Overview

- ❖ The Bottom-Up View in a Bear Market
- ❖ Small-Caps and Mid-Caps Reach 2008-9 Valuations
- ❖ Markets Think Forward

July 27, 2022

Dear Fellow Investor:

For the half year ended June 30, fully invested accounts in the Starvine Flagship Strategy decreased 26.5% to 27.4%, while fully invested accounts in the Mid-Large Cap Strategy decreased 25.1%% to 25.6%. During the six-month period, the S&P 500 Total Return Index decreased 18.6% in Canadian dollars (-20% in USD)[1] and the S&P TSX Total Return Index decreased 9.9%. The U.S. dollar strengthened by 1.3% relative to the Canadian dollar over the first half, providing a benefit given the significant presence of U.S. listed equities in each strategy.

Annualized results to June 30, 2022	Flagship	Mid-Large Cap
Inception date	*Feb. 10, 2015*	*Mar. 16, 2017*
Trailing:		
One year	-20.2%	-17.4%
Two Years	15.0%	15.4%
Three Years	7.0%	7.5%
Four Years	3.8%	5.1%
Five Years	5.6%	5.8%
Six Years	8.8%	*n/a*
Since Inception	4.7%	6.0%

Calendar year results:	Flagship	Mid-Large Cap
Inception date	*Feb. 10, 2015*	*Mar. 16, 2017*
2022 - year-to-date	-26.8%	-25.2%
2021	49.0%	45.3%
2020	5.1%	6.2%
2019	19.9%	21.4%
2018	-6.7%	-6.6%
2017	14.5%	3.9%
2016	4.2%	*n/a*
2015	-8.4%	*n/a*

[1] The benchmarks cited by Starvine are standards against which the performance of the strategies can be measured. However, the Starvine strategies approach portfolio construction with a bottom-up approach and thus do not refer to the composition of any index as a reference from which to select securities. Performance of the strategies may differ significantly relative to benchmarks in any time period.

The composite figures above are unaudited and include discretionary fee-paying accounts within each respective mandate. Composite results are presented as time weighted rates of return, net of management fees and other expenses. Results will vary with subscription date, most notably for recently formed accounts whose position weightings and cash levels tend to differ initially from the investment strategies. Clients will therefore each have their own net-of-all fees performance results from investing in Starvine. References made to indices may provide clients with a benchmark to compare results. However, the Starvine strategies are operated with a bottom-up selection framework and thus no effort is committed to tracking any index. Lastly, the composite results displayed above should not be interpreted as a reference for future returns.

H1 2022 went on record as the weakest first-half start to a year for the U.S. markets since 1970, or 52 years ago. The market turbulence was sparked by a combination of macro and geopolitical events, but most notably by the Fed's catch-up decisions to hike interest rates after backtracking on its previous belief that observed inflation in the economy was transitory. The Flagship and Mid-Large Cap strategies have thus far, in 2022, fallen behind the key indexes - trading more in line with the NASDAQ despite the absence of direct exposure to the technology sector. Besides the difficult market environment, additional factors have acted as headwinds: (1) exposure to sectors that fell out-of-favor, including non-bank financial companies, retail, and media, and (2) exposure to small- and mid-cap stocks, whose share prices have experienced heightened volatility in recent months.

Data from the Federal Reserve Bank of St. Louis illustrates that market participants expect inflation to be less than 2.4% on average over the next ten years. Historically, there has been a strong correlation between the growth in money supply (M2) and core inflation 13 months later. As the growth in M2 had collapsed to the pre-pandemic level in May 2022, the continued relationship with inflation would translate to 2.3% core inflation in June 2023.

Except for one new healthcare-related holding, recent trades in the strategies have been of an incremental nature, mostly driven by decisions to lean more into those names that I assessed to have been unfairly sold off due to near-term macro worries. The timing of these buys however was not the best, as most of the cash in the strategies was deployed before the market plunge in June.

