Overview

- ❖ 2022: Losers Overwhelmed Winners
- ❖ Small Cap Valuation Gap Remains
- ❖ Preparing for Recessions and Shooting Rabbits
- ❖ Immerse Yourself in Results Instead of Stock Price Movements

January 30, 2023

Dear Partner:

For the calendar year ended December 31, 2022, fully-invested accounts in the Starvine Flagship Strategy decreased -18.4% to -20.4%, while fully-invested accounts in the Mid-Large Cap Strategy decreased -20.4% to -21.5%. During the period, the S&P TSX Total Return Index[1] decreased -5.8%% and the S&P 500 Total Return Index decreased -12.2% in Canadian dollars (-18.1% in USD).

Annualized results to December 31, 2022	Flagship	Mid-Large Cap
Inception date	*Feb. 10, 2015*	*Mar. 16, 2017*
Trailing:		
One year	-18.8%	-21.0%
Two Years	10.0%	7.1%
Three Years	8.3%	6.8%
Four Years	11.1%	10.3%
Five Years	7.3%	6.7%
Six Years	8.5%	*n/a*
Seven Years	7.8%	*n/a*
Since Inception	5.7%	6.4%

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

[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.

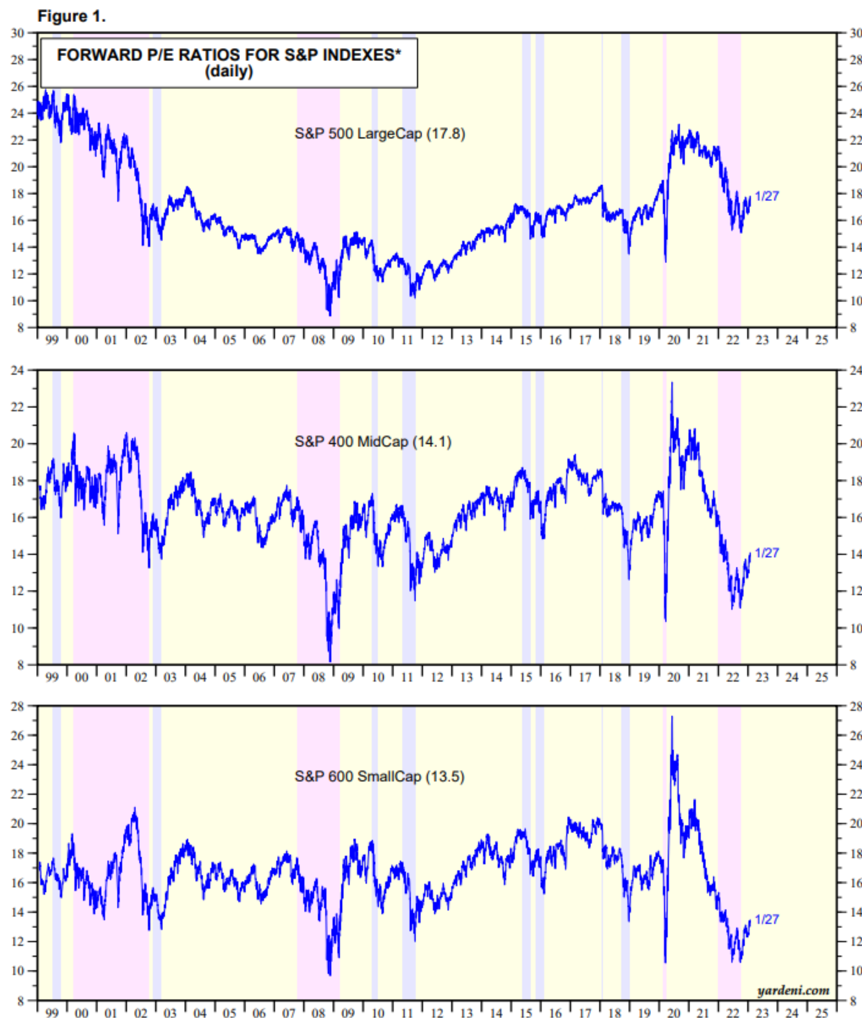
therefore each have their own net-of-all fees performance results from investing in Starvine. References made to indices may provide clients with a benchmark to compare results. However, the Starvine strategies are operated with a bottom-up selection framework and thus no effort is committed to tracking any index. Lastly, the composite results displayed above should not be interpreted as a reference for future returns.

