



Overview

- ❖ Outlook: 2015 was a tough year for most. What lies in store for 2016?
- ❖ Perfect storms can create coiled springs
- ❖ The uncommon sense of a checklist
- ❖ What's in a track record?

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Dear Starvine Capital Corporation Client:

In Q4 2015, accounts open and fully invested since the beginning of the quarter were up between 2.97%-3.27%. Performance exceeded the S&P TSX Total Return Index (down 1.4% in Q4) yet trailed the S&P 500 Total Return Index, which was up 7.04% (+11.43% in Canadian dollars) over the same time period. On an index level, the divergence between Canadian and U.S. markets was underscored by a high representation of mining and energy companies north of the border, contrasting against a more diversified market in the U.S. that has seen certain large components (e.g. “FANG stocks” – Facebook, Amazon, Netflix, and Google) rally strongly throughout the year. Since inception (February 2015), all Starvine accounts remain in the red. I commend investors who finished the year in profitable territory, as 2015 recorded the worst performance for equities in seven years. Notwithstanding the frustration of seeing undervalued holdings become even more undervalued, I remain steadfast in one conviction: Value works over the long haul. I would also contend that value is already at work, as depressed prices have led me to tilt the portfolio in the direction of opportunity, although these decisions have yet to pay off.

Outlook

Markets remain volatile and uncertainty remains high; global equities are under pressure due to panic selling in China, the claimed testing of a hydrogen bomb in North Korea, and increased tensions between Iran and Saudi Arabia. As a result, many companies are seeing significant price declines in their shares, unaccompanied by company-specific news or events. So is this a buying opportunity? In my opinion, yes. In the current environment, there are definitely pockets of opportunity that I believe will pay off if one's time horizon is long enough. The bottom-up investor should be finding plenty of interesting situations to look at these days, and by that I mean compelling absolute valuations based on current profits, with good growth prospects attached. Companies with exposure to emerging markets, healthcare, energy, and select consolidators (i.e. roll-ups that grow by acquisition) are seeing their stock prices pressured by downturns in end markets or macro worries.

Unsurprisingly, such situations do not present themselves without opposition in the general consensus. In some manner, you must be willing to be a contrarian and take an independent view for each idea. Often times, this means listening to the negative views that are pressuring a company's price, and then refuting those views and forming a conviction that the current price is imputing a high return based on where future cash flow is headed a few years into the future.

Perfect Storms and Coiled Springs

The final four months of 2015 resulted in significant changes in the composition of the Starvine strategy. In particular, I averaged down on two companies that are operated by some of the greatest capital allocators in existence as their stock prices were (and still are) being crunched by a confluence of headwinds. I believe these new core positions will in time prove to be quite satisfactory, albeit my timing in building the positions has been sub-par, thus hurting short-term performance.

North American companies with any of the following characteristics generally experienced a pummeling in their valuations in the latter half of the year:

- “Platform companies” that utilize debt to finance bolt-on acquisitions
- Downturns in end markets (e.g. agriculture, commodities) regardless of profit margin or capital intensity profile.
- U.S. companies with a significant share of earnings from non-U.S. currencies, especially those with emerging markets exposure

The companies that I elevated into core positions have a mixture of all of the above, and so it should not be too much of a surprise that each has published negative earnings revisions over the past few quarters. In either case, I believe anyone who is willing to look even two years out into the future will agree that the outlook should improve by then. Even in downturns, these companies remain highly cash generative. Having studied the track records of these management teams and their ability to rationally reinvest capital throughout the business cycle, I remain comfortable taking a contrarian stance. Perfect storms create falling knives, but also set up coiled springs (i.e. asymmetric situations).

On Checklists

Consistency is the “Holy Grail” in many aspects of life, and especially so for investors with a long-time horizon. All it takes is a few instances of permanent loss (large positions going bust) to scar an otherwise pristine track record. Just ask Bill Miller, who beat the market for 15 consecutive years, and then had that record irreparably damaged by an overconcentration in U.S. financial stocks going into the credit crisis. The old adage ‘a chain is only as strong as its weakest link’ really applies here; hence the prevention of mistakes to our best ability is every bit as important as finding winners. I often think about the biggest winners in my personal portfolio through the years and how I really could have achieved the same result with ideas that were less spectacular, and with less drama. Had I committed fewer errors, I could have slept a lot more. The same would apply for most investors.

I recently read “The Checklist Manifesto” by Atul Gawande. There is already a lot of existing investment literature about the importance of using checklists in investing, but it took a totally different viewpoint to drill the point home for me. Written from the standpoint of a surgeon, the book builds a compelling case for the explicit use of checklists for tasks that involve complexity.

