



Overview

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January 23, 2020

Dear Starvine Capital Client:

One year ago, the markets were on a rebound after being stunned by a harsh ending to 2018. Since then, equities have continued to rally, though tech companies have benefited in a disproportionate manner. For the 2019 calendar year, fully-invested accounts in the Starvine Flagship Strategy increased 19.7% to 20.0%, while Mid-Large Cap increased 21.2% to 21.3%, net of fees and expenses. This compares to an increase in the S&P TSX Total Return Index of 22.8% and an increase in the S&P 500 Total Return Index of 25.1% in Canadian dollars (31.5% in USD). The weakening of the U.S. dollar detracted from performance by an estimated 2.9% and 1.8% for the Flagship and Mid-Large Cap strategies respectively. Adjusting for currency closes the gap between the Starvine strategies and the S&P TSX Total Return Index for the year. Even so, the strategies trailed the S&P 500 Total Return Index.

In the second half of 2019, fully invested accounts in the Starvine Flagship Strategy increased 6.8% to 6.9%, while fully-invested accounts in the Mid-Large Cap Strategy increased 7.5% to 7.6%. During the period, the S&P TSX Total Return Index increased 5.7% and the S&P 500 Total Return Index increased 9.9% in Canadian dollars (10.9% in USD).

The first few weeks 2020 have been favorable for account values. It is always tempting to believe that upward moves are the result of being positioned in undervalued names. However, in the absence of much company-specific news, only earnings results and real catalysts over time will tell whether recent gains are warranted. From the standpoint of trading activity, the year 2019 was marked by low portfolio turnover. One new idea was added to Flagship, the more concentrated of the two strategies, while two new names were added to Mid-Large Cap.

Should We Hope for the Roaring or Boring 20s?

Compounding is not a relative concept - a company either proves to reinvest its free cash flow satisfactorily over a long stretch or fails in this regard. If successful, cash earnings per share demonstrate exponential growth over the long term. And by exponential, I do not mean to imply quick, smooth and uninterrupted progress. For example, if a company's earnings per share quintuples over 20 years, this would translate into 8.4% on a compound annual basis. One can surmise that assuming no change in the multiple at which these earnings are given by the market, the stock price would be up 5x over the two decades. The annualized result (8.4%) in this example is not fantastic, but due to the snowball effect of compounding, wealth is created over the long haul.

Being a bottom-up investor, it is convenient to claim I am fixated on the above. Indeed, I really do not spend much time worrying about the macro and instead tend to focus on valuation and company fundamentals. And yet I do not think it is a waste of time to observe the movement of the tide.

Let us revisit the Shiller PE Ratio, which attempts to remove cyclicity in earnings by taking a trailing 10-year average and adjusting past figures for inflation. After the rally in 2019, we can see that valuations now sit at levels witnessed in only a few instances over the past century.

