Overview

- Outlook: Neutral; Wary of Yield
- Grade Four Math Applied: A Few Case Studies

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Dear Starvine Capital Corporation Client:

In Q4 2016, accounts open and fully invested since the beginning of the quarter increased 5.32% to 5.39%. During the quarter, the S&P TSX Total Return Index increased 4.54%, while the S&P 500 Total Return Index increased 6.37% in Canadian dollars (3.82% in USD). Similar to last quarter, the Starvine strategy benefited from continued strengthening of the US dollar versus the Canadian dollar. Also, a largely unexpected Trump victory in the presidential election spurred a market rally, especially in U.S. small- and mid-cap companies. However, with the exception of one holding, the "Trump bump" has not clearly benefitted the Starvine strategy as far as price appreciation goes. For the year, the Starvine strategy did end up in positive territory, though it trailed the benchmark indexes. On an absolute basis, I expect 2017 to be a better year for the portfolio given the undervaluation of most of the holdings; average price-to-cash-flow was 10.4x cash flow (based on my estimates) at quarter end. Leaning towards contrarian situations in high quality companies, which comprise much of the portfolio, requires the willingness to wait a few years with no expectation of catalysts. Although underperforming benchmarks is never a great feeling, I remain steadfast that thinking in relative terms (i.e. aiming to beat the market in every year) is not conducive to helping people compound capital over the long term.

Despite the late year pull-back, commodities-related companies generally had a fantastic run in 2016 after a slump that lasted almost five years. Mining is capital intensive and highly cyclical, a combination that is conducive to requiring financing – and therefore equity dilution – when times are tough. I have a clear conscience staying out of that sector.

Outlook

The Starvine strategy is trading at 10.4x cash flow (or at a 9.6% free cash flow yield); valuation stayed level versus the most recent quarter, despite the overall increase in market values, due to rebalancing actions in the portfolio. The majority of the portfolio names remain undervalued as they are out of synch 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.

As I have previously discussed, we are in for a long, gradual rise in interest rates, which should serve as a headwind for stock valuations. But as long as great capital allocators run companies, or oversold sectors can be identified, there can always be big winners in any market. To generalize, I just think a large portion of the market has become desensitized to abnormally low interest rates, thereby creating a new normal of what is considered a good dividend yield. I am especially wary of Canadian companies that are viewed as reliable yield vehicles, thus driving up valuations faster than earnings. The rise in rates of relatively risk-free alternatives will redefine this new normal; the uncertainty remains in how long it will take. On the flipside, the aging demographic in North America will undoubtedly serve as a tailwind for the thirst for yield. Cutting through this noise requires a focus on (and not overpaying for) free cash flow from good businesses.

Grade Four Math

Using a blunt axe is better than taking a tree down with bare hands. Likewise, investors are better off using some quantitative tools, even if oversimplified, to make decisions. Buyers of rental properties typically seem to be conscious of how price compares to cash flow and levers that stand to grow cash flow, yet these considerations often are non-existent in the layman's stock portfolio.

Two factors are responsible for the outcome of most long term stock investments: earnings growth and multiple expansion (e.g. increase in price-earnings ratio). Without gaining an understanding of how these factors can play out in each situation, investors cannot articulate where they expect returns to come from. Excellent management, economic moats, and durable business models are vital buzzwords that enable earnings growth, but in isolation do not articulate why an investment is compelling.

As Charlie Munger has stated, "To the man with a hammer, everything looks like a nail." Applying the same tool to every situation is suboptimal. Price-earnings ratios can be dangerous if misapplied, and the metric cannot explain some of the best investment opportunities in existence. However, there are frameworks that do apply to the vast majority of investment situations, and it would be unwise not to keep in mind laws that are incontestable most of the time.

As noted above, returns over time can be attributed to two key factors:

- The growth in a company's earnings power on a per-share basis
- Multiple expansion

This simple analysis will shed no light on identifying companies with promising earnings growth potential, yet investors may take away key questions to ask themselves out of defensiveness before pulling the trigger on each investment.

Jarden: Set-up from Heaven

Jarden Corporation's price increased fifty-fold between the time Martin Franklin took over as CEO in 2001 and the eventual sale of the company to Newell Rubbermaid in 2015. It is a perfect example of what can happen when earnings growth and the trading multiple both grow over a longer period. Let's see roughly where the returns came from:

		2001	2015	Fold Increase
(a)	Cash Earnings Per Share	$0.34	$2.86	8.4
(b)	Price / Cash Earnings (x)	3.5x	21.0x	6.0
(c) = (a) x (b)	Price	$1.20	$60.00	50.4 *(8.4 x 6.9)*

We can put forward that investors made this massive gain because earnings grew more than eight-fold while its price-earnings ratio grew six-fold. (8.4 x 6 = 50.4). Had the return depended solely on earnings growth, investors would have made 8.4 times their money – still excellent by any standard – instead of 50x. The difference can be explained by the huge change in valuation multiple given by the market over the 14 year span. Franklin and Ashken joined the company in a time of uncertainty, and as their playbook of acquisition and organic growth worked out, the multiple which investors were willing to pay for Jarden's earnings swung from one extreme (3.5x) to a much higher level (21x). That same range implies being offered an initial cash earnings yield of 28.5% (1 ÷ 3.5) and then later selling to an investor willing to accept an earnings yield slightly under 5% (1 ÷ 21).

