parent company. Based on the last trade at C\$31.25, initial investors who bought in at \$10 realized a ~30% IRR (triple over four years), while those who opportunistically entered near the bottom realized a ~57% IRR (almost five-bagger over 3.5 years). Almost as a rule, freshly minted spin-offs like BRP do not screen well in commercial databases. While not overly arduous, assembling a thesis required going through the prospectus in detail to put some basic numbers together. The financial histories of each half were also obtainable on the respective company websites.

## An Unconscious Migration

Over the past several months, the Starvine strategy has become much more concentrated in companies in the US\$1-5 billion market cap range (59% of market value). This shift, though not by design, was primarily attributable to new names introduced into the strategy. The secondary cause was the precipitous drop in share prices of two companies that were previously classified in the US\$5-10 billion category. I often say that the US\$1-5 billion range is a sweet spot for finding unique ideas. There seems to be an abundance, especially in the U.S., of companies in this range with the combination of being #1 or #2 in their niche industries while flying under the radar of Wall Street.

<u>Market Cap (USD)</u>	<u>#</u> <u>Stocks</u>	<u>%</u> <u>Portfolio</u>
> 20 bn	0	0%
10 - 20 bn	2	6%
5 - 10 bn	2	12%
1 - 5 bn	10	59%
500 mm - 1 bn	1	10%
250 - 500 mm	2	14%

Unless there is another market shake-out in the near future, the odds are that I'll be inactive in terms of trading – with the exception of rebalancing. Much time is being spent nowadays on reviewing the existing holdings and a few opportunities on the watch list.

Yours truly,

Steven Ko  
Portfolio Manager

Attached is a discussion of the changes in holdings during Q3 2015 for existing investors.