STARVINE CAPITAL
CORPORATION

Overview

- Outlook: Macro is overrated; absolute value is underrated
- Investment System: Do you have one? Regulate your own actions!

October 11, 2016

Dear Starvine Capital Corporation Client:

In Q3 2016, accounts open and fully invested since the beginning of the quarter increased 7.21% to 7.41%. During the quarter, the S&P TSX Total Return Index increased 5.87%, while the S&P 500 Total Return Index increased 3.85% (5.31% in Canadian dollars). The Starvine strategy benefited from (1) a general market rally that saw the rebound in most holdings that suffered from selling pressure in the wake of the Brexit decision at the end of Q2 2016, (2) more positive versus negative earnings surprises, (3) a modest rally in the basket of three energy related stocks in the portfolio, and (4) a slight strengthening of the U.S. dollar vs. the Canadian dollar during the quarter. (Approximately ~70% of the strategy's holdings are denominated in USD.)

Two names were culled from the portfolio; one to raise cash to increase conviction in an existing holding, while the other was deleted as it proved to be a 'dud'. Initially, it was stated that the strategy would hold between twelve to twenty stocks at any given time. The strategy remains fairly concentrated, with 14 names and the five largest holdings representing 53% of the market value of assets under management.

<u>Outlook</u>

The Starvine strategy is trading at 10.5x cash flow (or at a 9.5% free cash flow yield); a little more expensive versus last quarter, but still at a good discount to the benchmark indexes referred to above. Whereas the S&P 500 and S&P TSX indexes are trading near 52-week highs, the Starvine strategy is at a 23% discount on average. Several of the portfolio names are undervalued because they are out-of-favor with the market in some manner, whether it be a whole sector that is in a downturn or negative headline risk plaguing a specific company.

At the risk of sounding obtuse, I keep abreast of macro news more for the entertainment factor than for the value it brings to selecting companies for long term ownership. I look at companies and valuation strictly from an absolute standpoint. If I believe the top holding is trading at 50% of intrinsic value (which I do) based on my assessment of the company's bottom-up merits, I would never fathom selling some or all of it in anticipation of a near term market sell-off that could drive the share price even lower. For example, the upcoming U.S. election may cause market volatility; however, it makes little sense to me to trade what I'm more sure of (the absolute value I see in several holdings) for unknowable implications of one party winning versus the other .

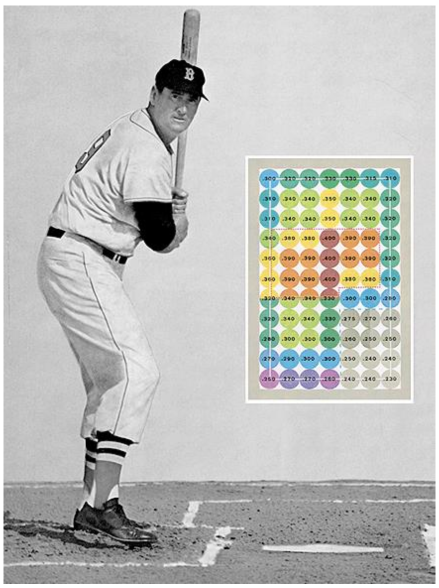
As interest rates are at historical lows, they have only one way to go. And as we know, rising interest rates are not conducive to rising valuations. So it isn't beyond the realm of possibility that we could be at the beginning of a long period of multiple contraction in the indexes. Regardless, we must continually obsess on what is knowable through research (management track record, economic moats, reinvestment opportunities and absolute valuation) and do our best to block out the macro noise.

Your Own Investment System: A Must Have

"Losers have goals. Winners have systems" **~ Scott Adams, creator of Dilbert**

In my teenage years, I seemed to always forget bringing something important when leaving the house. Whenever my father noticed, he would badger me. "You need a system!" was a recurring piece of advice. Clearly, I didn't have a check for remembering my keys or wallet, and at least 10 years would pass before I became smarter about it. I learned the hard way. Although I believe my father was really referring to the importance of having a checklist, there is a relationship between the two.

It would be reasonable to assume that if the traffic system in any large city were to be removed overnight, the accident rate would skyrocket. Left to our senses and second-to-second reactions, we do not stand much of a chance to organize ourselves en masse. The same goes for public education. Without a system, some students may be better off if teachers were left completely to their own innovations, but I think we can agree that society would be worse off if there weren't any consistency in the education curriculum.



In the world of baseball, Billy Beane has a system for identifying undervalued athletes. He is thus able to consistently squeeze much out of a limited annual budget. In another baseball example, Ted Williams developed a system that resulted in the highest on-base percentage of all time. By dividing the strike zone into seventy-seven cells, and swinging only at the cells with the highest probabilities of success, Williams secured his place in history.