Shiller PE Ratio

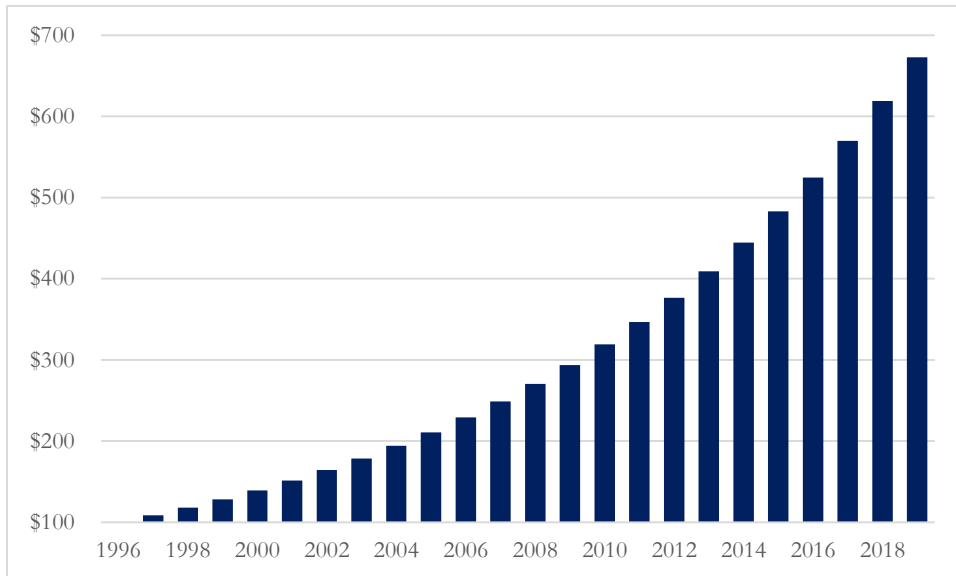


Sources: Robert Shiller

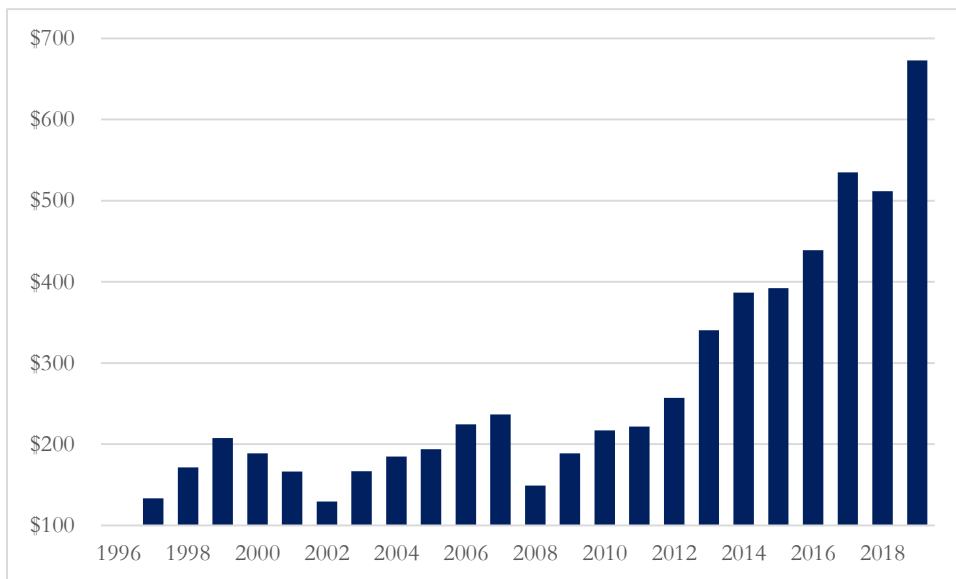
On the surface, it would be difficult to posit that markets are cheap. Only on two prior occasions in modern history were markets more expensive - pre-crash 1929 and the tech bubble in 2000. To the extent that tech companies again are leading the charge, I do not believe a violent crash is imminent. Still, I find it hard to believe the indexes - especially the S&P 500 - are positioned for a great decade ahead. Whatever the actual fluctuations turn out to be in the S&P between now and 2030, let us hope from this perch that a low single digit percentage rate of compounding is achieved for that index. The markets just finished experiencing the Roaring Tens, so I believe a Boring Twenties is more warranted from this point.

Compounding With Equities: A Distorted Staircase

Picture the graph below as a flight of stairs where each step is spaced one year apart. Certainly, it is odd to experience a climb where each step is higher than the last by the same percentage. One would expect to learn about the concept of compounding for the first time with the aid of such a graph; the snowball effect that leads to exponential growth can be seen and easily understood.



Now visualize yourself stumbling through this staircase:



This was the actual compounding path of the S&P 500 since the end of 1996 (base \$100). If a flight of stairs were to be built to scale, it would be a frustrating experience to walk through it. Even though both scenarios above share the identical beginning and end points, the first depicts a predictable path, whereas the second is quite the opposite.

With the second, it would be difficult to have a sense of whether one is headed up or down without the benefit of being able to see a step ahead. Such is investing. Telling an investor who endured a three year slide from 1999 to 2002 that the right thing to do was not just to hold on faithfully - but to plunge in more money when patience was tested for years - would have been a difficult request. Ditto for those who committed in 2007. And yet committing more capital into the vast majority of value strategies in downturns would have been a sound way to beat the underlying strategies themselves. Acting as a contrarian with contrarian investing strategies can pay well over time.

It is easy to understand the concept of compound interest as the math is straightforward. But human nature renders it tough to achieve with stock investing. Alas, no amount of raw intelligence or analytical ability can substitute the need for faith. We need faith in the investment process, and faith that how we look at investing is correct long-term despite receiving no confirmation from short-term results. It almost seems as if markets are designed to reward those with a strong stomach.

Sector Breakdown

| Flagship | | Mid-Large Cap | |
|----------------------|----------------------|-----------------------------|----------------------|
| <u>Sector</u> | <u>Weight</u> | <u>Sector</u> | <u>Weight</u> |
| Healthcare | 27.5% | Healthcare | 26.5% |
| Financials | 14.8% | Financials/Asset Management | 15.1% |
| Private Equity | 10.2% | Real Estate | 13.5% |
| Technology | 10.2% | E-commerce | 6.7% |
| E-commerce | 7.7% | Private Equity | 6.7% |
| Specialty Chemicals | 7.3% | Infrastructure | 6.4% |
| U.S. Real Estate | 6.8% | Technology | 6.4% |
| Media/Broadband | 6.2% | Packaged Food | 5.9% |
| Packaged Food | 6.2% | Specialty Chemicals | 4.5% |
| Energy | 2.1% | Media/Broadband | 4.4% |
| Cash | 1.1% | Energy | 1.8% |
| | | Consumer Diversified | 1.2% |
| | | Cash | 1.0% |

Is it a sound decision to sell a significant portion of one's account now into cash in preparation for a downturn? Regardless of valuation? That is a difficult question, to which I offer two thoughts.

First, think of a portfolio as a structure built of 15-20 scarce bricks - scarce because you are disciplined about how much to pay for each brick, and also because you have specifications as to the dimensions and materials required of each brick. Should someone offer a price far more than the brick is reasonably worth, it makes perfect sense to take the cash. Alternatively, an offer may be received that is around fair value, but you see an offer for a similar brick at a much lower price. In that case, a kind of arbitrage can be achieved via selling the brick, replacing it with the cheaper one (that is of similar quality), and pocketing the cash. Further, an offer may come through for one-third to one-half of all the bricks at prices above any rational scenario, in which case it makes sense to sell a big portion of your holdings and sit on cash. The point is that the investor is basing decisions on a brick-by-brick framework, not solely the worry of looking at how expensive the market is as a whole.

Second, let's go back to the basic meaning of owning shares in a public company: anyone can own a fraction of a listed company at the press of a button. Your ownership and influence in the company may be miniscule, though all the same you are entitled to the long-term increase (or decrease) of the company's value on a per-

share basis. Still, the quoted value of any given stock may fluctuate wildly and independently of the company's growing earnings power. In fact that is a guarantee. It may therefore be logical to occasionally take advantage of opportunities presented to us. And yes, in the absence of consistent inflows of capital, a fully-invested account must sell one holding to buy another idea. So the point isn't that we should dogmatically hold everything forever, but for the true long-term 'compounders', switching in and out of great companies that were bought at good prices is unlikely to prove to be very productive in hindsight.

Sincerely,

Steven Ko
Portfolio Manager

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