Calendar year results:	Flagship	Mid-Large Cap
Inception date	*Feb. 10, 2015*	*Mar. 16, 2017*
2022	-18.8%	-21.0%
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*

Commentary

The year of 2022 was not a great one for the Flagship and Mid-Large Cap strategies in terms of price movements. Although it was the toughest year for the S&P 500 since 2008 and much of the decline in the Starvine strategies can be attributed to unusual market volatility, a few of the key holdings skewed performance downward with their share prices closing down more than 50% over the 12 month period. I believe the market overreacted in those instances, and moreover those holdings dropped even more at the tail end of the year when tax-loss harvesting and window-dressing by investment funds in all likelihood turbo-charged the selling pressure. It is probable that this is what occurred given the strong rebound in the losers in the first few weeks of the new year. To highlight the impact that those losers had on calendar year performance, consider that if 2022 ended last Friday (January 27) instead of on December 31, the performance relative to the S&P 500 over the near 13 month period would have been positive for the Flagship strategy and almost break even for the Mid-Large Cap strategy. . A comparison with the S&P/TSX Index was more difficult given that index held up among the best in the world in 2022, with its drawdown largely offset by energy stocks - that sector was absent in the Starvine strategies.

The discount of small- and mid-cap stocks relative to large-cap stocks still exists, at least compared to most points since 1999. On an absolute basis, the S&P 500 (i.e., large-caps) do not at present appear undervalued, while small-caps still trading at a clear discount to its own P/E range over the same time span. The argument can be made that large-caps should correct more given the likelihood that higher interest rates may remain for the foreseeable future, just as much as the counterpoint that small-caps should revert back to valuations more comparable to large-caps. Either way, the financial media usually refers only to the S&P 500's trading multiple to form an impression of the market's valuation level, whereas a bottom-up investor's portfolio may bear little resemblance to that index. I can see that the valuations of the small- and mid-cap stocks in the Starvine strategies support the statistics in the updated graphs below, with a few holdings currently trading at far cheaper multiples.



Source: Yardeni Research

Turnover in the strategies was moderate during the year, with two new companies introduced (one via spin-off from an existing holding) and capital shifted between holdings to take advantage of valuation disconnects that surfaced during bouts of market volatility. At the moment, the winners of 2022 are above target weight, and this was accentuated by the losers shrinking in market value. To some extent, the situation may self-correct should the underperformers continue to rebound. Otherwise, rebalancing decisions are ready in the event any given holding breaches the hard limit and hence triggers a partial sale.

Recession, Recession, Recession

It is timely to bring up an oft shared quote of Peter Lynch: "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." Value investors typically like to zig when others zag, and as a result most would likely view current times as conducive to adding to last year's losers. However, over-preparing for corrections is a case of zagging when others zag. Just like a rabbit, the market thinks forward. So if one shoots where the rabbit was, one misses the target. Likewise, repositioning a portfolio to become more defensive after a year of volatility could turn out to be the opposite of what *should* be done given some of the opportunities that are currently available.

I never understood why the media's narrative frames a recession as resembling a binary event, as if a dimmable light switch must sit in either the on or off position. The National Bureau of Economic Research (NBER) may very well declare a recession, but if the past is useful as a precedent, it may do so with a lag exceeding eight months after what it only in hindsight considers the beginning of the recession. It goes without saying that waiting not only for an official declaration of a recession, and further for "things in the economy to get better", is a recipe for shooting where the rabbit used to sit. Markets always think forward.

If an investor has an intended time horizon exceeding even two years, what should instead always remain top of mind is the health of the investee businesses. Are the moats widening or narrowing? How well are the management teams running the businesses? Have earnings been reinvested satisfactorily and does the capital allocation make sound sense? Lastly, how does the valuation square up with all the pros and cons?

Switching back to the short term, the S&P 500 appreciated 23.9% one year out on a median basis (presented in the H1 2002 commentary) from the inception date of the last 12 bear markets dating back to 1957. If the bear market that began on June 13, 2022 follows a comparable course, the S&P 500 will appreciate ~12% over the next 4.5 months. I have no opinion or conviction on the likelihood of that outcome coming to fruition, but nonetheless it will be entertaining to observe.

I am happy with the holdings in the strategies, both from a valuation perspective and the prospect of them reinvesting profits at healthy rates of return. To paraphrase Chris Mayer's advice when he joined me for a recent podcast episode, one should remain focused on a business's underlying progress and not stock price movements. Although 2022 goes on record as the worst year thus far for the Starvine strategies, overall I was impressed by the financial and operating results of the holdings. Certain key holdings took advantage of depressed share prices by repurchasing 14%-15% of outstanding shares during the calendar year. From these lower valuations and ongoing growth in the companies, the value proposition embedded in the strategies is more compelling versus one year ago. I look forward to reporting again in six months.

Sincerely,

Steven Ko
Portfolio Manager

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