Scott Adams has written about the importance of focusing on systems rather than setting specific goals. Success favors those who focus on getting their roadmap correct. Fixating on pinpoint goals, such as achieving a minimum 15% total return in every year, could lead to overly-aggressive behavior or decisions incongruent with one's investment philosophy. However, upping the odds of long term success by identifying well-run, sound businesses – and then buying them only when favorably priced – is a system. Actually, I would say that sums up what Starvine's and most value investors' approaches aim to achieve.

The majority of market participants trade without a system; this is especially true for retail investors. But why is this important to acknowledge? Well, if one of your objectives is to compound money over the long term (say 10+ years), the following applies to you. Picture your portfolio in 20 years: it is much larger than you expected solely because of shrewd stock picking. Wonderful. Now I present a few rhetorical questions. Would you have preferred the outcome to be the result of a successive string of one-off, large bets? Or would you go for the methodical path that is more measured and hence more replicable in nature? Which one would truly serve your interests better? Long term consistency is the holy grail of compounding. In order to achieve the investment success we desire over decades, it stands to reason that a system must be employed. And a system is carried out with a set of rules. The following are examples of considerations to reflect on before establishing your own rules:

Stock Selection

- Do I have an investment checklist?
    - What requirements must an idea satisfy before I allow myself to buy the stock?
    - How do I employ this checklist without stifling creativity? When can exceptions be made?
- Do I have an adequate watch list of stocks on which ongoing due diligence is being conducted?
    - Companies not currently in the portfolio but under study or waiting for the right price
- Past mistakes:
    - Have I identified the real reason for past errors? (e.g. psychological, incorrect assumptions, superficial analysis)
    - How do I prevent repeating past mistakes?

Portfolio Management

- What would trigger a trade?
    - Do I have an objective ranking system to help in allocating money between stocks?
    - How frequently or infrequently should the portfolio be rebalanced?
    - Under what conditions will a holding be sold?
- What should be the maximum exposure to each name, regardless of conviction level?
    - If a candidate is a 'special situation' and does not meet typical checklist requirements, what should its exposure limit be?
- Diversification:
    - What is the min/max number of stocks that should be in the portfolio at any given time?
    - What is the minimum amount of time required for upkeep on each holding?
    - Do I have the resources to keep abreast of all the stocks (including the watch list) in sufficient detail?
    - Am I overexposed to any particular sector or theme?
- How much cash should be held at all times?

If we could identify a 100-bagger (i.e. a stock whose price goes up 100x) with complete certainty, there would be only one stock in the account and therefore no need for a portfolio management system. Life would be bliss and happiness. However, that's not how reality plays out for 99.9% of us, and hence the need to employ guardrails to protect us from ourselves. The above are questions to help investors think about topics on which basic guidelines in managing your portfolio can be set.

Notice how I refrain from suggesting numbers to use in your rules. That is because no one size ever fits all. Also, my intention is to encourage people to realize the importance of having a system (whatever the investment philosophy), rather than promote how to execute the strategy.

Over time, your system should evolve. If you are a buy and hold, long only value investor, short term randomness cannot be eliminated, as far as fluctuations in portfolio value are concerned. Perhaps it also can be posited that mistakes can never be completely quashed. However, a framework based on sound logic will aid in keeping your decisions grounded. For example, if your valuation of a shiny new investment idea shows that it is priced approximately at intrinsic value, how could it make sense to source the funds from selling an existing holding that is trading at 50% of intrinsic value? Maybe there is a way it can make perfect sense given the subjective nature of valuation. The point here is that an investor with an objective ranking method stands a better chance of making rational decisions versus one that goes totally off instinct.

Ultimately, rules mean trade-offs and compromise. By being systematic in our investing, we are instilling discipline and order into decisions. Continually questioning the rules we set for ourselves will also encourage us to be thoughtful about what level of diversification optimizes the gain from research efforts versus protecting from the downside of human error.

Sector Breakdown

Sector	Weight
Healthcare	16.3%
Industrials	16.1%
Energy	14.3%
Media/broadband	13.3%
Specialty chemicals	11.4%
U.S. real estate	10.8%
Technology	8.8%
Food	6.3%

In Closing

I believe it is likely that we will see market volatility in the final quarter of 2016 – the U.S. election and anticipation about Fed interest rate decisions almost guarantee it, in my opinion. The indexes are also not cheap versus historical averages. Despite these dour comments, I remain optimistic from the vantage point of a bottom-up stock picker. There is absolute value to be found in quality companies. As always, it just requires a willingness to stand in direct opposition to the crowd and the vision to think in years rather than days or months.

Sincerely,

Steven Ko
Portfolio Manager