More than two-thirds of the market value of each strategy is represented by companies whose revenues are of a business-to-business nature. These companies have identifiable moats, pricing power, and in select cases, business models that either directly pass-through costs or have inflation escalators. As for the consumer discretionary names, the share prices of those have been slashed such that the value is extremely compelling on an absolute basis. I do expect a strong snap-back in the strategies at some point in the future, provided the portfolio companies display a threshold of resilience and continued growth in the coming quarters.

A bear market is defined as a 20%+ drop within at least a two-month period. Below is a list of the bear markets recorded over the past 65 years, before the one we recently entered in June:

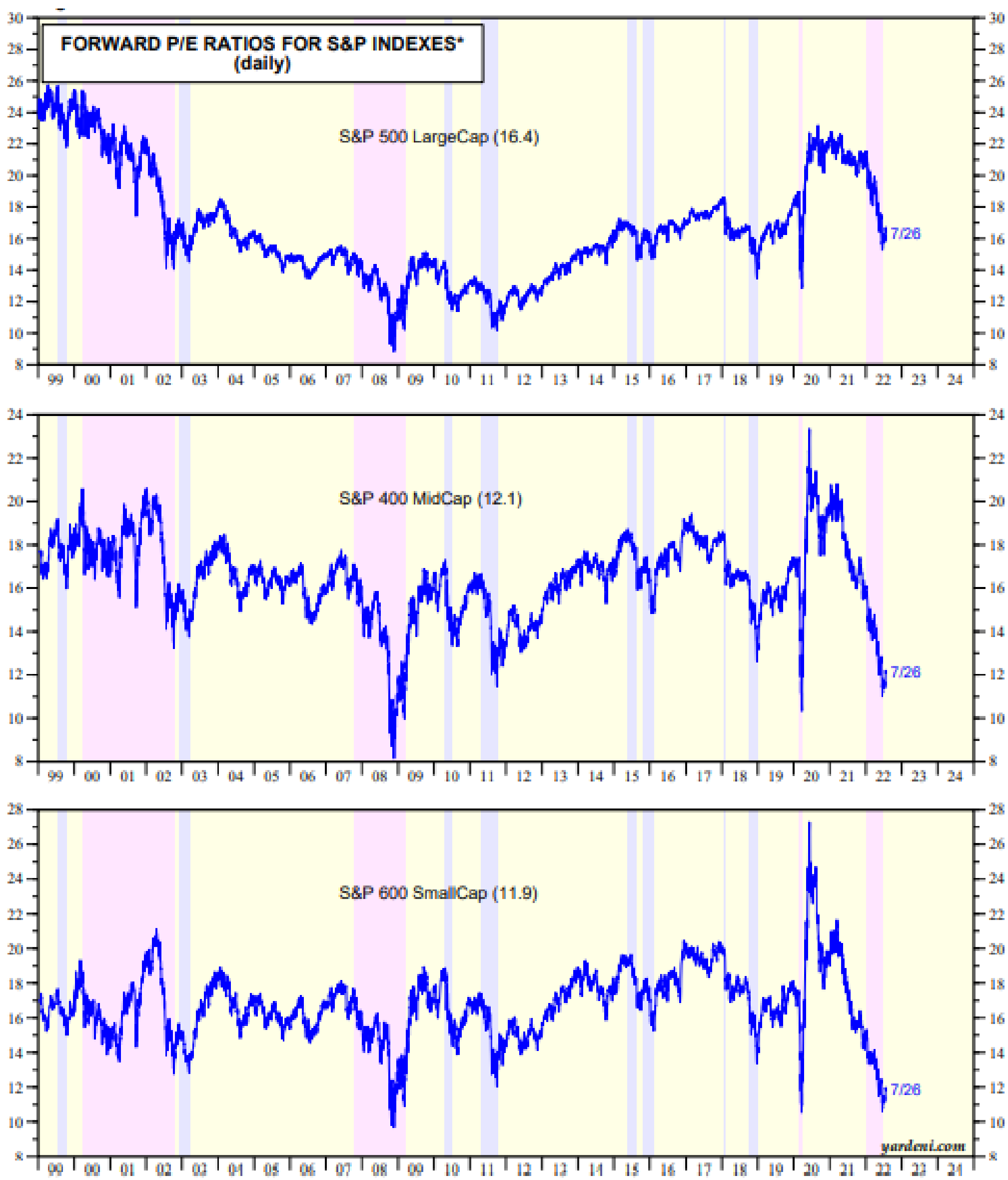
Entered bear market	One year later
Oct. 21, 1957	31.0%
May 28, 1962	26.1%
Aug. 29, 1966	24.6%
Jan. 29, 1970	11.8%
Nov. 27, 1973	-26.9%
Feb. 22, 1982	30.4%
Oct. 19, 1987	23.2%
March 12, 2001	-1.2%
July 10, 2002	7.4%
July 9, 2008	-29.1%
Feb. 23, 2009	47.3%
March 12, 2020	59.0%
Median	23.9%