It may seem like common sense that the medical professionals operating on a patient should have clean hands; failure of just one individual out of several on an operating team can lead to an infection in the patient. And yet Gawande’s findings illustrated a marked reduction in mortality relating to surgery after a formal checklist was enforced in hospitals to ensure hand washing. Can investors learn from this and achieve better results by using a practical checklist? I certainly think so. Our memories are faulty, and our thinking can become muddled on a bad day. Potentially, it may be on one of those rare off days that you decide to make a big bet on a shiny, new investment. I believe the resistance many have to adopting a checklist is the very simplicity of it – it’s like riding a bike with training wheels. Additionally, practitioners in any field may not see the virtue of introducing an extra step into the decision making process that questions the judgment they have accumulated through years of experience.

If I reflect on the investing errors I made in the past, it may be foolhardy to think that all of them could have been prevented with a checklist, but certainly some of them were avoidable. As simple as the whole idea sounds, this book had a profound impact on my investing. I believe a good place to start is to soberly reflect on past mistakes and list the root causes. I have mentioned before that I believe most errors originate from psychological missteps rather than the ability to perform competent fundamental analysis. For example, the growth assumptions used in a valuation may have been far too optimistic, thereby leading you to overpay for a company in hindsight. However, the root cause may have been over-optimism towards a certain sector. A checklist question that forces you to confront this tendency, along with the names of past mistakes attached to this folly, might deter you from getting pulled along the same path again.

Previously, aside from writing a thesis statement and performing a valuation, I made mental notes to check for certain things in each investment. The problem though with such a practice is that it is easy to subconsciously take short-cuts. I now have a checklist with 13 items and a column to identify lousy investments that were chosen as a result of not paying attention to each item. Let's see how this works out in a few years.

Examination of Track Records

A critical item on my checklist is the examination of a CEO's past results. I briefly discussed the importance of capital allocation in the Q2 2015 letter, though some may be wondering what degree of resources is required to assess a management team's track record. It's tough to assess someone's capital allocation ability without a history. The great news is that a reasonably comprehensive assessment can be accomplished with a good ole' internet connection and a simple spreadsheet. If the company makes available several years of its annual reports on the corporate website, the do-it-yourself investor has plenty of sumptuous data to start digging through. If not, the documents should be retrievable on a securities regulator's website (e.g. SEDAR in Canada and SEC.gov in the U.S.).

In plain English, the reason why investors use the words "capital allocation" so much is because they are trying to assess how effective management is at directing cash flow to uses that fuel further growth in cash flow on a per share basis. An analogous example would be a rental property that you hired a management company to not only look after, but also to reinvest the earnings at their sole discretion. What would you want to know before signing? Chances are you would want to see the manager's results with other clients' money. Furthermore, in addition to the surface results, you may be interested in learning about *how* said results were achieved, and if the conditions allowing those results still apply going forward. Clearly, external factors such as the general economy and housing market will form the backdrop which the CEO must work off of. Still, the odds are obviously much more in your favor if an above average manager is identified. Likewise, before investing in a public company whose policy is to reinvest some or all of its earnings to achieve growth (versus paying out dividends), it would be in your best interest to examine how management behaved under various conditions in the past. Were they able to take advantage of distressed times in the industry and grow market share while competitors retreated?

The wonderful thing about public companies is that their financial statements disclose enough to assemble a rough track record, allowing us a cursory look at how value was created and what levers were pulled. The following will not work for every situation; however, given several years of data under the same CEO or management team, it should be telling of whether value has been created in hindsight. Re-assembling the past by keying in public data into a spreadsheet will allow us to discern whether:

- Cash flow per share or book value per share grew at a satisfactory rate
- Free cash flow was invested well through the years. If reinvested internally, did it result in strong growth in cash flow per share? Did ROE (net income divided by beginning of year equity) increase over time? Did acquisitions result in an increase in cash flow per share? (i.e. was it immediately accretive?)
- Management raised cash by issuing new shares (only good if used in a way that grew cash flow per share – if not immediately then after a reasonable time; otherwise investors lost the expenditure).
- Management repurchased shares (Did they take advantage of low valuations during the recession?)
- Dilution from stock option issuance is reasonable

For spin-offs or companies formed too recently to have a track record spanning several years, one option is to see if the CEO ran another company for several years and then study his/her record there. Personally, I would want to see a timeline of rational decisions that led to an increase in profitability over time. The obvious (and potentially dangerous) assumption here is that the past applies to the future. It is important to keep in mind that the above discussion does not apply well to cyclical companies (e.g. energy and mining) whose earnings power typically fluctuates with a commodity price, rather than management's ability to invest.

In Closing

According to the Wall Street Journal, the five flattest years in the S&P 500 since 1911 have been precedents for a sizeable pop in the subsequent year, four out of five times. Thus far, 2016 is showing this statistic to have little utility, though it is early days yet. Ultimately, noise in the form of multiples expanding and contracting will

always be present, often with no relation to long-term fundamental progress on the company level. With the exception of the energy related stocks, most companies in the Starvine strategy continue to grow their earnings on a per share basis.

Sincerely,

Steven Ko
Portfolio Manager

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Attached is a discussion of the changes in holdings during Q4 2015 for existing investors.