To be clear, I believe that shrewd decisions were responsible for most of Jarden's returns. Franklin and Ashken were skilled at acquiring durable brands and then making them more valuable. But this example shows the impact when both the trading multiple and earnings growth can compound in one's favor. There is a one-time nature when

profiting from multiple expansion. Once you benefit from riding it from a low to high number, gravity takes hold because the market's perception typically has already gone from pessimism to optimism in such situations. Hence investors should be cognizant after a big run on a stock's price-earnings multiple that the go-forward potential for profit may be limited to the rate of earnings growth. Moreover, excessive multiple expansion can be a source of risk as the next example illustrates.

Coca-Cola: Indiscriminate Buying of Quality = Long-Term Suffering

		1998	2015	Fold Increase
(a)	Cash Earnings Per Share	$0.52	$1.67	3.2
(b)	Price / Cash Earnings (x)	64.3x	23.3x	0.4
(c) = (a) x (b)	Price	$33.50	$42.96	1.2 (3.2 x 0.4)

Coca-Cola serves as a classic example of how buying in at a lofty initial price-earnings ratio can become an acute source of regret. At 64x, the price-earnings multiple was so high in 1998 that underperformance of expectations in earnings growth was bound to crater the stock price over a lengthy period. At the end of the seventh year, an investor would have been sitting on losses of 32%, only to break even sometime in the eleventh year (including the reinvestment of dividends).

Earnings per share more than tripled (7% annualized) over 17 years, yet the share price increased only 20% over the entire period (1% annualized). Total returns would have been closer to 3.5% annualized if accounting for reinvestment of dividends – clearly less than what any investor who bought at the end of 1998 expected. That would have been the result over the better part of two decades.

Such a high multiple is indicative of optimism of the company's growth prospects at the time. To put it in perspective, paying 64x cash earnings is akin to accepting a 1.6% yield (1 ÷ 64). There are times when paying what appears to be a high valuation can make sense, but generally, price is a high jump bar over which actual results must deliver; failure to do so results in sorrow.

The example of Coke highlights the fallacy of believing that valuation doesn't matter when buying high quality assets. Valuation always matters. High quality should translate into consciously assigning a higher multiple versus a lower quality counterpart. However, paying 64x annual earnings in 1998 effectively meant that earnings had to grow at a very high rate, and for a prolonged period, to justify the steep price.

Rules of thumb were not proffered here, and that's because the point is for people get a sense of extremes and ask questions. But know that all else being equal, the lower the bar one sets in the price arena, the less vulnerable one is to earnings results not meeting expectations. Put another way, if a tightrope walker is only one foot above the ground, how much can the fall hurt?

The next time a hot stock tip is proposed at a cocktail party, it is acceptable to ask elementary questions. Aside from questions relating to the quality of the business, how much of the stock's past gain came from multiple expansion versus earnings growth? What is a reasonable outcome for those two factors over the next five to ten years? No idea? If it's just an insignificant sum being speculated on, consider using the funds to take a small vacation instead - the risk-reward payoff is bound to be more favorable than in pure speculation.

Sector Breakdown

Significant rebalancing occurred during the quarter, resulting in a more even distribution across sectors. 'Business services' was also added as a new category; this reflects the holding of one company that was re-categorized from the Industrials category.

Sector	Weight
Healthcare	14.3%
Specialty chemicals	13.4%
Energy	11.6%
Industrials	10.6%
U.S. real estate	10.4%
Media/broadband	10.4%
Food	10.3%
Technology	10.2%
Business services	7.5%
Cash	1.3%

In Closing

I continue to see better risk-return opportunities in the U.S. versus Canada. Perhaps this is due to a bias formed over the years, but the U.S. is a much deeper market that is not nearly as dependent on commodities. And so it is only natural that the odds are higher of unique, non-cyclical situations surfacing. Offsetting this advantage is currency volatility; all funds managed are of Canadian origin, thus guaranteeing that a significant portion of the strategy (currently ~35%) is invested in Canadian companies. In the long term, I believe the better opportunities in the U.S. warrant exposure to currency fluctuations. However, if the USD appreciated significantly from this point, I would shift funds to the Canadian side of the strategy to limit currency exposure.

Sincerely,

Steven Ko
Portfolio Manager

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