Source: Dow Jones Market Data

The sample size here is small, but markets have had a decent record of recovering from a 20% drop within one year. I have no predictions on the length or severity the current bear market, or the likelihood of a final capitulation before the bottom is reached. Why try to know the unknowable?

Small Caps and Mid Caps Creamed

Market commentators have written much about the observation that 'stocks still aren't cheap' despite the decline that has ensued since early January. I believe those comments are referring to the S&P 500, which is comprised of large cap stocks. In the graphs below, the recent market pull-back has resulted in a price-to-earnings ratio (based on analyst consensus estimates) for large cap stocks that now falls in a 'normal' range, going back more than two decades.



Source: Yardeni Research

However, the past several months have impacted the small- and mid-cap index valuations much more severely, bringing them back to levels last seen in the 2008-9 recession and the initial covid lockdown in 2020. Had one concentrated into mid-caps and below in past downturns, there would have been an opportunity to gain from multiple expansion in short order. I believe we are seeing another similar opportunity now, but with less macroeconomic uncertainty relative to 2008 and 2020.

Bear markets and recessions cause real pain to most households. On the contrary, such times can turn out to be life-changing events for those with the ability and willingness to take the plunge.

This brings us back to what value investing aims for and why, as a philosophy, it makes a lot of sense at any point in the cycle as a style that actively avoids permanent loss of capital. There are plenty of interpretations of value investing that range from 'bargain only' selection of the Ben Graham model, to more quality-focused approaches that more heavily weigh attributes like a company's moats, growth prospects, and a management's ability to allocate capital. Wherever one may practice on the value spectrum, a few basic fixations should remain in focus. Where does a stock's current price hover relative to the underlying company's earnings power? What scenarios of future earnings growth and trading multiples are imputed in the current price? All else being equal, the lower the price, the larger the buffer for the above assumptions to underwhelm and one can still come out with a profit.

I'd like to close on a final thought before wrapping up: stock prices at any given point in time mostly reflect the market's expectations of the future, plus noise. Prices will rally when companies' results surprise to the upside relative to expectations, or when investors can look beyond a recession. What is less obvious, but more important to keep in mind for the long-term investor, is that tough economic times represent windows of opportunity for companies to go on the offensive and build shareholder value. Those with strong balance sheets will have a palette of options, which include the opportunistic repurchasing their own shares for bargain prices, buying other businesses on favorable terms, and organically building out operations when most competitors clam up. A few examples include Brookfield Asset Management's normal course issuer bid to purchase up to 10% of its public float and Franchise Group's announced program to buy-back up to $500 million (~40% of its market cap). When a company has ample financial capacity and its stock price is down significantly, cannibalizing its own shares can be a great avenue to reinvest profits.

Sincerely,

Steven Ko
Portfolio Manager

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